

The Great Succession Challenge of Asian Business

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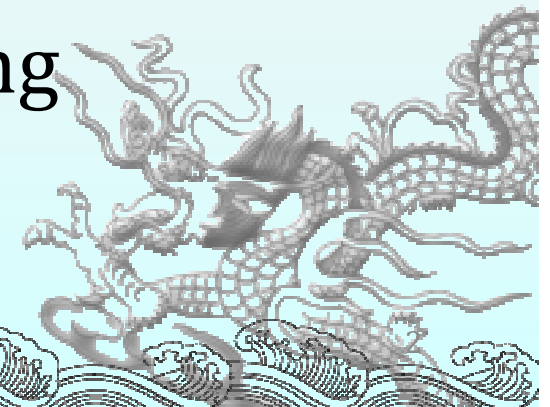
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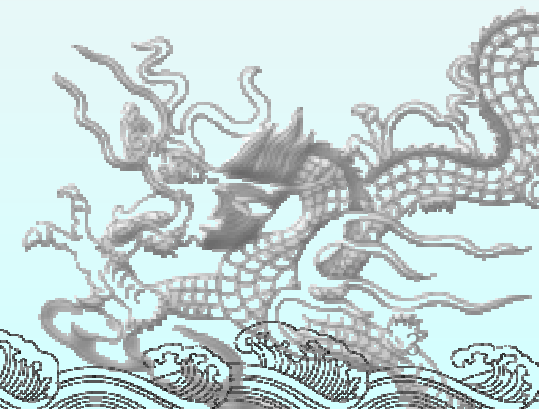
Outline

- ◆ Leadership succession as an urgent and challenging task
- ◆ Difficulties in passing along intangibles
- ◆ Roadblocks
- ◆ Family and corporate governance for sustainability
- ◆ Institutional reforms for removing sustainability roadblocks



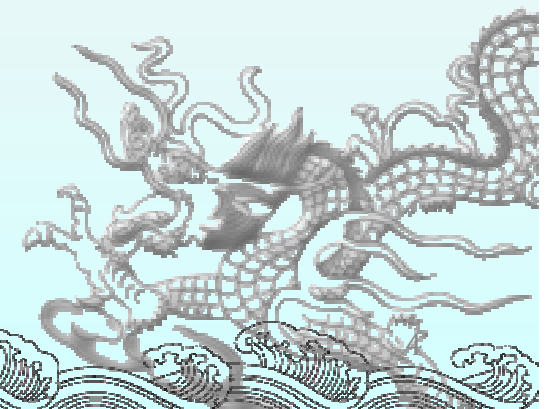
Leadership Succession in Asian Business Is Urgent and Challenging

- ◆ Most Asian businesses were started up after WWII.
- ◆ Mostly family owned and managed
- ◆ Most have experienced leadership succession or will soon face succession



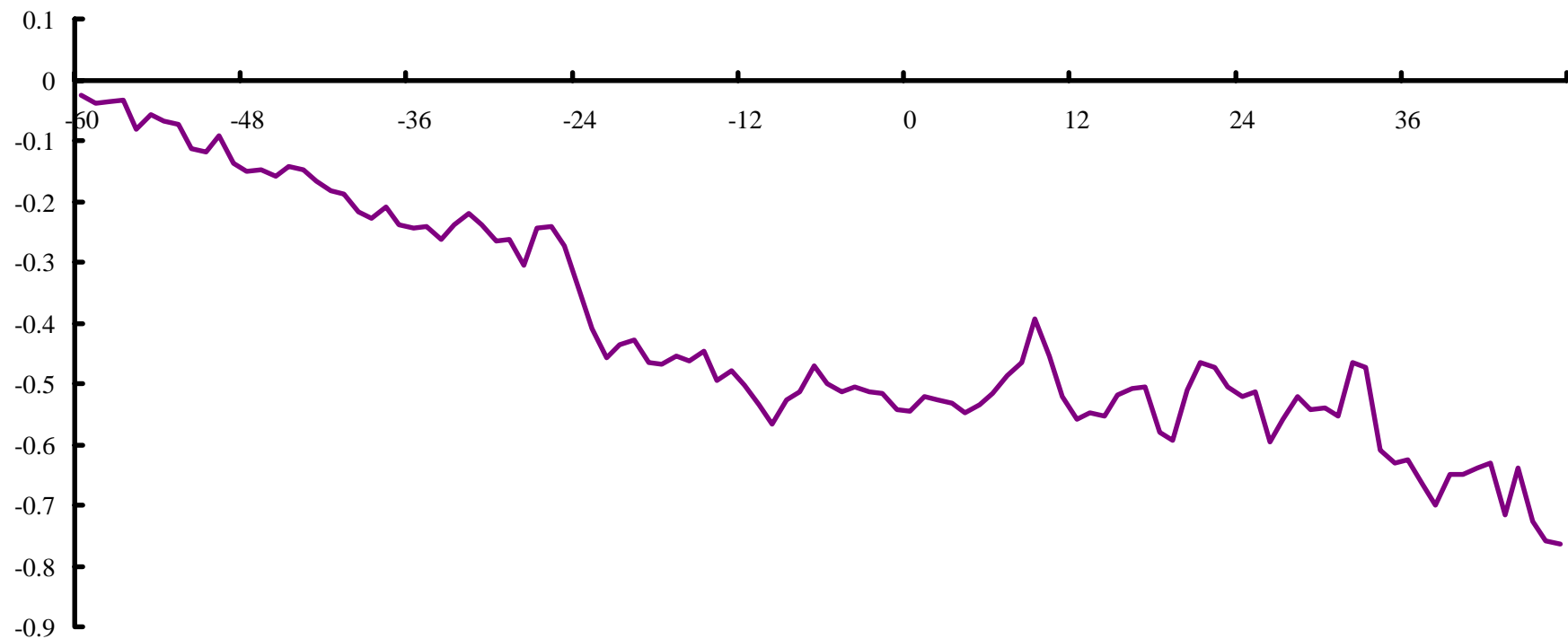
Succession is great challenge

- ◆ Our research on 250 family firms in Hong Kong, Taiwan and Singapore shows,
- ◆ Family firms has great wealth loss in succession process, - **60%** accumulated stock return from five years before succession to three years after succession.
- ◆ That is, owners of 100 dollars stock only have 40 dollars left after succession.
- ◆ Compared with Taiwan and Singapore, 80 family firms in Hong Kong have **-120%** loss.



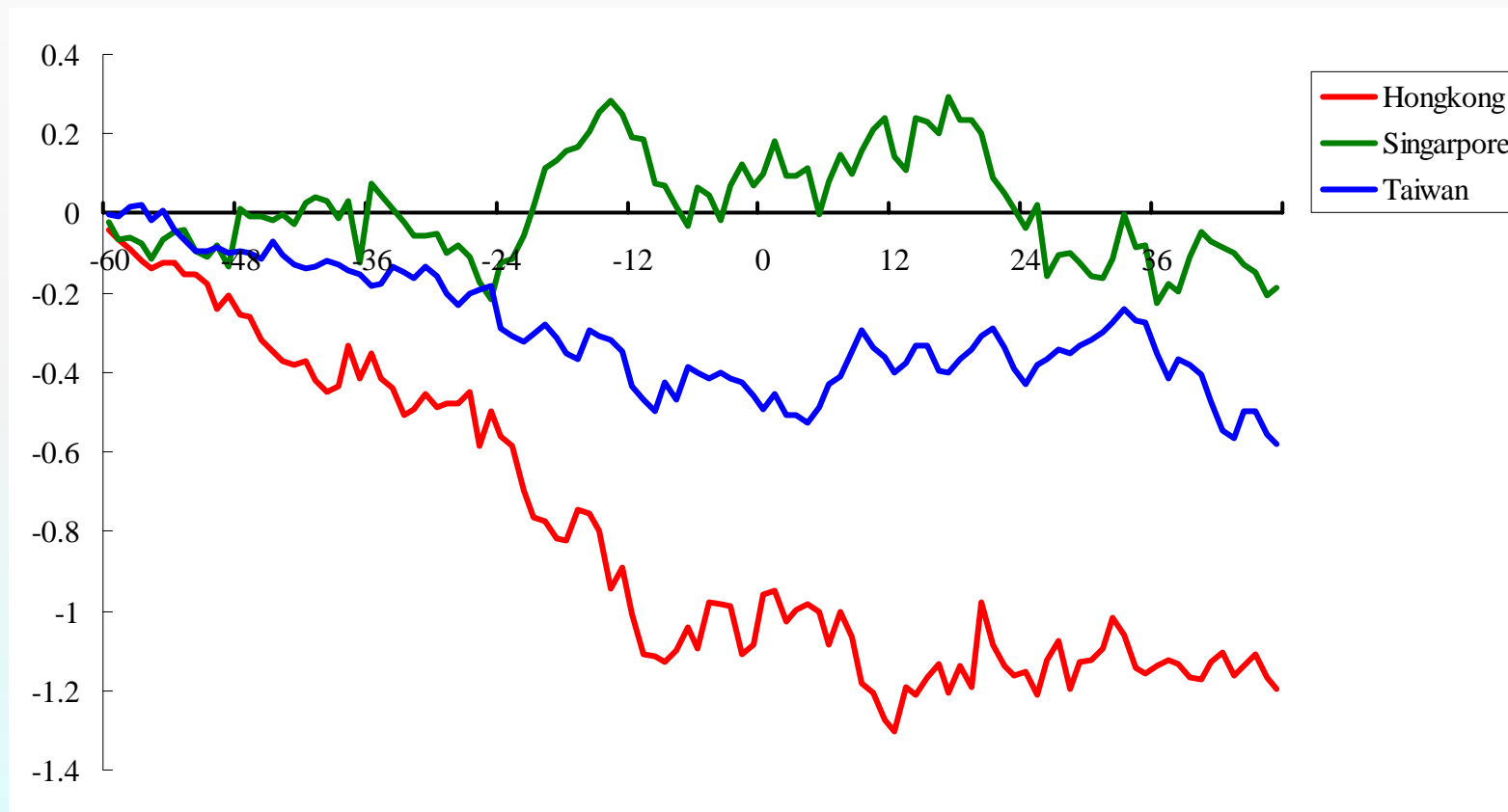
Wealth loss of family firms in succession

(monthly accumulated stock return, 217 firms in HK, Taiwan, Singapore 1980s – 2000s)



Wealth loss of family firms in succession

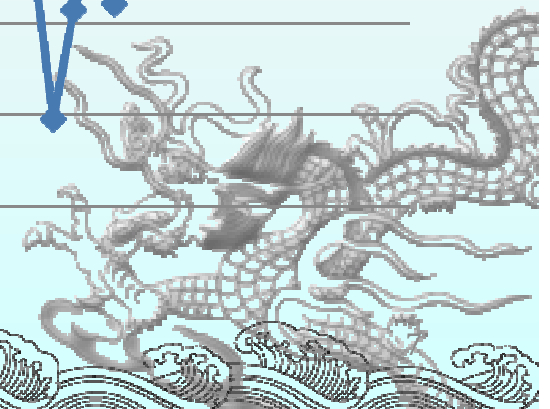
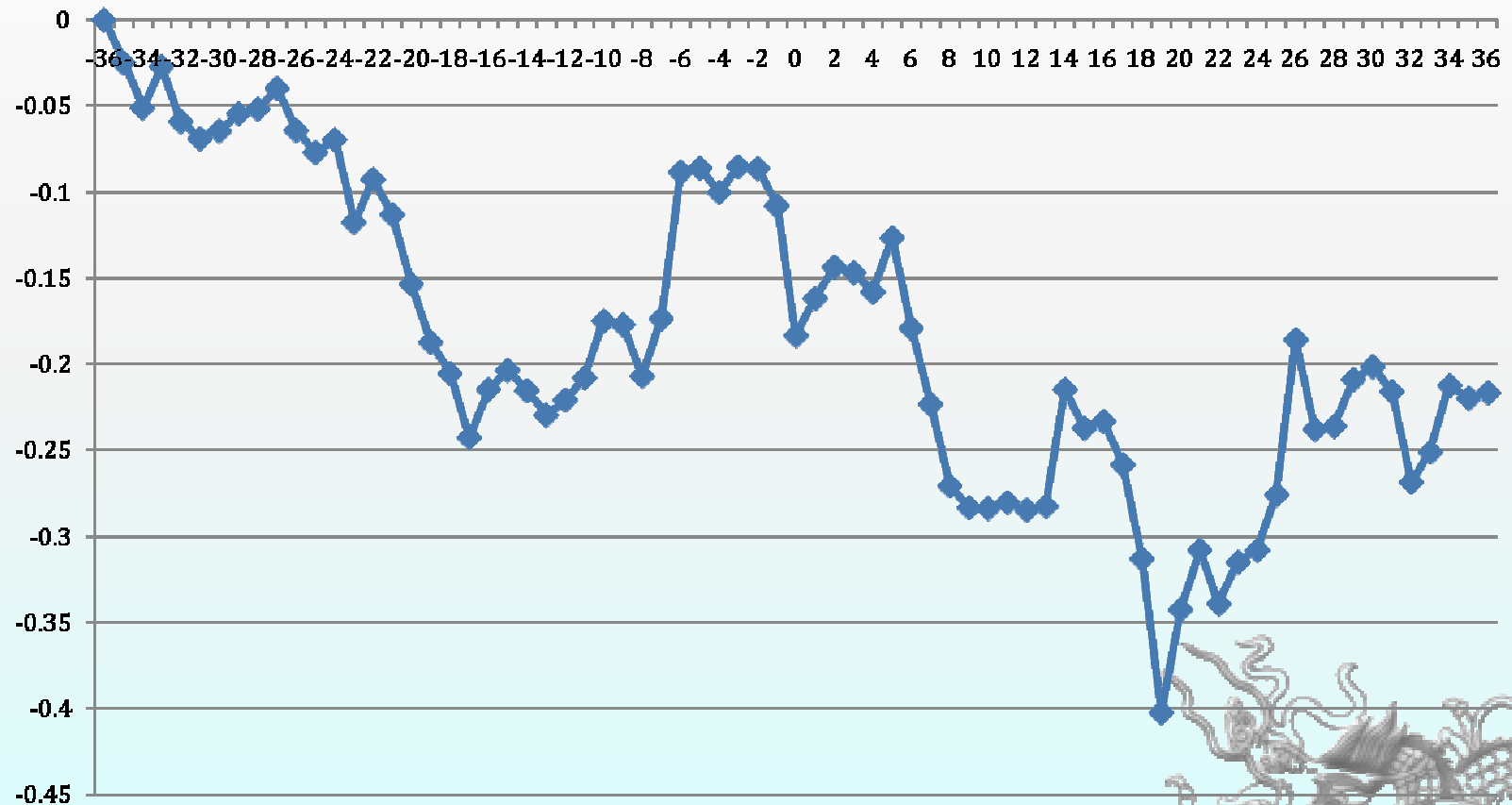
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Wealth loss of family firms in succession

