Know the Turf!

Typical Issues in Small- and Medium-sized Private Chinese Chemical Companies

Chinese small and medium-sized enterprises (SMEs) in the chemical and other industries have achieved rapid growth in the past years and are contributing to China's economic development.

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SMEs, in general, face distinctive problems such as lack of financing, constrained managerial capabilities, low productivity, difficulties in exploiting technology, finding and retaining key talents, and regulatory burdens. Contrarily, SMEs can often be more flexible and responsive to customer needs, and, if well run and innovative not only in regard to products and services but also in regard to internal processes etc., can ultimately improve business performance and sustainably succeed in the market. Two key challenges are, in particular, finding the right growth strategy and implementing suitable supporting processes as the company grows and becomes a more and more complex operation.

Private and Family-owned Enterprises

Private/family-owned enterprises differ from non-family SMEs in terms of the overlap between business and the family environments. The involvement of the family in the management of a company could be extensive in China. The founder or owner, the direct family members, often members of the extended family as well as individuals related by marriage hold top management positions or line-management positions throughout the organizations. Often also friends or "old buddies" (wider social group of the owner—guanxi) could be employed in key management positions.

Such an organizational structure cannot be found only in companies founded by a Chinese entrepreneur but also in foreign-invested companies. For example, one foreign chemical company wanted to set up a company in China and decided to hire a local Chinese general manager. As the general manager started to build the organization, he gave management positions and other positions to his family members including in-laws and close friends mostly ignoring needed expertise. Apparently, the whole process was not sufficiently oversighted by the parent company. As a result, the local company remained to stay rather small compared to international competitors despite the fact that the foreign company entered China relatively early in that particular niche market.

The local business owner puts more importance on the bond of trust rather than on expertise, competency, and qualification; it is easier to do business with closely known people. Positive aspects of building such an organization are, for instance, possible sustainment of the owner's vision by the new generation, if there are no severe intergenerational conflicts, and organizational stability as far as top management and lower management levels are concerned.

Organizational Management Challenges

On the other hand, there are also unique organizational management challenges. This is true especially in the management of non-family employees. Favoritism or nepotism are more prevalent in the family businesses of countries where traditional ties and relations are still intensive, and work life and family life are less separated. Favoring relatives and close friends with respect to performance evaluation, overlook of underperformance, reward, support, and promotion as well as actual non-involvement of out-of-group managers in the decision-making process causes perceived unfairness, decreased job satisfaction, and thus reduced loyalty of non-family and out-of-group members towards the organization.

There is largely a distrust of the system, even if policies and procedures are quite formalized, as essentially decisions are almost always made by the founder in the end. Such favoritism and management lead to an increase in labor turnover rate, decrease in organizational commitment, reduction of work efficiency, lower productivity, drop in quality or services, less knowledge sharing, diminished innovation ability, decrease of competitiveness, declining profitability, and ultimately loss of the enterprise in the long run. If the owner is aware of such challenges, these negative aspects can be reduced.

Besides people management there are other challenges often seen in Chinese local companies. Quite often the planning horizon in SMEs is very short and the business strategy is unclear and changes because an opportunistic pursuit of short-term opportunities has been quite successful in a seemingly ever-growing market. Previous success during a period when productivity and competition were less an issue as the market grew rapidly has given the false impression that a later investment into unrelated businesses would be also unproblematic despite missing expertise.

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Fast growth in the past has also been concealing internal management and business process challenges, which will eventually surface. Indeed, family-owned enterprises exist that grew to a substantial size with revenues of billions of Chinese yuan (hundreds of millions of euros) and staff of several hundreds of employees.

An example is a Chinese family-owned chemical company founded in the 1990s. The founder struck luck when he was initially trading chemical products. Today, the company is also manufacturing specialty chemicals. The group has a few subsidiaries and an international joint venture with non-controlling interest in China. The enterprise employs a few hundred people and the annual revenue of the firm excluding the JV is some billion Chinese yuan with net profit in the lower single-digit percentage range. Almost 80% of the revenue is generated by one entity. Practically all products manufactured at the main plant experienced commoditization over the years, and the net profit highly depends on the raw material prices. Contrarily, the net profit of the foreign-managed JV is much higher and more stable. In fact, besides the influx of borrowings and subsidies, the group is living on the profits made by the JV.

Some newly established endeavors and investments in fixed assets do not generate profit, draining money since years. The founder owns a majority of the stocks, and the larger part of the rest is in the hands of the family.

Family members and relatives hold certain key functions and several other positions. Reporting and controlling systems are formal. Employees are being remunerated a base salary plus a limited bonus based on KPIs. Advanced training courses and programs are available but not always effective. The owner sticks with his family and old friends, needed information was not shared with newly hired professional managers, and the owner made decisions bypassing those senior managers, who all left after a short time. Many employees who are not locally bound by their own families also left the firm.

Certainly, the owner is ambitious focusing on expansion. Debt and earnings from the joint venture are financing the investment in fixed assets and growth. Given size, complexity, and age of the business one would expect a delegative management style, yet the founder keeps his directive leadership style—absolute monarchy; it's an imbalance, which creates a serious problem, eventually endangering the future of the firm.

Analysis and Recommendation

The founder fell into two traps: The first one being the danger-of-omnipotence-syndrome (owner tries to grow too fast or runs out of cash) and the second one being the danger-of-omniscience-syndrome (owner is unable to delegate effectively). Indeed, the owner continues to pursuit unprofitable businesses: besides his oldest business that gives him a small profit, and the profit-making JV, all other subsidiaries are not profitable. However, the biggest problem, obviously, is omniscience. The founder is unwilling to give up control which would be necessary to develop a larger and more complex organization. The owner has not made decisions about what to pursue and what not to do and did not develop an effective teamwork among the senior management group that is critical for a delegation-demanding growth stage.

A turnaround approach for the corporation might look as follows:

- Stop money-losing businesses and sell unnecessary fixed assets.
- Add new higher-margin products to the core business to shift away from the old, commoditized product line (product development portfolio).
- Establish an innovation strategy focusing on one dimension at a time, either horizontal or vertical expansion related to the existing business.
- Reconfigure systems for supporting long-term growth and allow effective decentralization while balancing control and nourishing entrepreneurial spirit.
- And first and most importantly, the founder must learn to let go. He could be owner but with no executive duties. Daily operations and strategic planning should be done by a team of professional managers.

Piece of Advice

Attention should be paid by those Western companies, which have already localized or intend to localize many positions in China, to the possibility that the working styles of the local management potentially resemble those in Chinese companies, with the risks outlined above. Headquarters should have knowledgeable managers experienced in Chinese culture and business. Foreign management in China should know the turf.

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