Private firms

Pink capitalists in bloom

by Scott Kennedy

For years, China's vibrant private sector firms have faced all sorts of discrimination: difficulty getting bank loans, high interest rates on the loans that are available, extortion by corrupt officials, outright nationalization, bans from investing in certain sectors, and rapacious competition from subsidized state-owned enterprises (SOEs). Despite all this, the private sector has steadily increased its share of economic output. But many liberals and much of the Chinese press believe the tide turned when the 2009-10 stimulus program handed SOEs cheap loans from state banks, allowing them to regain lost ground—a process dubbed "the state advances and the private sector retreats" (*guojin mintui*).

Despite years of discrimination, China's private sector has steadily increased its share of economic output

In reality, China's private sector has proven amazingly resilient. A recent research trip across the private-enterprise bastion of Zhejiang, together with an examination of national and regional data, show that private firms are doing better than generally appreciated. Some of their problems result from embedded political discrimination, but others simply stem from the business cycle or structural changes (such as rising wages and a stronger currency) that hit export-oriented, labor-intensive firms particularly hard.

In the face of these challenges, some private companies are going under or selling out to their state-owned competitors. But many are prospering through a variety of savvy strategies. When Dragonomics first visited Zhejiang in 2003, the success of private firms clearly came from natural entrepreneurial enthusiasm. Today, the winning recipe is more complex: it requires both integration with the national economy and blending into the political mainstream. This mountainous, coastal province is no longer a world apart: China and Zhejiang are evolving together. China's economy is becoming more privatized; Zhejiang's private enterprises are becoming more accommodating of state interests.

Institutional discrimination

Since the late 1990s, China's government has tolerated, but not embraced, the private sector. SOEs still have a big edge in gaining the resources needed for success: capital, land, labor, raw materials, policy information and customers. The fundamental discrimination is in finance. The private sector likely accounts for around two-thirds of China's GDP, but in 2010 it received just 30% of corporate loans, compared to 62% for the state sector.

The government tolerates, but does not embrace, private companies

In Zhejiang, where over 90% of the economy is in private hands, non-state companies do receive the lion's share of loans: one banker in Wenzhou (the nation's private-sector Mecca) reported that 95% of his

Scott Kennedy is director of the Research Center for Chinese Politics & Business at Indiana University.

Not quite so stingy

Corporate bank loans by enterprise ownership, % of total

	2009	2010
State-owned enterprises	55.6	52.2
Collectives	9.0	9.4
Private	26.3	30.1
Foreign (including HK/Macau/Taiwan)	9.0	8.3

Source: PBC, GaveKal Data

Private companies' borrowing costs are typically triple the official one-year benchmark rate

branch's loans go to private firms. But they typically pay a far higher rate of interest than SOEs, and must finance a higher share of their projects with their own capital. As a result, their effective cost of capital is usually well over 20%, more than triple the official one-year benchmark bank loan rate of 6.7%. Private firms' access to capital markets, through stock market listings or bond issuance, is also very limited. Many private firms resort to gray-market private lenders, who are often subject to prosecution (or persecution) by the authorities. In the most infamous case, Zhejiang entrepreneur Wu Ying was convicted in 2009 of fraudulent lending and borrowing practices involving almost Rmb800m. Her death sentence was reaffirmed by Zhejiang's supreme court in January, causing a national firestorm, although the national Supreme People's Court struck down the sentence (but not the guilty verdict) in April.

Market entry barriers are another problem: the government welcomes private investment in high-competition, low-margin industries such as light manufacturing, but actively thwarts it in high-rent sectors such as telecoms services and petrochemicals. Private firms have chipped away at these barriers for years but risk expropriation if they come too close to damaging big SOE competitors. SOEs have profits handed to them on a platter, while private firms must scrape for every nickel.

Rising costs, squeezed margins

But not all private-sector problems result from a malign state. Normal cyclical economic headwinds have been much in evidence in the past few years. Most of the firms I interviewed in Zhejiang stressed the volatility generated by the 2008 global financial crisis, the 2009-10 stimulus program, and the monetary tightening since mid-2010.

China's 2008 stimulus program brought little direct benefit to private firms

The first effect of the financial crisis was to dry up export demand, a key source of income for many Zhejiang companies. The subsequent stimulus targeted large-scale infrastructure projects: SOEs were the main beneficiaries, but private firms reoriented much of their own business toward real estate and related sectors. Then in mid-2010 fears of an asset bubble and mounting debt drove central authorities to close off the spigot to real estate, particularly for private firms. As a result, their borrowing costs rose considerably in the latter half of 2010 and throughout 2011. The stimulus also increased demand for raw materials, which meant higher costs for downstream firms, in many cases private enterprises.