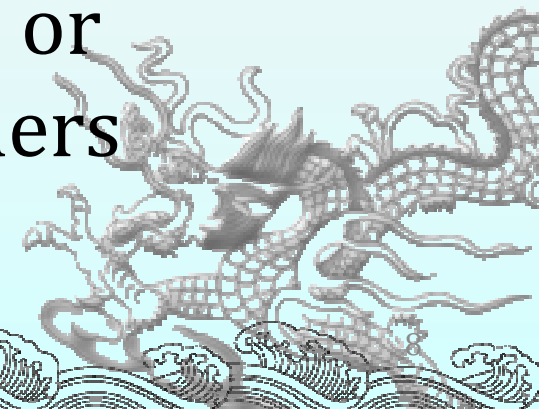
(monthly accumulated stock return, 12 firms in China, 2000-2008)

Average



Ownership and Control Transition

- ◆ Not an ordinary CEO turnover
- ◆ Business ownership in emerging markets is typically concentrated in a family
- ◆ Business succession in emerging markets typically involve turnovers of both ownership and control to different groups (generations) of family members or occasionally to non-family outsiders



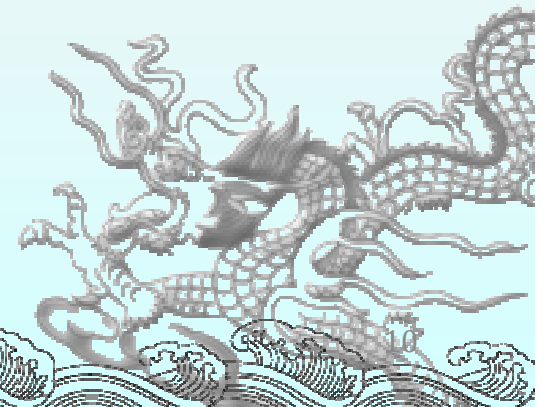
Most Asian Firms Choose Family Succession

Successor Choice of 217 Publicly Traded Family Firms in Asia (Fan, Jian, Yeh, 2009)

	Hong Kong		Singapore		Taiwan		Total	
Family member	43	69%	17	36%	80	74%	140	65%
Heir	18	29%	4	9%	57	53%	79	36%
Relative	25	40%	13	28%	23	21%	61	28%
Outsiders	6	10%	17	36%	24	22%	47	22%
Sold-out	13	21%	8	17%	4	4%	25	12%
Unknown	0	0%	5	11%	0	0%	5	2%
Total	62	100%	47	100%	108	100%	217	100%

Why are successions so challenging?

- ◆ Difficult to pass over critical specialized assets
- ◆ Stumbled by roadblocks



SPECIALIZED (FAMILY) ASSETS

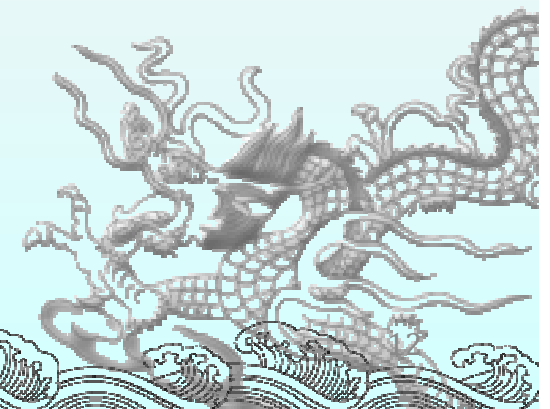
- ◆ Value Based Leadership
- ◆ Relationship, network
- ◆ Culture, common practice, implicit rules
- ◆ Human capital (skills, techniques, creativity)
- ◆ Common properties
- ◆ History, Longevity

- ◆ These assets, often intangible, can critically contribute to the success of a family business, but they are specialized to the entrepreneur and his/her family, cannot be quickly learned or easily bought and sold in marketplace

Value-based Leadership in Wahaha (China)



- ◆ Wahaha is literally a laughing sound in Chinese opera
- ◆ But it is also the name of the largest bottled water and soft drink producer in China
- ◆ Founder, chairman and CEO: Zong Qinghou, currently the richest person in China
- ◆ Role model: Chairman Mao, an “open minded dictator”
- ◆ Zong does not use computer. Making order by phone calls and approve/disapprove subordinates’ requests by traditional brush pen with red ink



The Ideology campaign of Wahaha against Danone

- ◆ Danone: a French based global dairy products, bottle water producer
- ◆ 50-50 joint venture
 - ◆ Danone provided financing in return for the right of Wahaha brand; Wahaha provided management and production
- ◆ The dispute
 - ◆ Danone accused Zong set up factories outside the JV to produce and sell products that were supposed to be produced and sold under the JV.
- ◆ The defense by Zong
 - ◆ The Wahaha brand was never approved by the Chinese government. Therefore Danone did not have the right for the brand
 - ◆ National media campaign portraying Danone as a vicious intruder trying to take over Chinese businesses, just like its French ancestor
- ◆ The outcome
 - ◆ Danone lost the legal case, sold its JV back to Wahaha, and exit the China market in 2009

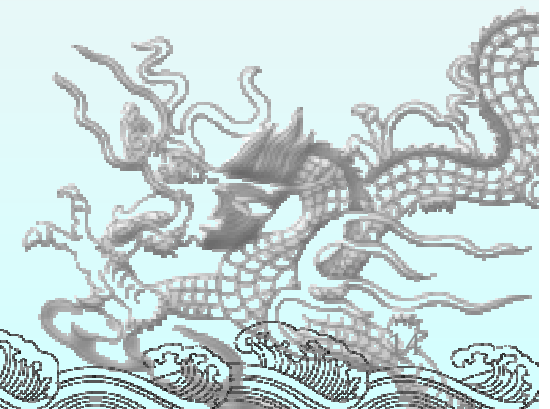


Succession Challenge

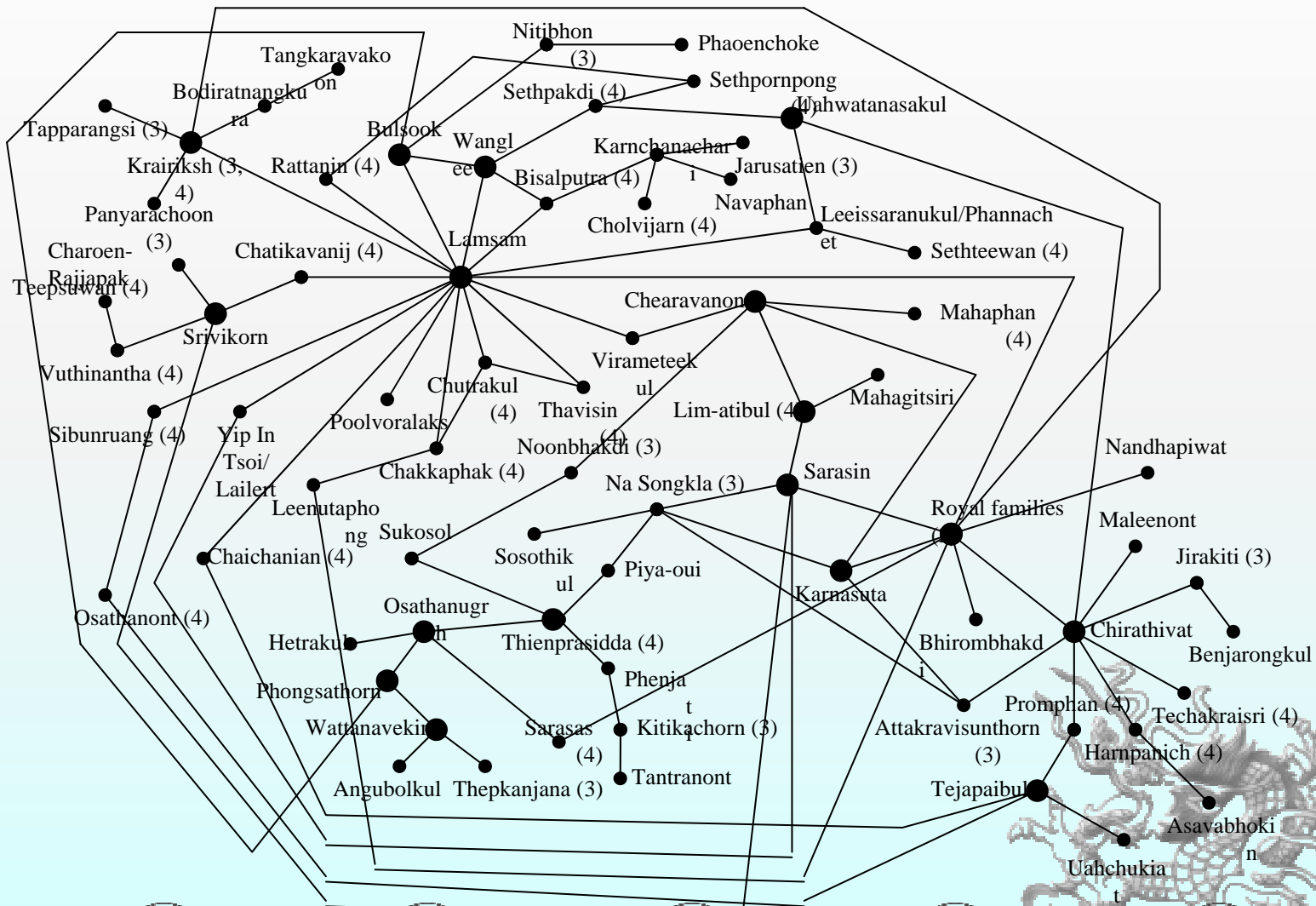


Difficulty in transferring personal value

- ◆ In emerging markets in particular China, leaders' personal values heavily influences business decisions and outcomes
- ◆ But there can be only one Zong Qinghou, just like there can be only one Warrant Buffet and Steve Job



Network created by marriages (Thailand)



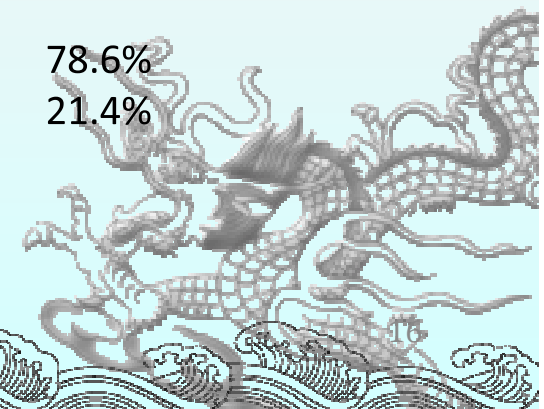
The partner's family background

(Bunkanwanicha, Fan, Wiwattanakantang, 2010)

The partner's family background

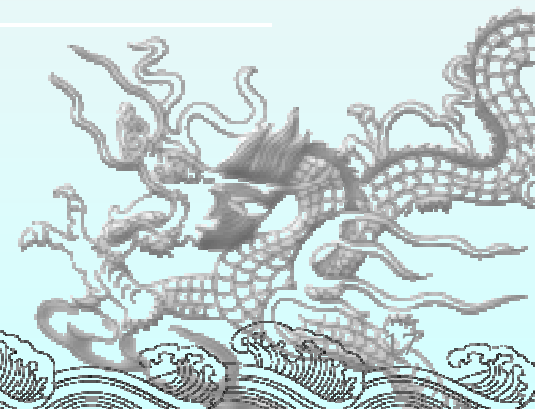
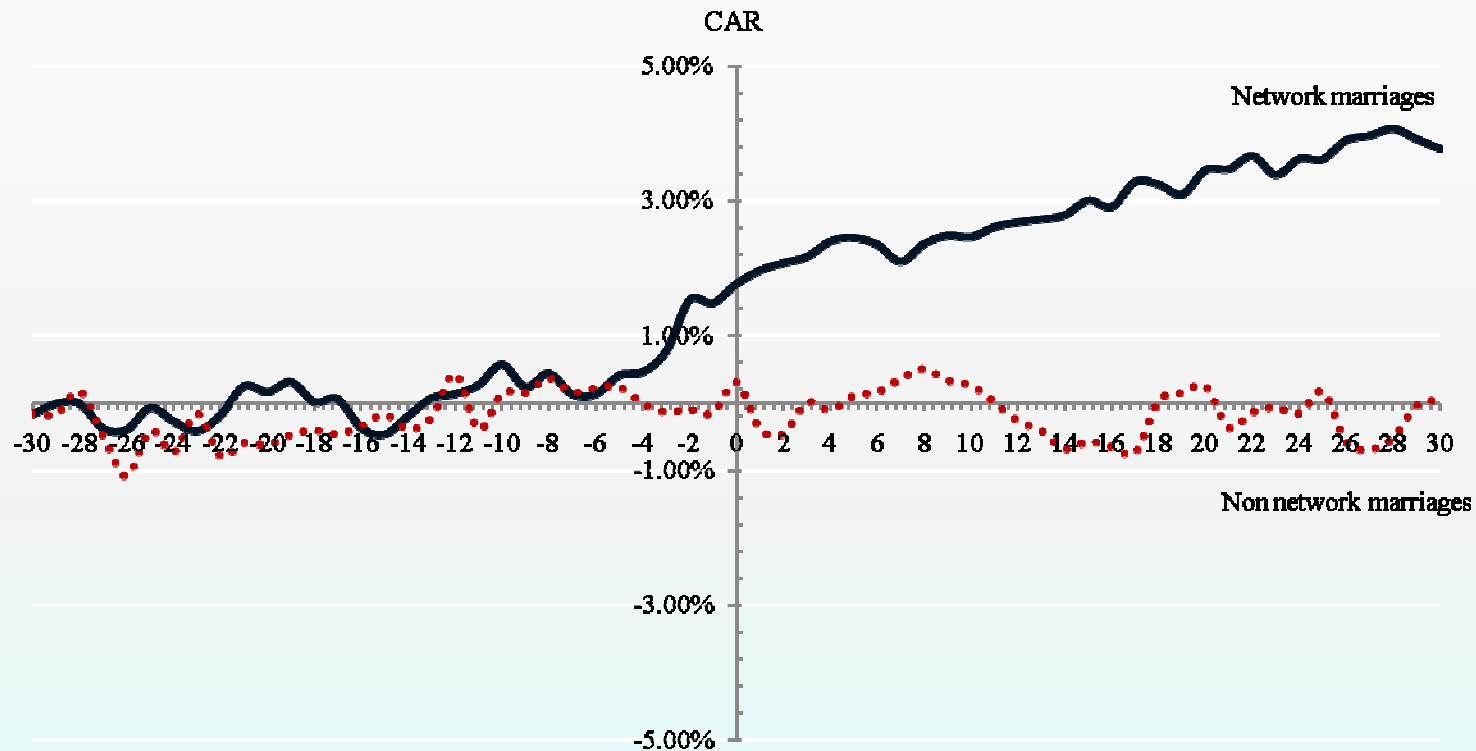
	Number	Percentage
A. Family background		
Royal, noble [1]	9	6.4%
Politician, military, civil servants [2]	35	25.0%
Big business [3]	18*	12.9%
Business [4]	48	34.3%
Foreigner [5]	9	6.4%
Others [6]	21	15.0%
B. Type of networks		
Political network [1]+[2]	44	31.4%
Business network [3]+[4]	66	47.1%
Non network [5]+[6]	30	21.4%
C. Network marriage?		
Network	110	78.6%
Non network	30	21.4%

* Each side of the couple is analyzed separately



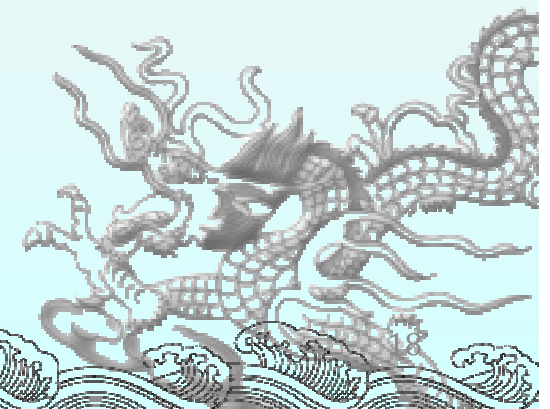
The stock market reaction to marital news

(Bunkanwanicha, Fan, Wiwattanakantang, 2010)



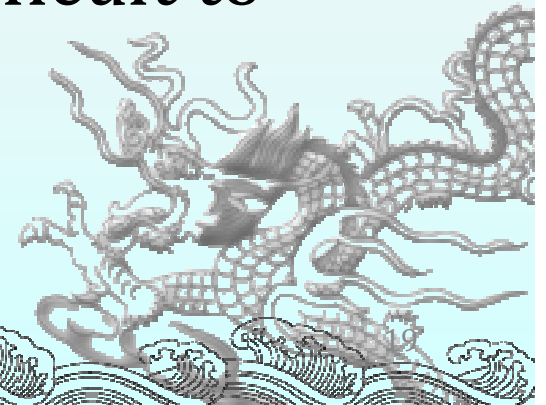
Difficulty in transferring relationships

- ◆ Almost all businesses are interconnected in emerging markets, even if they are legally independent
- ◆ These network organizations (Williamson, 1985) are one-of-a-kind, difficult to transfer across generations

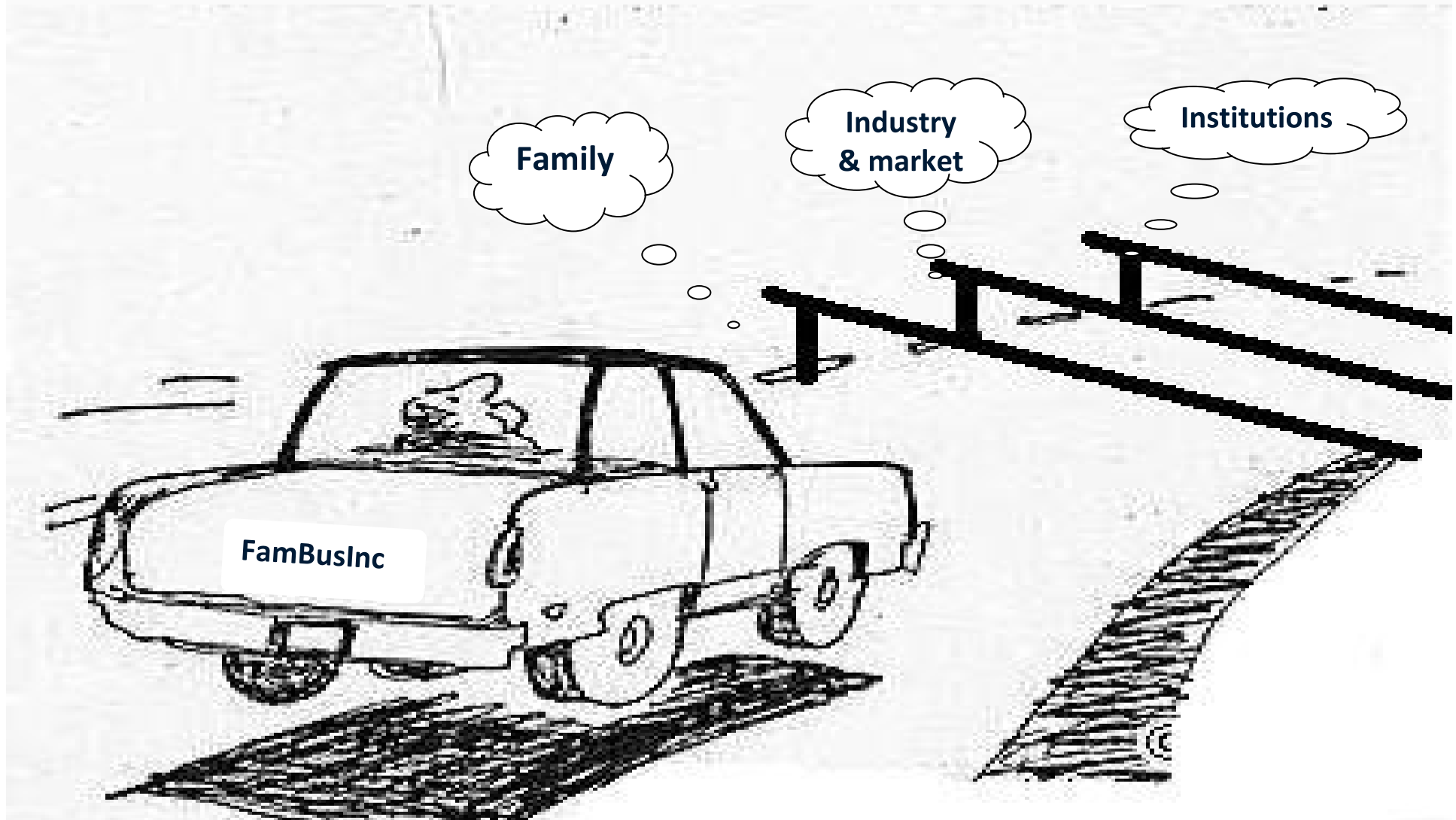


Family versus Corporate Governance

- ◆ Because corporations are owned and managed by families, family governance is critically important to corporate performance
- ◆ Family relationships are governed by traditional value system (custom, social norm, religion), not formal laws or regulations
- ◆ Again, family cultural values are difficult to transfer across generations

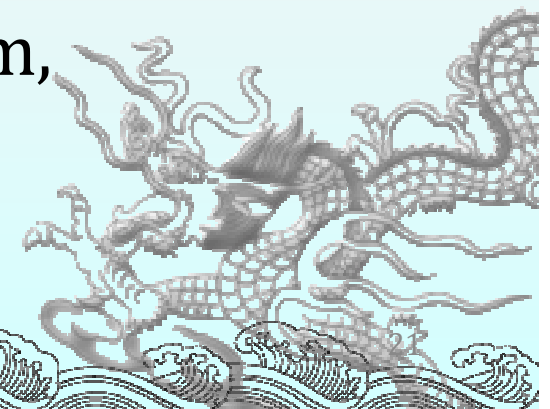


ROADBLOCKS of ASIAN BUSINESS



Roadblocks

- ◆ Family roadblocks
 - ◆ Number of people, health, harmony, psychology, competence
- ◆ Industry and market roadblocks
 - ◆ Financing, technology, demand and supply, regulations, etc.
- ◆ Country/regional institutional roadblocks
 - ◆ tax, property rights, political system, government quality, wars, etc.



The Rise and Fall of Family Owned Banks in Hong Kong

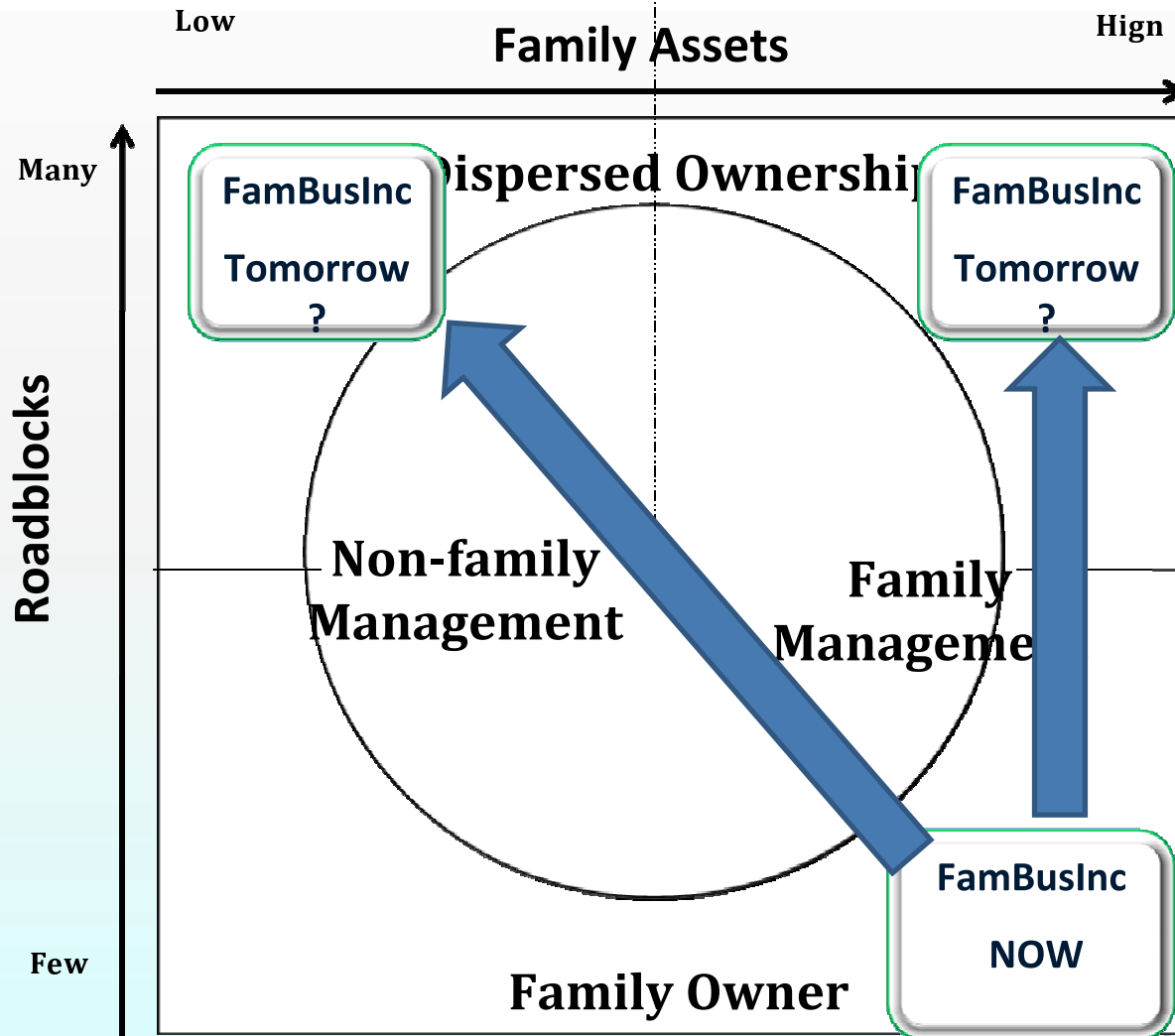


The rise and fall of family owned banks in Hong Kong

- ◆ Chinese civil war 1946-49: Many rich people and their money escaped to Hong Kong.
- ◆ 1948 banking act licensed 143 banks to operate in Hong Kong.
- ◆ Chinese owned family banks.
- ◆ 1978 the licence system were removed and competition increased from abroad.
- ◆ Today less than 10 family banks remain and relationship banking is less important.
- ◆ Even relationship banking face stiff competition.