As foreign demand fell and raw materials costs rose, firms' basic cost structures were also changing. Wages, already on the rise, jumped even

Not so bad

Private firms' share of selected indicators, % of total

	Zhejiang		National	
	2006	2010	2006	2010
Industrial enterprises	62.9	72.6	49.6	60.3
Employees	47.8	54.5	26.8	34.7
Fixed assets	33.3	41.1	13.2	19.7
Gross industrial output value	65.8	67.8	21.2	30.5
Exports	34.4	42.8	22.1	30.5
Pre-tax profits	30.9	37.1	16.4	28.5

Source: NBS, GK Dragonomics estimates

more with a new labor law in 2008. Steady currency appreciation added to the pain. The cyclical downturn and rising costs hammered Zhejiang's labor-intensive exporters: in the first eight months of 2011, about 22,000 Zhejiang private firms failed, as many as in all of 2008. Yet many consider this painful retrenchment a necessary corrective to a decade of zooming exports and a couple of years of monetary incontinence.

Private firms are still feeling the pinch, but the mood has brightened substantially since the summer of 2011. Larger entrepreneurs believe the province and country have passed through the nadir of the tightening. The cost of capital has fallen; private SMEs that effectively paid 20-25% for loans in 2011 now pay 15%, and bigger companies pay well under 10%.

Some retreat!

Moreover, both interviews and data do not fully support the common view that the private sector has been in retreat since 2008—either in Zhejiang or in the country as a whole. Zhejiang is special: it boasts 139 private-sector firms with annual revenues of at least Rmb5 bn, by far the largest concentration in the country. But though the level of private capital is higher in Zhejiang than elsewhere, the trend toward greater private ownership is equally apparent across the country. By whatever measure you choose—firm numbers, employees, assets, industrial output, export value or profits—the private sector grew substantially between 2006 and 2010, precisely the period when SOEs supposedly made their inroads.

Despite a widespread perception that SOEs have been on the rise in recent years, the private sector grew substantially from 2006-10

When we analyze fixed-asset investment (FAI) by sector, a similar picture emerges. The private sector share of FAI rose in 14 of the 19 sectors from 2006 to 2010; the average for all sectors was an 8 percentage point rise, from 36% to 44%. According to the National Bureau of Statistics, private-sector profits rose 46% year on year in 2011; by contrast, SOE profits rose just 13%. And the private-sector share of new bank loans, though still disproportionately low, is also on the rise—from 26% in 2009 to 30% in 2010. The conclusion seems clear: the private sector is not in retreat, but is continuing to advance. The only question is at what speed.

It would be beyond wishful thinking to attribute the continuing rise of the private sector to active state policy. Some interviewees in Zhejiang praised former provincial Party Secretary (and incoming President) Xi Jinping, along with the current governor Xia Baolong, as being pragmatic

More advance than retreat

Private sector share of fixed-asset investment, %*

Sector	2006	2010	Change, pp
Wholesale/retail	63.1	71.4	8.3
Hotels/restaurants	63.5	70.8	7.3
Manufacturing	52.8	69.0	16.2
Real estate	60.5	55.6	-4.9
Residential services	52.8	48.1	-4.7
Agriculture/forestry/livestock	30.0	42.1	12.1
Mining	23.0	38.3	15.3
Culture/sports/entertainment	22.3	31.5	9.2
Leasing and commercial services	35.0	30.9	-4.1
Construction	38.5	29.5	-9.0
Scientific research, geological survey	15.2	26.9	11.7
Power generation and supply	11.5	15.4	3.9
Finance	8.2	13.4	5.2
Education	10.3	10.8	0.5
Telecoms/computer services/software	4.6	10.7	6.1
Sanitation/social welfare services	10.6	10.4	-0.2
Transportation/savings/postal	4.8	8.6	3.8
Water, environment	5.9	7.6	1.7
Public management/social organizations	4.2	6.9	2.7
Average of all sectors	**35.7**	**43.6**	**7.9**

*Red entries are industries where the private sector's share of fixed asset investment declined from 2006-10
Source: NBS, GaveKal Data

and business friendly. But many others were harshly critical and said that, at best, Communist Party leaders have grudgingly accepted that the private sector is an important—but not *the most* important—component of a modern economy and a stable polity.

A new species: pink capitalists

Private firms manage their relations with the state through strategies that are more cooperative than confrontational

Yet however much they moan about the government's hostile attitude, private companies' day-to-day behavior makes them, as scholar Bruce Dickson noted in his 2010 book of the same name, "allies of the state." Private firms in Zhejiang and elsewhere manage their relations with the state through a variety of economic and political strategies that are frequently more cooperative than confrontational.