Roadblocks risk family losing control

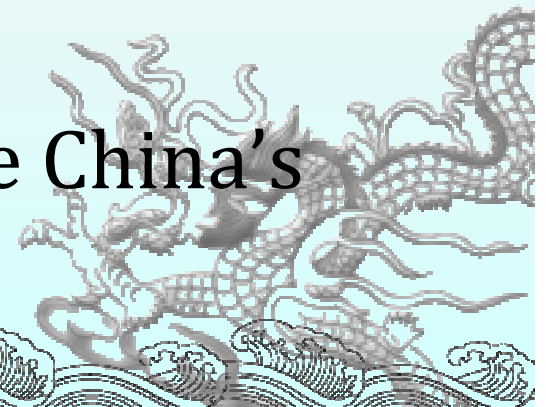


Institutional Roadblocks and Private Sector Business Sustainability in China



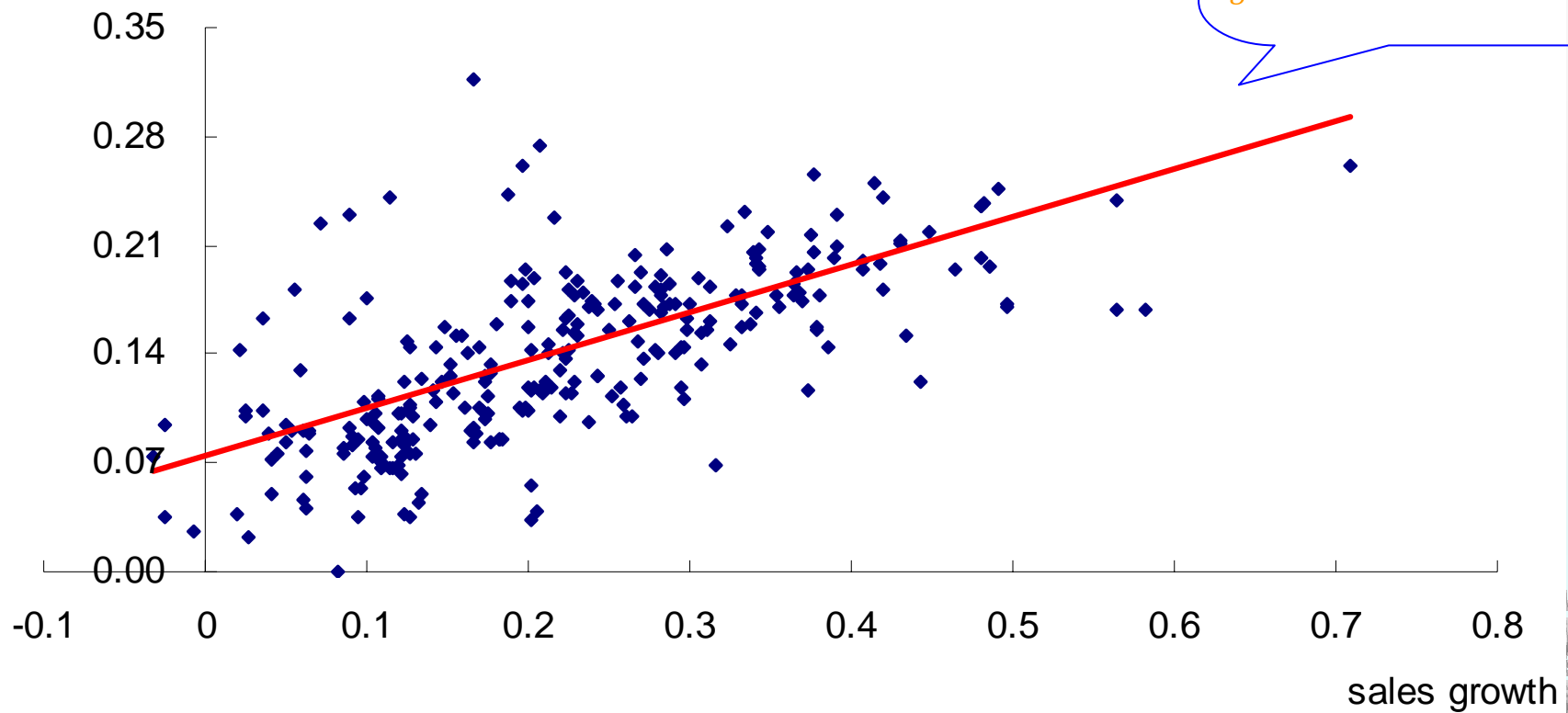
China Paradox

- ◆ Phenomenal growth since 1978
 - ◆ Total GDP have just surpassed Japan, now next to only U.S.
- ◆ However, weak institution development
- ◆ Puzzling why China grows so fast given the weak institutions
 - ◆ Beyond just starting “low”?
- ◆ What are the roles of the corporate sector in China’s development?
- ◆ In particular, how sustainable are China’s private sector businesses?



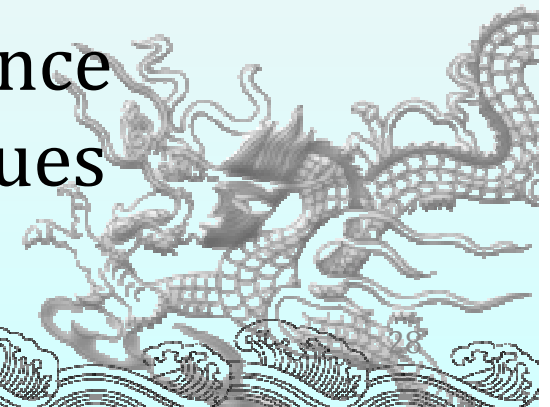
Provincial GDP growth and firms sales growth

Correlation of GDP growth and firm sales growth



Symptoms of sustainability issues

- ◆ Business as the founder's one-man show
 - ◆ Lack of successor and professional management
- ◆ Too little or too much cash
 - ◆ Cross-sectional and time-serial mis-matched financing and investment opportunities
- ◆ Wasteful investment and diversification
- ◆ Imitation instead of innovation
- ◆ Political rent seeking, corruption
- ◆ Poor family and corporate governance
- ◆ Environmental and labor safety issues



Key Institutional Roadblocks

- ◆ Value vacuum – formal or informal
- ◆ One child policy, Hukou system
- ◆ Dominant state sector
 - ◆ Frequent government changes in macro-policies (exchange rates, interest rates, etc.)
 - ◆ Government dominance/intervention in input and output markets
 - ◆ Varying local government quality
- ◆ Slow development of financial system and capital markets

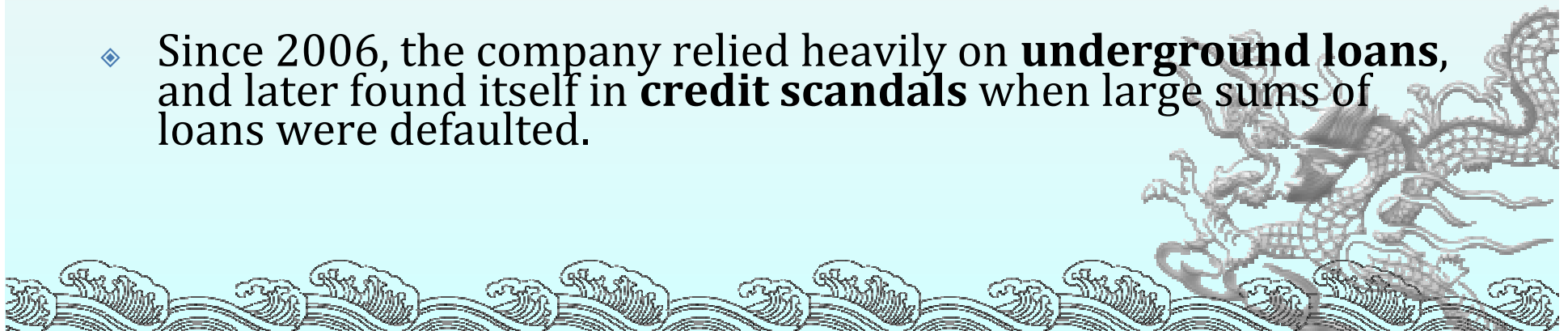


Disrupted Leadership Succession of Zhejiang Guangsha Co., Ltd (China)



Zhejiang Guangsha Co., Ltd

- ◆ Founded by **Lou Zhongfu** in the small city of **Dongyang** in Zhejiang province in 1984, **Zhejiang Guangsha Co., Ltd** is now a large private run company with core business in **construction** and **real estate**.
- ◆ It was **listed** in Shanghai Stock Exchange in 1997, and **diversified** to other industries such as finance, tourism, education, IT, etc.
- ◆ Guangsha performed poorly in the stock market over the years, and reported **loss** of ¥0.177 billion and ¥0.272 billion in 2005 and 2006. The stock was marked “**ST**” in 2007.
- ◆ Since 2006, the company relied heavily on **underground loans**, and later found itself in **credit scandals** when large sums of loans were defaulted.



Guangsha: Group Structure



广厦控股
Guangsha Holdings

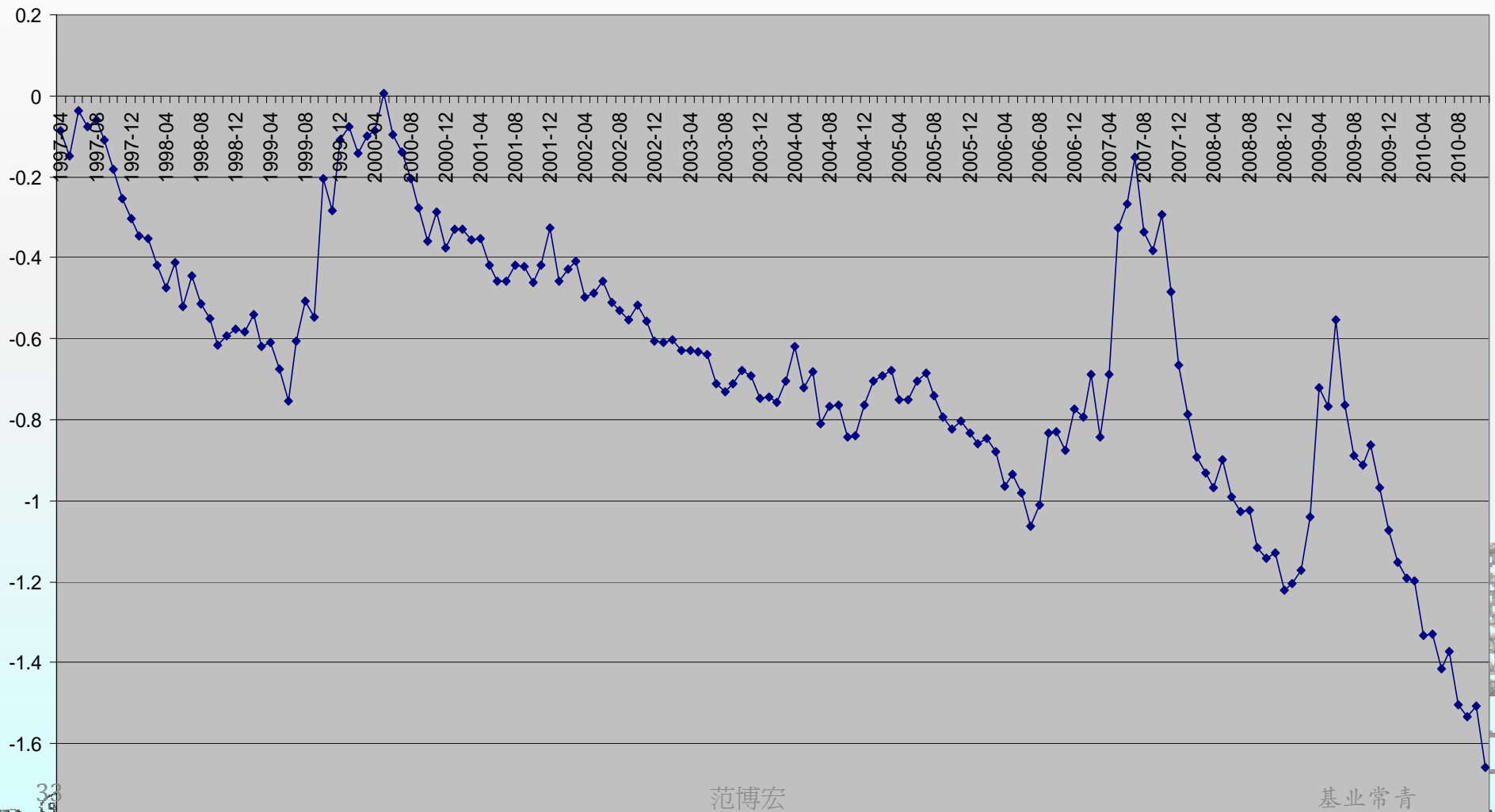


浙江广厦股份有限公司
Zhejiang Guangsha Co., Ltd



广厦建设
Guangsha
Construction

Watershed Stock Performance since IPO



范博宏

基业常青

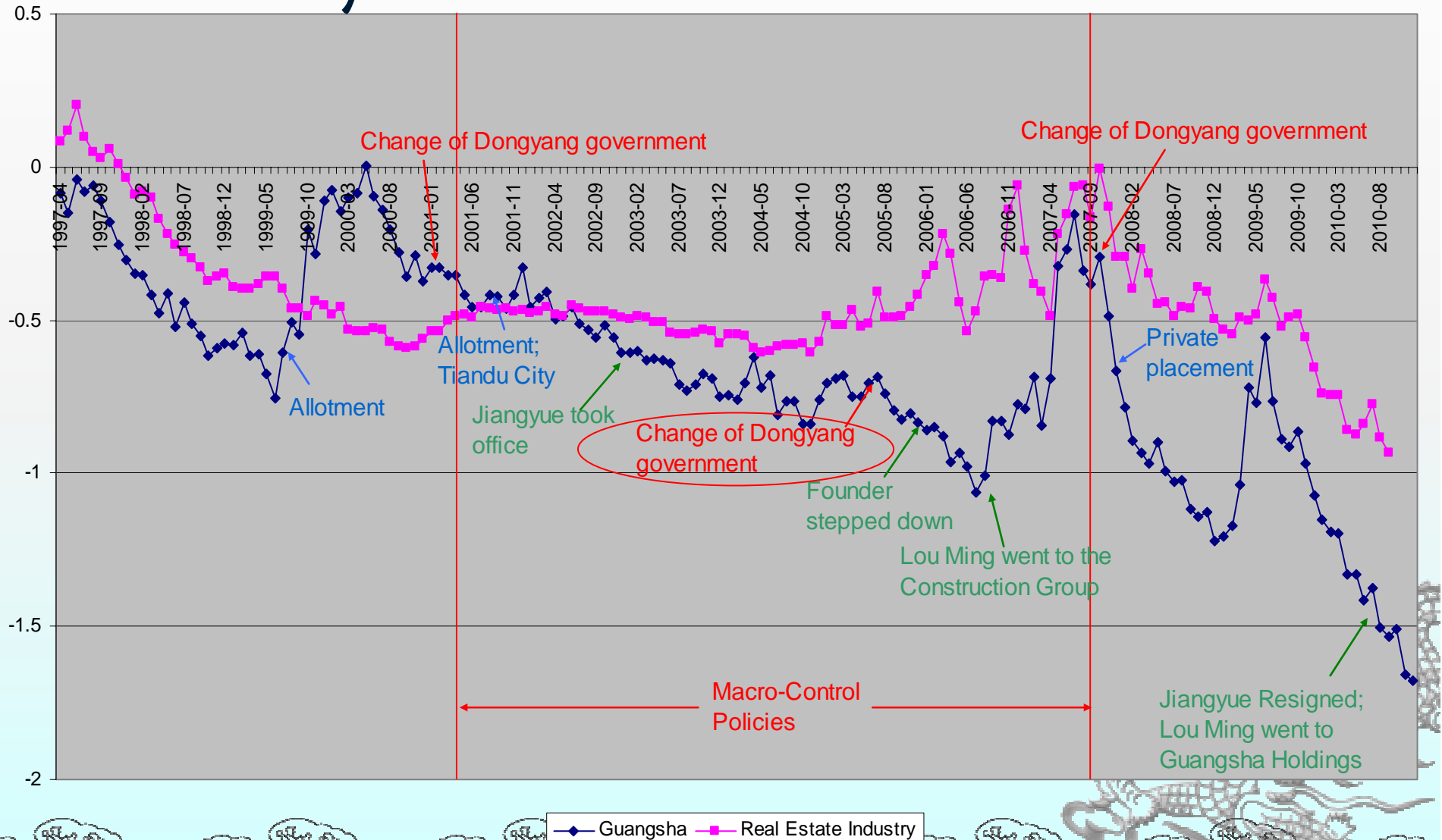
The Lou Family

- ◆ Born in 1954, **Lou Zhongfu** used to be a **worker** in a construction company before he became the **manager**, and turned the small company into the multi-industry group.
- ◆ Lou is **bold** and presumably good at setting up **connections**. He is a Communist Party member, and the **Deputy Director of People's Congress in Dongyang City**.
- ◆ Lou's elder son **Lou Ming** was born in 1973. He joined the **army** before he entered the family business. He also joined the city's **People's Congress** in 2007.
- ◆ The younger son **Lou Jiangyue** was born in 1974, and showed some **business talent** while working with his father.

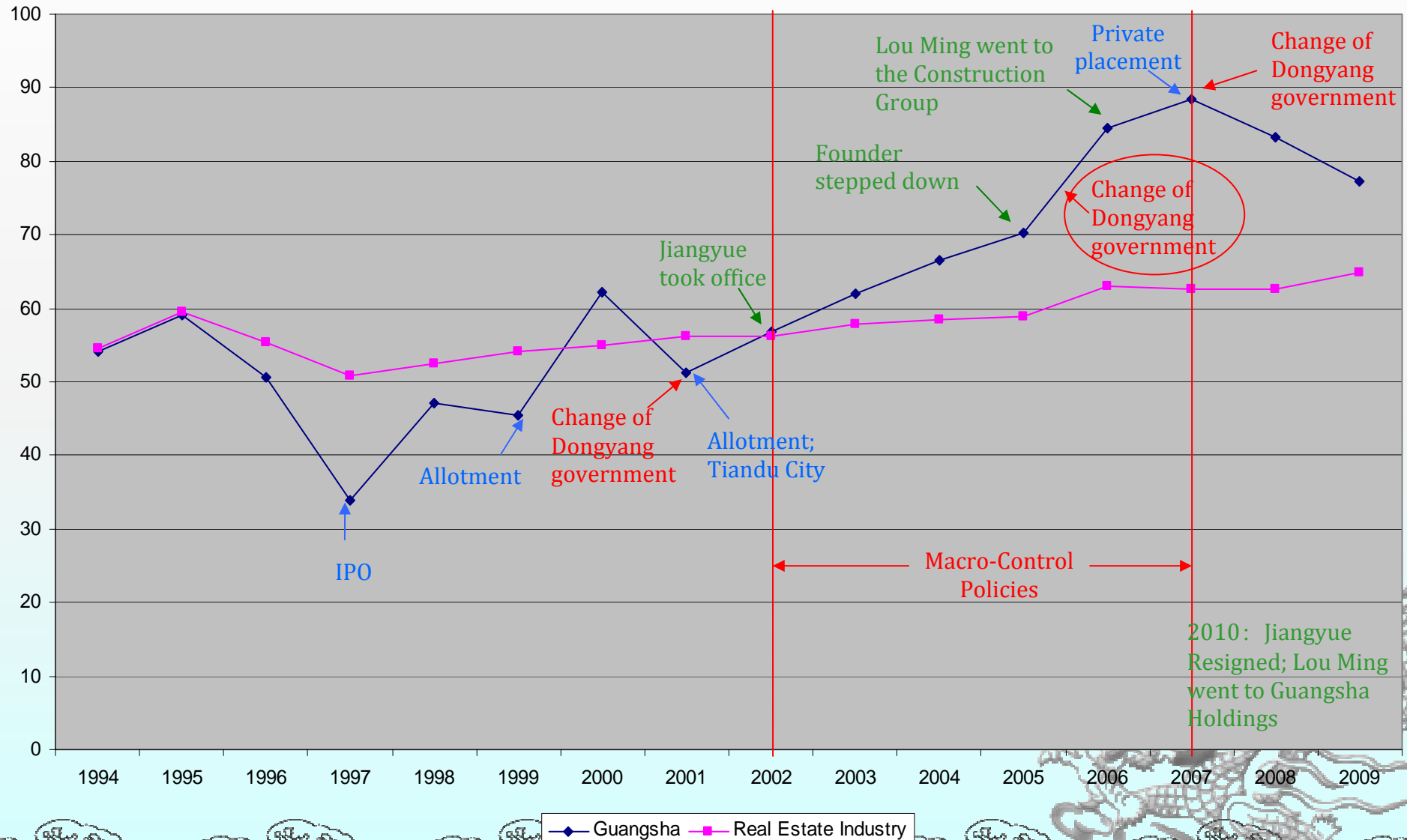


Bumpy Succession

Monthly Cumulative Abnormal Return



Debt Ratio



2010: Jiangyue Resigned; Lou Ming went to Guangsha Holdings

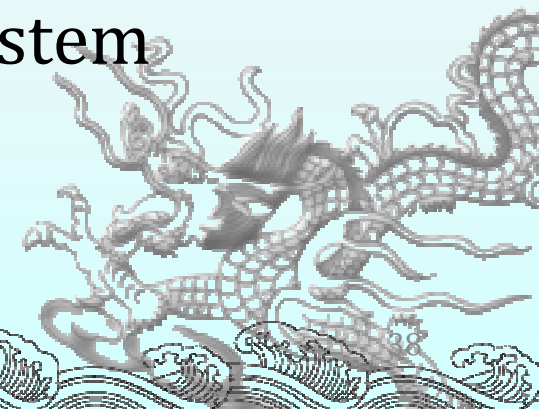
Lessons Learned

- ◆ Guangsha was dragged down because of
 - ◆ Over-reliance on government connections and developed business strategies accordingly
 - ◆ Sudden change of local government
 - ◆ Macro-control policies
 - ◆ Started succession at a turbulent time
- ◆ Immediate succession following major investment decisions might be risky.
- ◆ Chinese private run enterprises, while closely tied with the government, should beware of roadblocks, especially the uncertainties in political changes.

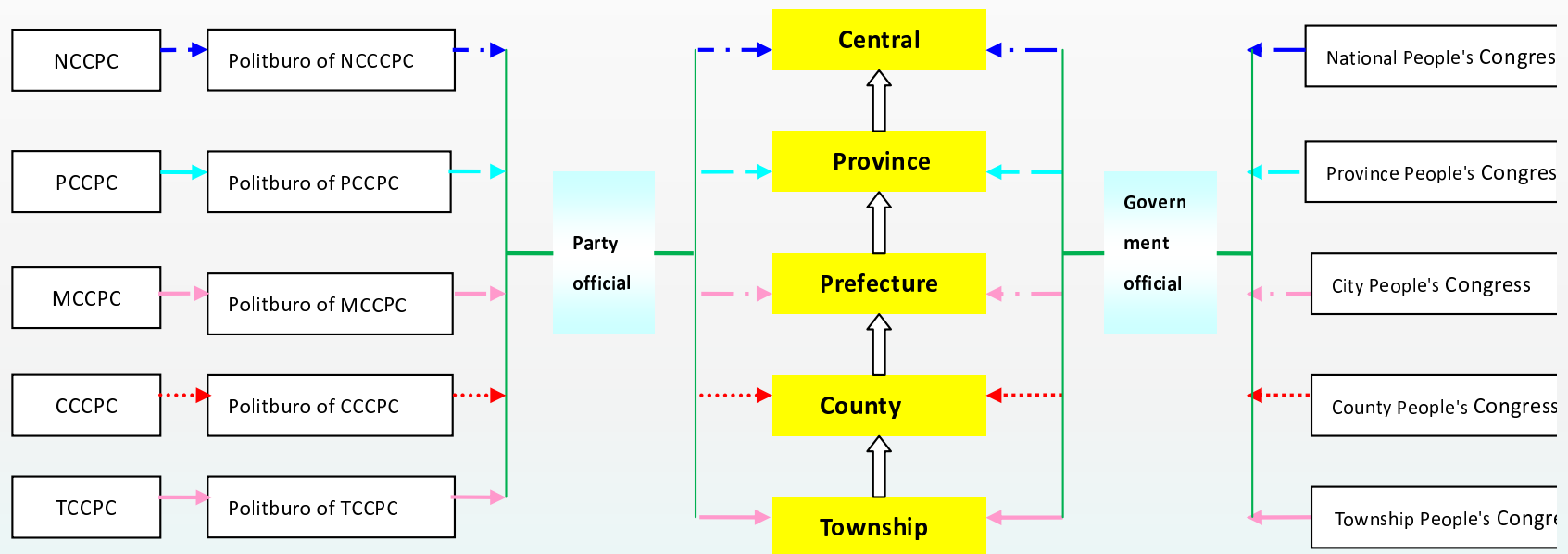


The Visible Hand behind China's Growth (Fan, Huang, Morck, Yeung, 2010)

- ◆ We conjecture that the China's growth and sustainability issues are critically related to the quality of various levels of government as key players
- ◆ To better understand China's development trends, it is important to know how the government runs the economy
 - ◆ It is still a command and control system
 - ◆ But, with decentralization



The Dual Government-Party System

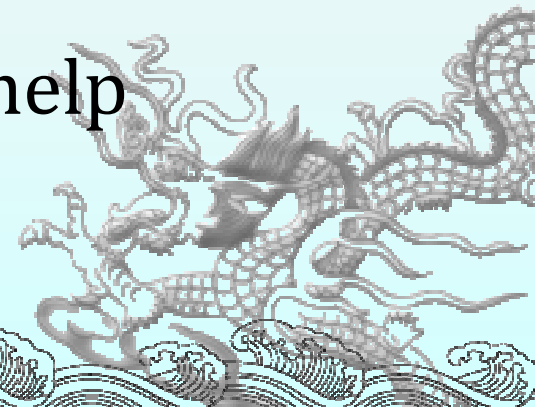


Note: NCCPC denotes National Congress of Communist Party of China; PCCPC denotes Provincial Congress of Communist Party of China; MCCPC denotes Municipal Congress of Communist Party of China; CCCPC denotes County Congress of Communist Party of China; TCCPC denotes Township Congress of Communist Party of China.



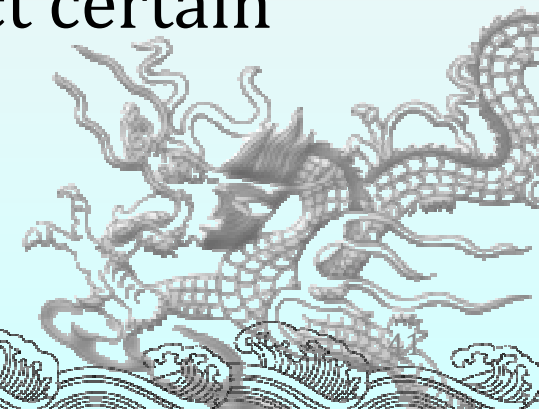
Bureaucrats' Incentive

- ◆ Bureaucrats' pay is low. Their performance is motivated primarily by **promotion**, which in turn is tied to local economic growth.
- ◆ By our estimation, it takes almost **2 percent** of extra annual GDP growth over the national average during a provincial bureaucrat's term of service before he can be promoted to the next level
- ◆ Strong desire to influence firms to help boosting local GDP



Bureaucrat Allocation System

- ◆ The markets and firms are very far from being free, as **bureaucrats heavily intervene transactions and key firm decisions**
 - ◆ The rights to allocate key input such as land, public utilities, natural resources, finance are in the hands of bureaucrats either via direct ownership or regulatory policies
 - ◆ Subsidies, tax breaks, entry regulations and other policies to promote or protect certain firms or sectors

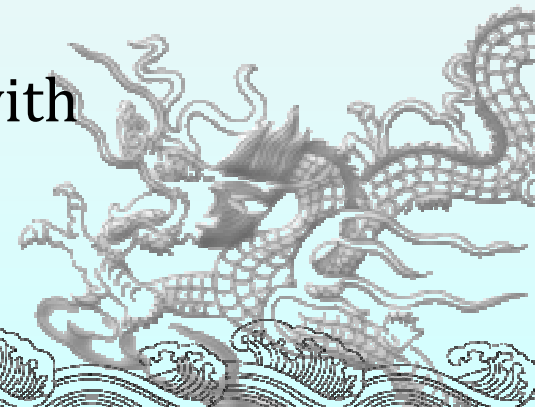


Examples of Local Policies to Promote Enterprises

Province	City	County	Year	Finance	Land	Tax	Administration	Others	Merger, reorganization	Award
Hebei	Shijiazhuang		2007	√		√	√			√
	Tangshan		2006						√	
Jiangsu	Suzhou		2006	√		√	√	√	√	√
	Hangzhou		2004	√		√			√	√
	Ningbo		2006		√				√	√
Zhejiang	Wenzhou		2004	√	√		√			
	Jiaojiang		2006	√						√
	Wenling		2006		√			√		
Hubei	Wuhan		1996	√		√	√	√		
Guangxi	Liuzhou		2008						√	
	Yulin		2008			√		√		
	-		2007	√	√	√	√	√	√	√
Sichuan	Chengdu		2008	√	√					√
	Chengdu	Pixian	2008	√	√	√	√	√		√
	Zigong		2007	√	√	√	√		√	√
	Neijiang		2008	√			√		√	
	Bazhong	Nanjiang	2007	√	√	√	√	√	√	√
	Wenshan		2007				√	√		√
Ningxia	-		2007			√	√		√	
	Shizuishan		2007			√			√	√
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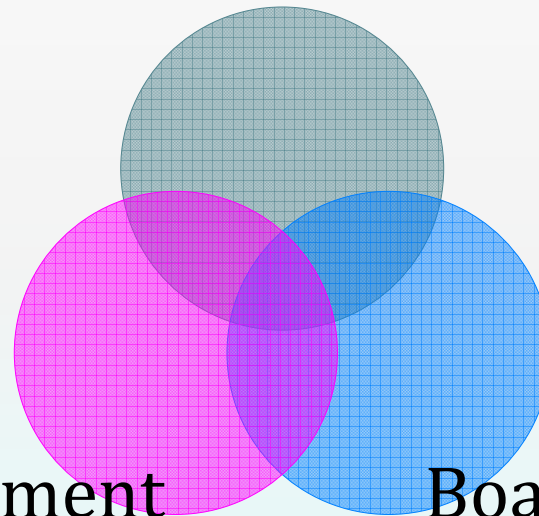
Bureaucrat Affiliated Firms