To deal with the institutional, cyclical and structural challenges noted above, some private firms simply sell out to competitors, which are frequently bigger SOEs. Many diversify outside their core competencies—mainly into real estate and commodities trading—searching for quick returns. Others outsource the labor-intensive elements of their business to enterprises in less expensive provinces or even southeast Asia. Another option is to expand vertically, up and down the supply chain, to gain new technical capabilities and to control costs. And still others invest more in R&D in order to move up the value-added chain.

Regardless of which business approach they take, virtually every private company has a political strategy as well. It is now standard practice for private entrepreneurs to be Communist Party members and to form Party committees in their firms. Many business leaders have become deputies in a local, provincial or national People's Congress or in the official advisory body, the Chinese People's Political Consultative Conference. None of these bodies are powerful, but they are forums where entrepreneurs can interact with officials, lobby for their companies and industry, and display allegiance to the state. Quite a few private companies are run by former SOE managers or local government officials. A smaller proportion direct their products and services at government customers, and a minority of private firms have formed in-depth partnerships with state-owned counterparts to take advantage of SOEs' access to capital, resources and contracts.

Many business leaders have taken positions in local or national political bodies

Private strategies

Each of these strategies is visible among Zhejiang's private businesses, as the following examples demonstrate:

Neoglory, a large jewelry producer in Yiwu, in central Zhejiang, was founded by the highly entrepreneurial Zhou Xiaoguang. Zhou is one of the country's most active deputies of the National People's Congress (NPC). She has submitted over 400 resolutions and proposals for consideration by her fellow deputies and the government. The foyer of the company's headquarters is festooned with photographs of her with top Chinese leaders, including Xi Jinping. Although her NPC duties are officially only part-time, Zhou must drop everything when the government calls a meeting, no matter what hour of the day. In 2011, Neoglory was one of a small number of private companies approved by the National Development and Reform Commission (NDRC) to issue bonds. Its seven-year, Rmb1.8 bn issue carried an interest rate of 8.1%, less than the firm would have paid for a comparable bank loan.

Based in Wenzhou, **Tsingshan Group** is China's third-largest producer of stainless steel, behind state-owned Taiyuan and Baoshan, against whom it competes for customers in the petrochemicals, construction, auto and machinery industries. Its 10,000 employees produced 1.6m tons of steel products in 2011, generating sales of Rmb32 bn and pre-tax profit of Rmb2.5 bn. After buying firms in Fujian, Guangdong and Henan, and investing in an Indonesian mine, Tsingshan now has over 70 companies under its umbrella. In late 2011 it was approved to set up a stainless steel electronic commodity exchange. Tsingshan seems like an efficient, forward-looking company, but its success likely depends heavily on the fact that former Wenzhou government officials are among its founders.

Look below the surface, and many private companies rely on official connections for their success

Hangzhou-based **Hengyi**, a big producer of chemicals used in textiles, has pursued a strategy of partnering with potential competitors. In 2001 and 2005, it formed joint ventures with two other private firms, and quickly became one of the country's leading producers of PET and PTA, which are used in chemical fibers such as polyester. Last year, Hengyi went a step further and formed an Rmb3.6 bn venture with state-owned petrochemicals giant Sinopec to produce caprolactam (CPL). As it has grown from its base in Hangzhou to open facilities around China, Hengyi has listed on the Shenzhen stock market and issued corporate debt.

Another Hangzhou firm, **Wensli**, is the country's most famous silk maker. Long focused on the domestic consumer market, with a logo eerily similar to that of Hermes and 2011 sales of over Rmb1 bn, Wensli now invests 5% of its income in R&D. But its success may owe as much to the two terms its founder served as an NPC deputy—which may explain why the company dominates the market for ceremonial silk gifts used by local governments, research institutes and universities. In 2011, Wensli was approved by the China Banking Regulatory Commission to open a small finance company.

A marriage built to last?

Marriages of convenience with the Communist party-state are an almost indispensable part of life for private firms

These examples all suggest that making an accommodation with the Communist party-state is indispensable for a private firm's success. But the political transformation of private firms is not absolute: China's entrepreneurs are more pink than red. Their partnership with the Party is a marriage of convenience. The uncertainty surrounding this political variable leads to endemic short-termism. Everywhere I went in Zhejiang private business leaders told me they plan only a couple years into the future. How about five years ahead? That is too far into the murky distance.

Many of these executives are sending their children abroad to study, not just for graduate school or undergraduate degrees, but even for high school. Foreign educations prepare these children for two possible futures: driving the family firms higher with modern management techniques, or starting from scratch abroad if the domestic environment turns sour—or if they simply have no stomach for the political shadow plays their parents performed. At the moment, a hazy social contract ties together China's political and economic elites, enabling the private sector—despite its many disadvantages—to make a steady advance. Yet there is always the risk that this contract might dissolve, leaving private companies, and the economy as a whole, with a questionable future.