- ◆ Chinese bureaucrats have powerful tools to intervene firms
 - ◆ For SOEs, key firm decision rights (personnel, ownership transfer) are in the hands of bureaucrats
 - ◆ Many “private firms” are outcome of privatization of SOEs and TVEs approved by bureaucrats. Only connected individuals can thrive
 - ◆ Self-made entrepreneurs would need good relationship with bureaucrats to win support, access to key input, and protection
- ◆ In effect, most firms in China are affiliated with bureaucrats



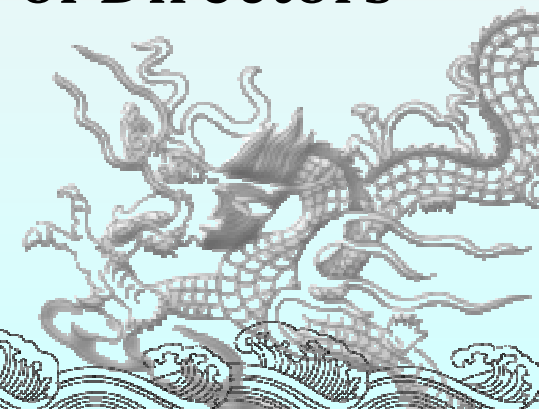
Power Structure of Chinese Companies

Party Committee

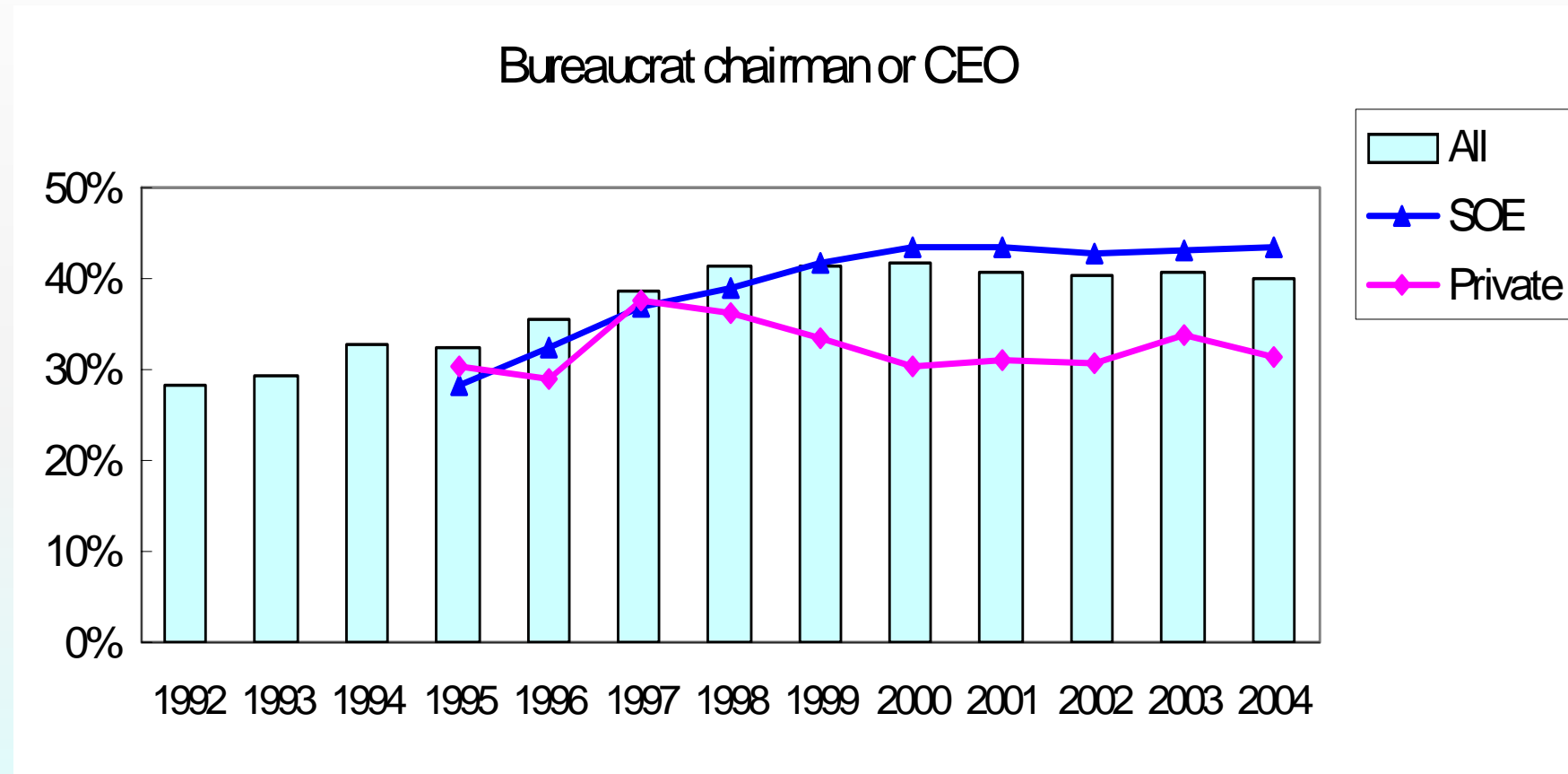


Senior Management

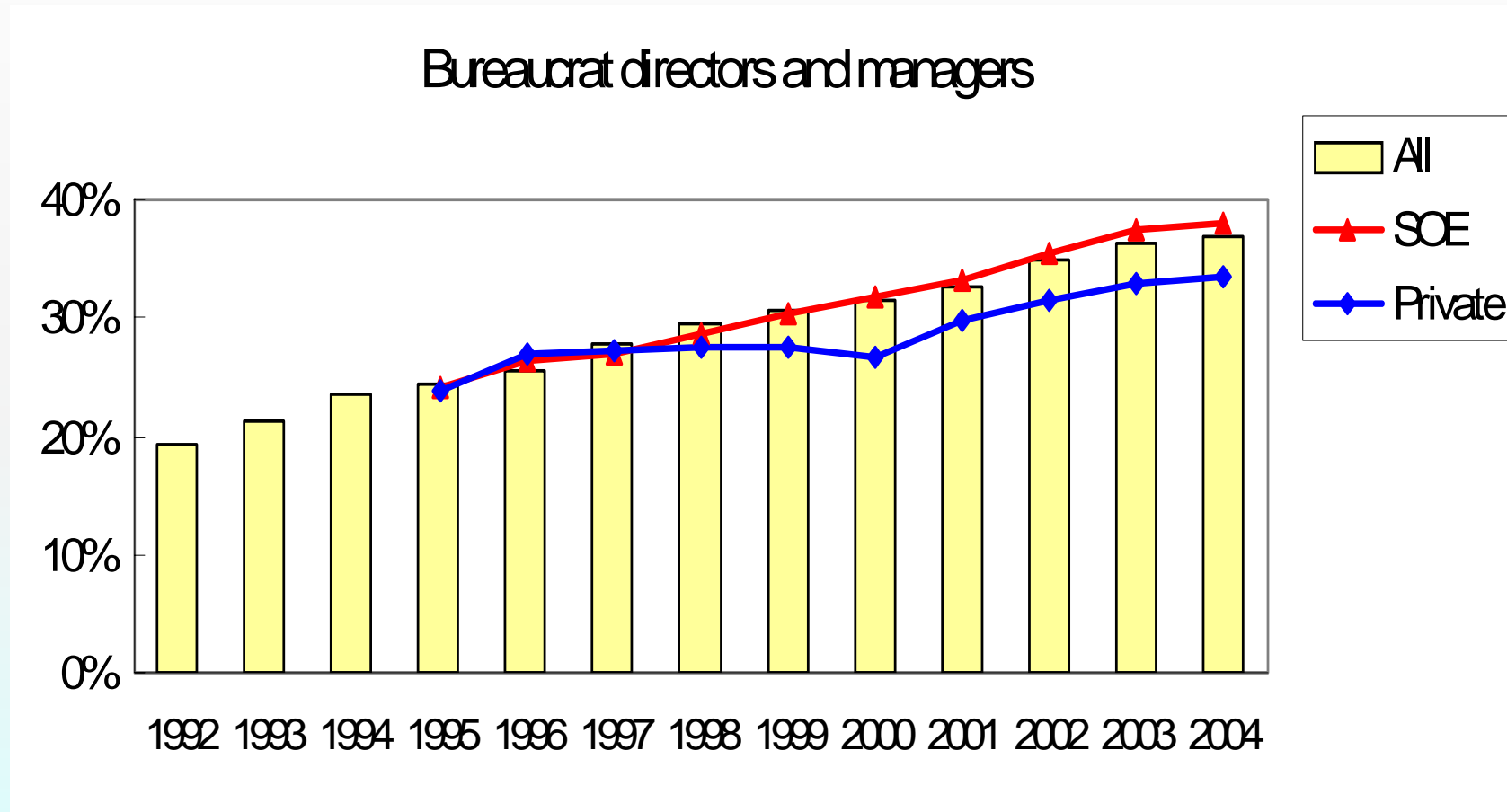
Board of Directors



Bureaucrat as chairman or CEO



Bureaucrats as directors and managers



Bureaucrat Quality

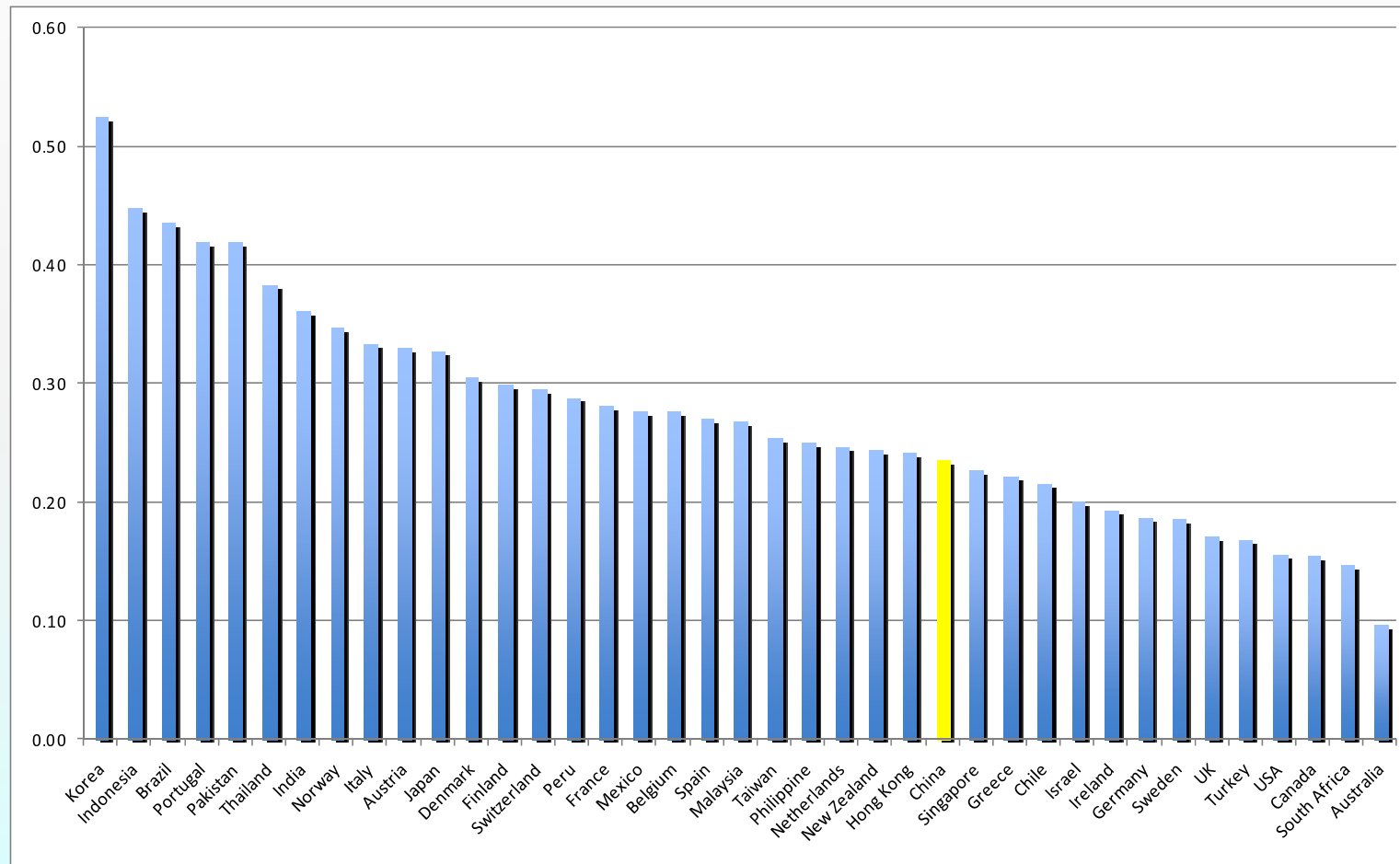
- ◆ To what extent a bureaucrat would act in the best interest of citizen if his behavior is unconstrained by formal institutions
- ◆ High quality bureaucrats balance firm objectives with social objectives;
- ◆ Bad bureaucrats focus on self-interest, use their power to transfer resources to individuals and firms to win benefits and support
- ◆ The efficiency of a bureaucrat allocation system depends critically on the quality of bureaucrats and institutional disciplines governing their behaviors
 - ◆ Bureaucrat allocation system can lead to productive firm and economy growth, and better social wellbeing providing bureaucrat quality is high
 - ◆ Giving unconstrained power to bad bureaucrats can lead to firm and economy growth without profit and productivity, and detriment citizen's wellbeing.

Institutional Distortions of Corporate Investment & Finance

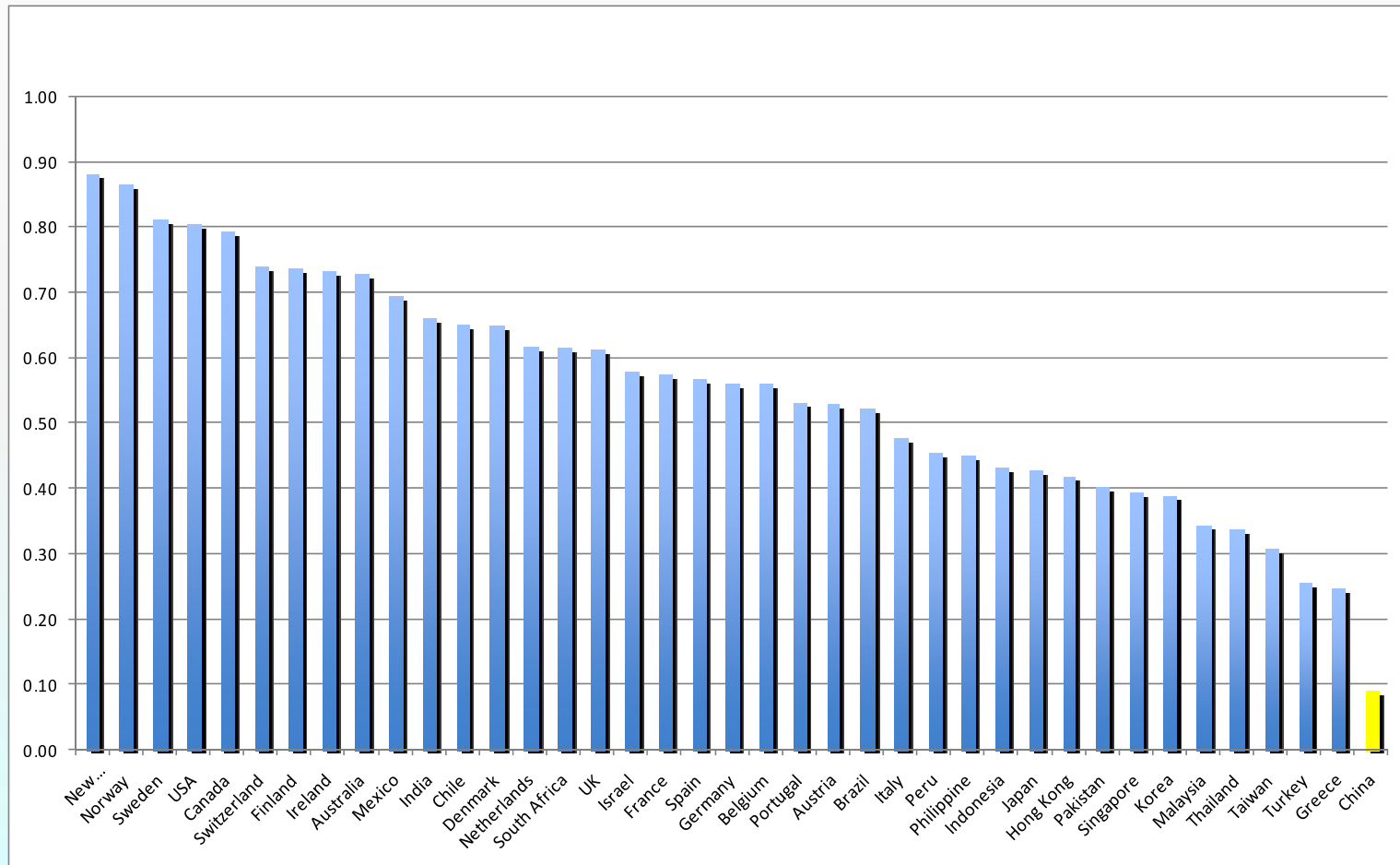
- ◆ Government big push expansion
- ◆ State controlled banking system's lending bias
- ◆ Poor public governance



Cross country pattern of corporate leverage (1991-2006) (Fan, Titman, Twite, forthcoming)



Cross country pattern of corporate debt maturity (1991-2006) (Fan, Titman, Twite, forthcoming)



Public governance and corporate finance

- ◆ Why the lack of long-term financing instruments?
- ◆ In weak institution countries debt (bank loans) provide better enforcement than equity
- ◆ Bureaucrats channel funds to their favored firms through banks they control
- ◆ **Only well connected firms have access to long-term loans**
- ◆ There are several studies in emerging markets providing consistent evidence. We offer a cleaner test using Chinese data

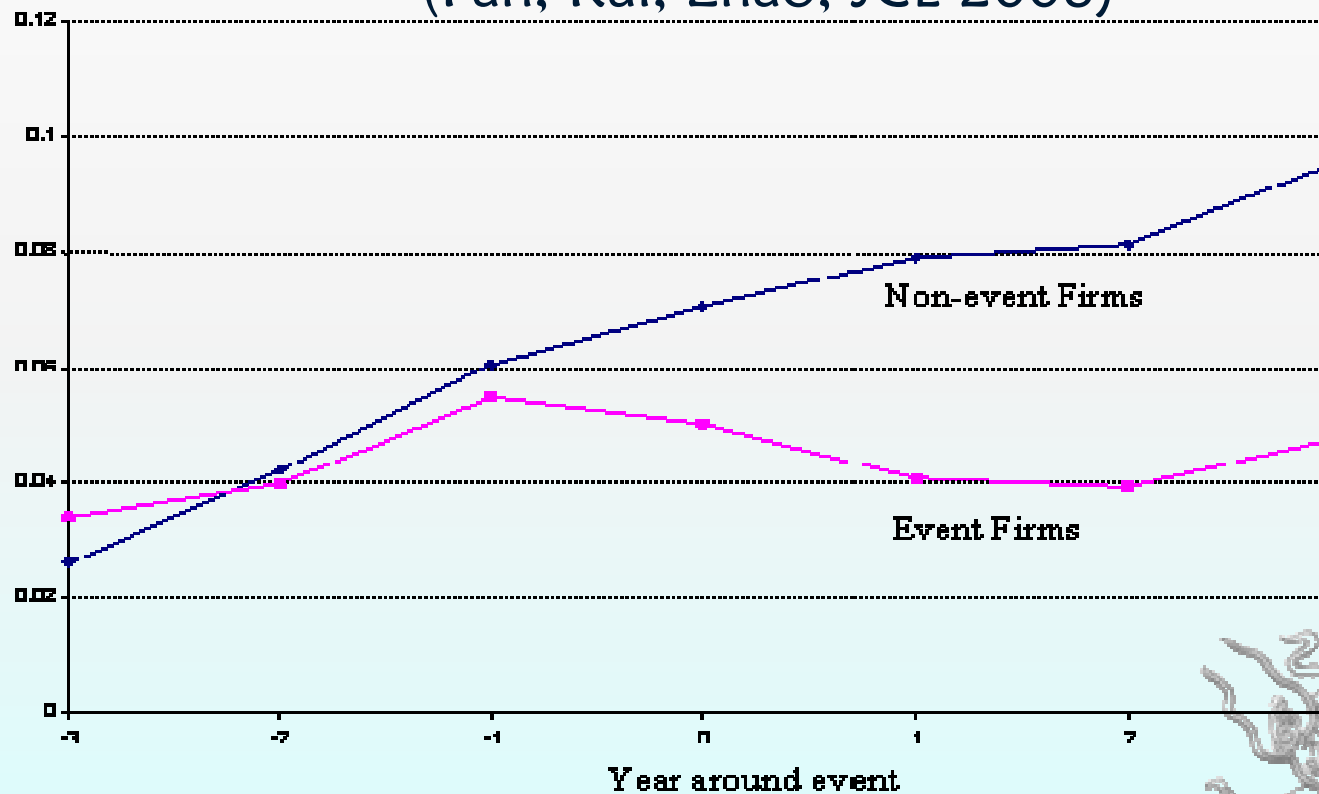


The Scandal List

Province	Name	Position	Event Day	Sentence Day	Sentence	Number of firms in the province	The Bribing Firms	The Connected Firms	The Non-event Firms
Anhui	Wang Huizhong	Vice-Province Governor	20010407	20031229	Death Penalty	25	1	1	23
Bank	Liu Jingbao	Vice-Chairman & CEO of Bank Of China (HK)	20030525	N/A	N/A (Still under investigation)	10	2	1	7
Bank	Wang Xuebin	CEO of China Construction Bank	20020111	20031210	12 years of imprisonment	25	1	3	21
Beijing	Chen Xitong	CPC Secretary	19950426	19980731	16 years of imprisonment	12	5	4	3
Central	Xu Penghang	Vice chairman of national defense technology commission and national economics and trade commission	20001011	20001011	Dismissal from the service	24	0	2	22
Fujian	Shi Zhaobin	Vice-CPC Secretary	19990818	20010927	Dismissal from the service and CPC	12	0	2	10
Guangxi	Chen Kejie	Chairman of Municipality	20000111	20000731	Death Penalty	13	0	0	13
Guangxi	Liu Zhubin	Vice-Chairman of Municipality	20000319	20020624	15 years of imprisonment	2	2	0	0
Guangxi	Wang Qinglu	Vice-Chairman of PPCC	20010222	20010222	Dismissal from the service and CPC	17	1	4	12
Guangxi	Xu Binsong	Vice-Chairman of Municipality	19980523	19990827	Life imprisonment	12	1	3	8
Guizhou	Liu Changgui	Vice-Province Governor	20030417	20040430	11 years of imprisonment	12	1	1	10
Guizhou	Liu Fangren	CPC Secretary & PC Chairman	20030422	20040629	Life imprisonment	10	2	2	6
Hainan	Xin Yejiang	Vice-PC Chairman	19961227	19980526	5 years of imprisonment	33	1	4	28
Hebei	Chen Weigao	CPC Secretary & PC Chairman	20000301	20030809	Dismissal from CPC	51	5	6	40
Hebei	Cong Fukui	Vice-Province Governor	20000627	20010518	Dismissal from the service and CPC	34	5	3	26
Hebei	Jiang Dianwu	Vice-PC Chairman	19971101	19981207	10 years of imprisonment	27	1	2	24
Hubei	Li Daqiang	Vice-Province Governor	20000925	20000925	Dismissal from the service and CPC	13	0	1	12
Hubei	Meng QingPing	Vice-Province Governor	19980410	19991201	10 years of imprisonment	5	5	0	0
Jiangxi	Hu Changqing	Vice-Province Governor	19990808	20000215	Death Penalty	10	2	0	8
Liaoning	Mu TuoXing	Vice-Province Governor	20010321	20011113	Death Penalty	6	0	1	5
Xingjiang	AmanHaji	Vice-Province Governor	20031015	N/A	N/A (Still under investigation)	1	1	0	0
Yunnan	Li Jiating	Vice CPC Secretary & Province Governor	20010620	20030509	Death Penalty	35	2	3	30
Zhejiang	Xu Yunhong	Vice-Province Governor	19990922	20001017	10 years of imprisonment	5	5	0	0
Total						394	43	43	308

Corruption and Access to Long-term Loans

(Fan, Rui, Zhao, JCE 2008)



Diversification of a bureaucrat affiliated firms

Good Business is More Businesses?



1998



1999



2001



2002



2003



rice

medicine

real estate

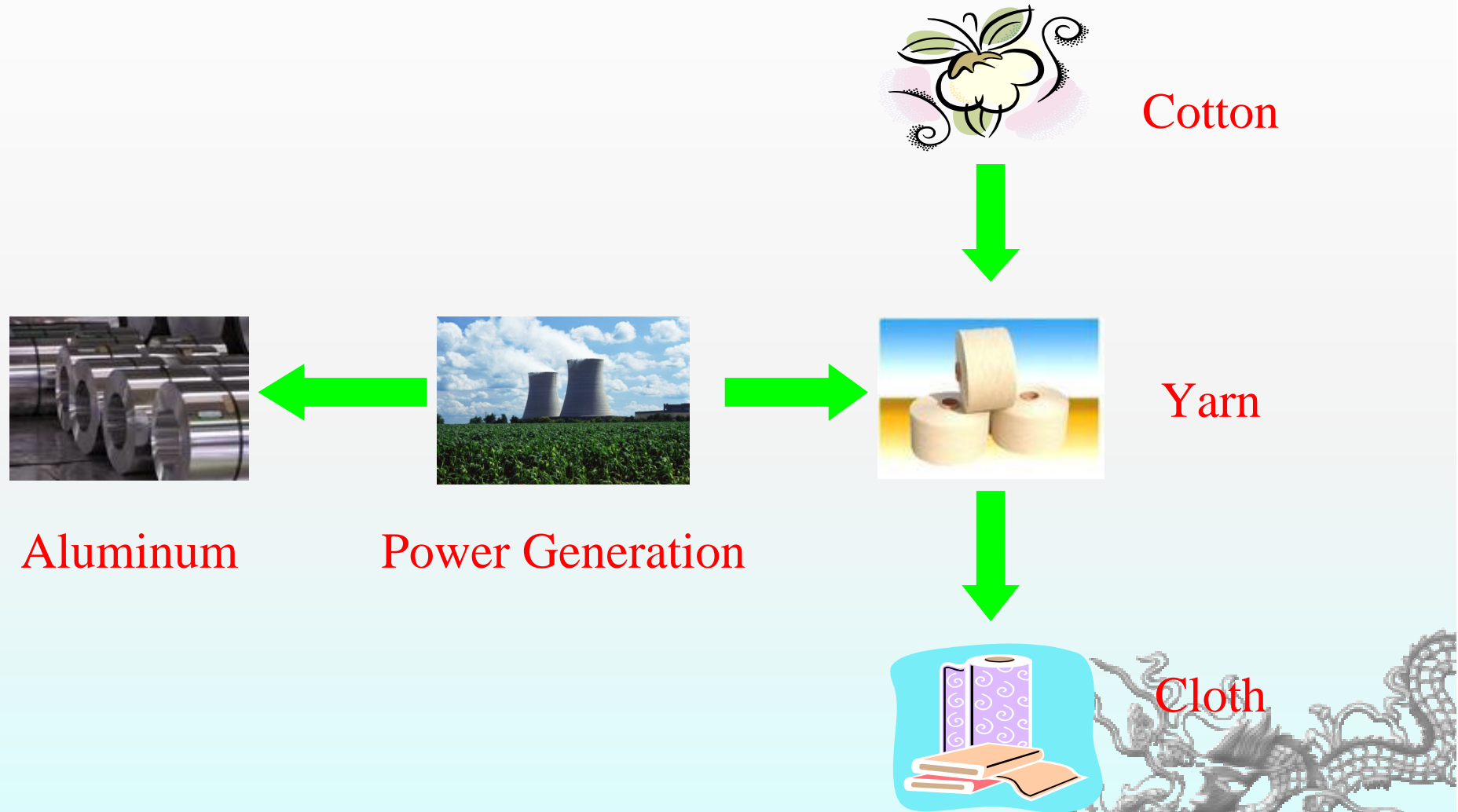
milk

electricity

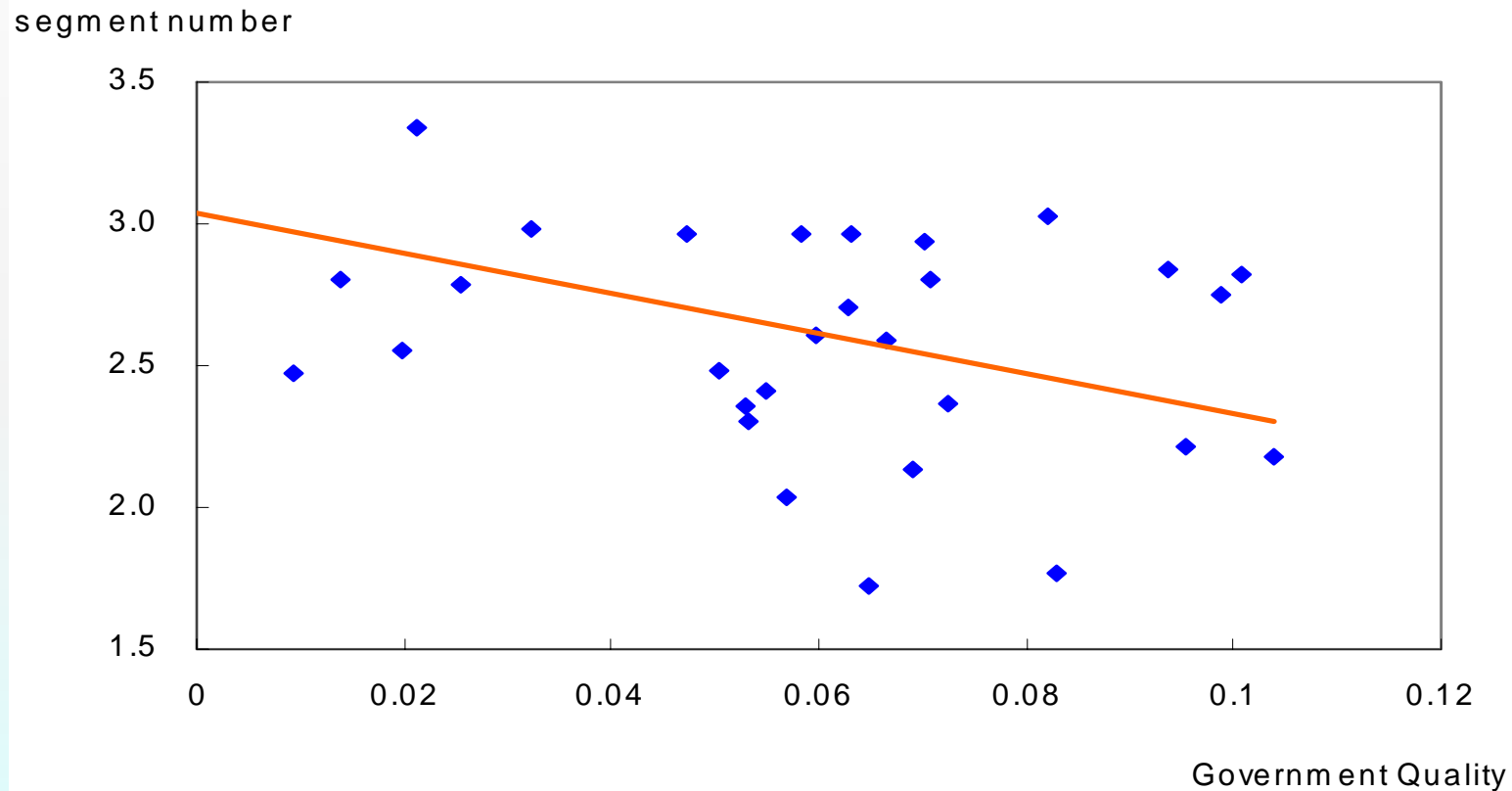
sewage works



We make everything ourselves - Vertical integration of Weiqiao Textile Group

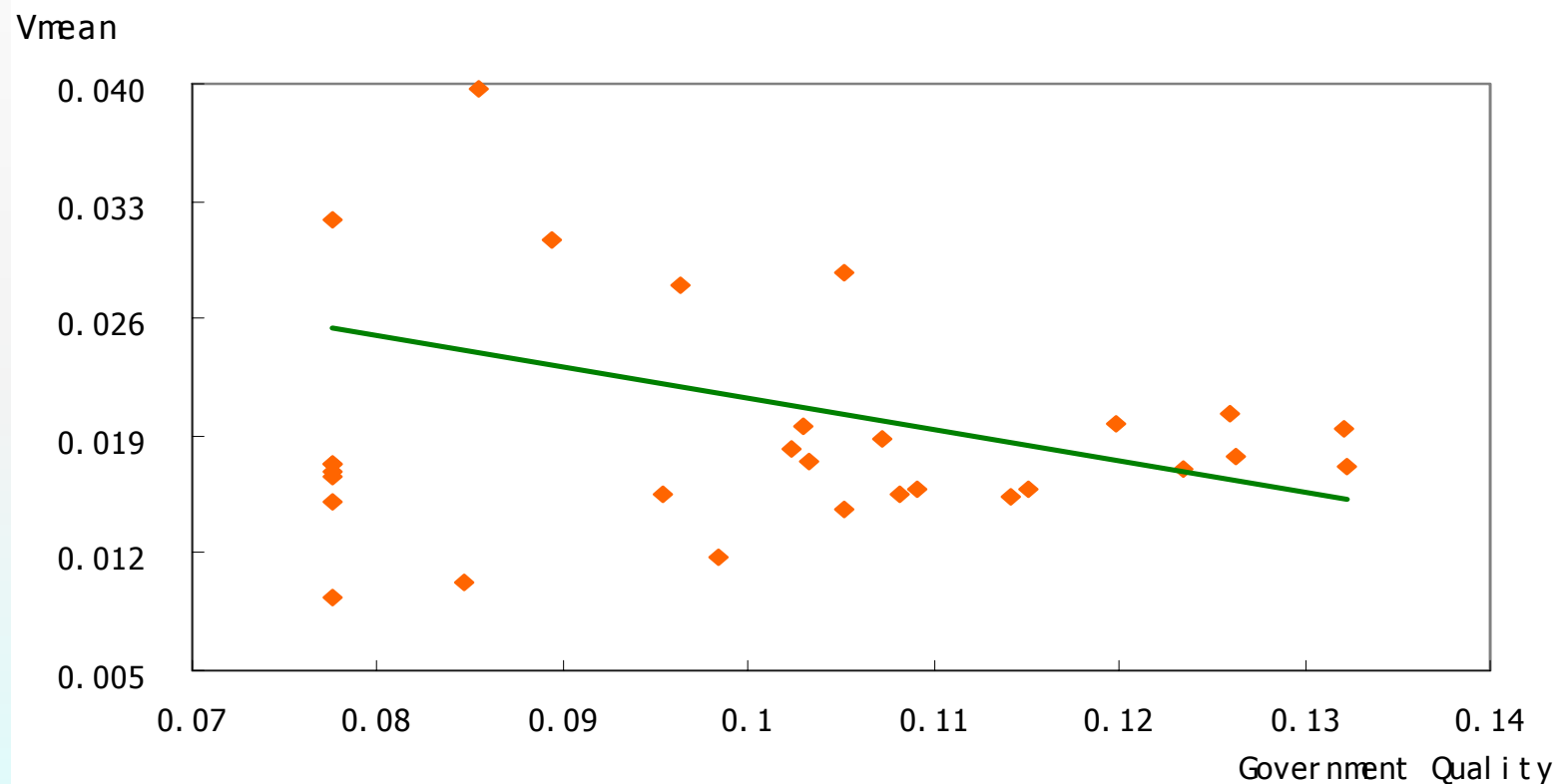


Government quality and diversification

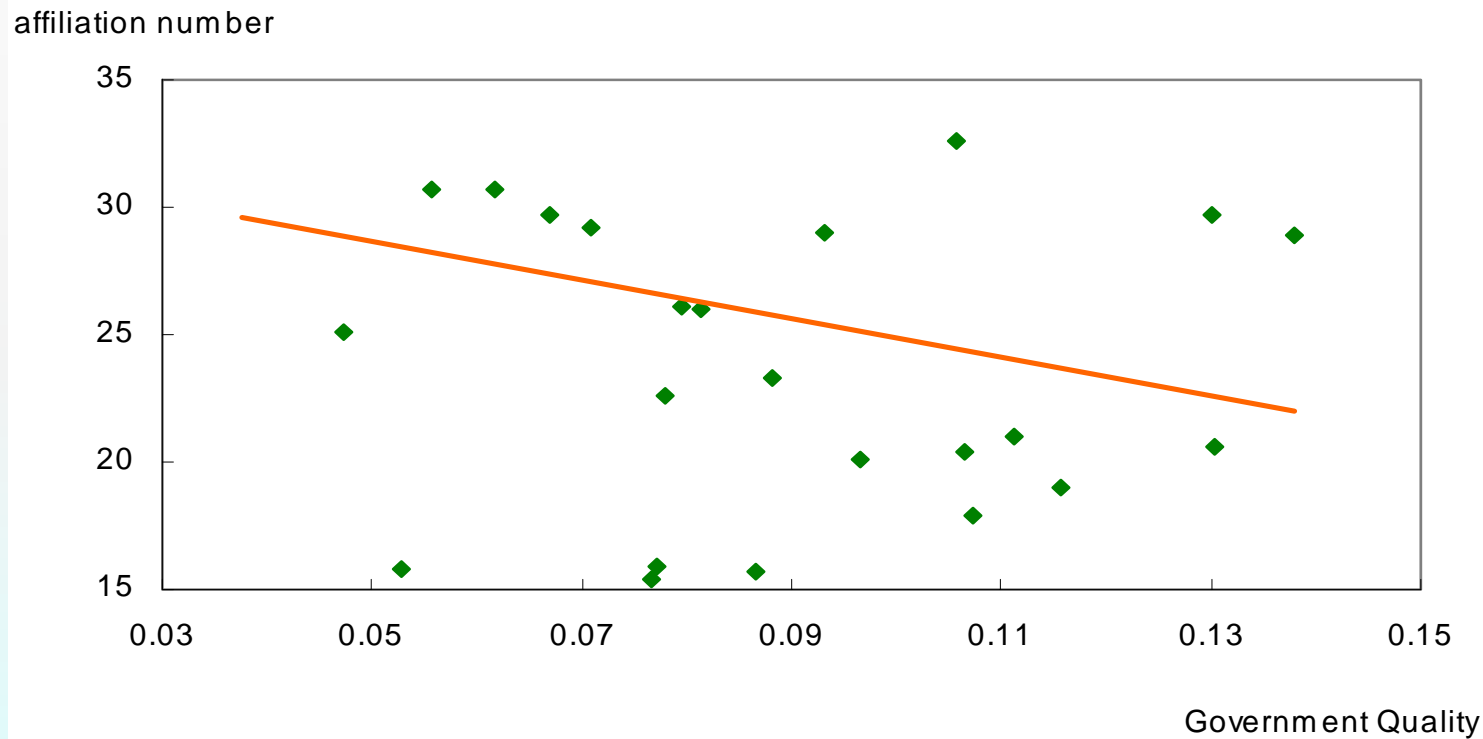


Government quality and vertical integration

(Fan, Huang, Morck, Yeung, 2008)



Government quality and the span of business group



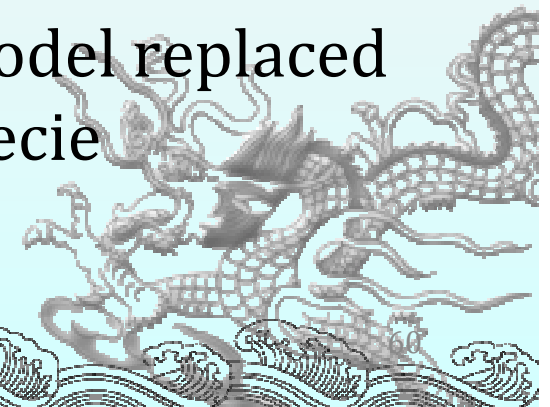
Is China Business Sustainable across Generation?

- ◆ Highly questionable
- ◆ Most businesses will face succession challenges that are greater than those in other Asian economies
- ◆ Worst outcome – **the expropriation game**
 - ◆ Anticipating the challenges, businessmen make only short-term speculative investment while under-invest in innovation and long-term opportunities.
 - ◆ They may flee the country, leaving debt and social problems to future generations



Deadweight Loss or Creative Destruction?

- ◆ Schumpeterian creative destruction?
 - ◆ Are new and better ideas/products replacing old ones?
 - ◆ Is the market based model replace the relationship model?
 - ◆ Are innovative firms replacing rent seeking firms?
- ◆ Re-inventing the wheel?
 - ◆ Self-destructive relationship based model replaced by another generation of the same specie



Creative Destruction or Social Loss?

- ◆ We suspect the latter
- ◆ Weak institutions impose huge costs on and even destroy family businesses that are otherwise productive and viable
- ◆ Socially undesirable because valuable assets are permanently dissipated and hard to be rebuilt
- ◆ Worst still, underinvestment and expropriation problems
- ◆ Institutional reforms to remove roadblocks and help business sustainability are urgently needed



Institutional Reforms for Sustaining the Private Sector Business in China

- ◆ Rebuilding value and family governance
- ◆ Institutional reforms
 - ◆ Influencing bureaucrat behaviors through promotion incentives
 - ◆ Fighting corruption
 - ◆ Relaxing Hukou regulations and one-child policy
 - ◆ Improving property right protection and encouraging innovation
 - ◆ Facilitating market development
 - ◆ Encouraging corporate social responsibility



Thank you

