Using Ownership Incentives in China
CASE STUDY
December 2011
Case #ILB1002a

By Tamara Carleton

Roy Weber met Cheng Wang, a business consultant and Chinese entrepreneur, at Cheng's hotel bar in Silicon Valley. Although Roy was slightly familiar with Chinese business practices, he welcomed more advice from a Chinese national. Could Roy transplant Silicon Valley's model of employee ownership to China, and what would this process entail for a technology startup?

Business Snapshot

As a seasoned entrepreneur in Silicon Valley, California, Roy was focused on building a new business called PeriRaden (all identifying details have been removed) in the consumer mobile market. In the last two years, Roy had built a small founding team, mainly comprised of a dozen trusted colleagues from previous efforts. This team worked with a handful of contract developers, writers, designers/artists, and student interns on a project basis. This hiring approach allowed Roy to maintain a lean and flexible company in the early years.

PeriRaden's product was developed and tested with beta users in the first year and then gradually adapted for multiple leading mobile platforms, including Apple iPhone, iPad, and Google's Android. The team was not focused exclusively on the American mobile market, recognizing that lucrative opportunities existed in other parts of the world, particularly emerging economies.

In its first year, the startup operated on Roy's personal savings. By the start of the second year, the startup had completed an angel round with three investors, two of whom lived in the U.S. and a third based predominantly in East Asia, that provided for staff salaries and an operational budget.

An Ownership Culture in Silicon Valley

Like most startups in Silicon Valley, Roy used company equity in combination with salary to compensate and motivate his American team. The common stock was distributed to PeriRaden employees and significant advisors with a one-year cliff, five-year vesting period during the second year.

The traditional business practice in the world is to reserve equity for management. However, Silicon Valley has challenged this notion. Since the mid 1900s, Silicon Valley has led other regions and industries in its practice of employee ownership, epitomizing the benefits of sharing the wealth more broadly.

In their book *In the Company of Owners*, Joseph Blasi, Douglas Kruse, and Aaron

Bernstein describe how the practice of employee ownership has defined Silicon Valley's history, starting with technology companies such as Fairchild Semiconductor, Varian Associates, and Hewlett Packard (HP).[1] In those early years, company management initially reserved stock options only for engineers and scientists who had direct impact on a product's success, and then management gradually treated all employees, including line workers, as part owners who could spur creativity and productivity within the company.

This partnership approach spread steadily across Silicon Valley through the 1960s and 1970s, and firms without links to Fairchild or HP accepted the notion of sharing wealth with employees. The change in a company's ownership model also changed company culture. Employees gained more decision-making input about their work, and authority was pushed further down the ranks to ordinary workers. Corporate hierarchies were often flattened, and on the whole, an employee in any new enterprise in Silicon Valley today expects to receive stock ownership.

At PeriRaden, employees embraced the Silicon Valley culture of ownership because they felt that shared responsibility leads to greater potential reward. One senior employee said, "I don't personally have a problem with doing something involving more stock for people, less money as salary. It does tend to make for more motivated staff with more skin in the game."

Growth Opportunities in China

Most of PeriRaden's initial focus had been on the American market, but by the second year, the team had begun testing Chinese translations of mobile content. Based on this success, Roy began to consider the growth potential in China and the value of establishing offices in China in parallel with his U.S. team. With advice from his company's investor from Asia, he knew he could find the resources to scale PeriRaden quickly and tailor their products appropriately for a local market. By the end of the year, he began to discuss the possibility of a Chinese office more earnestly with his board and partners. The board was also highly supportive of bringing in a Chinese team and extending the company's ownership culture.

Roy liked the idea of motivating and retaining a Chinese staff through employee ownership. From experience, he believed that by giving employees a stake in their company, they would have more incentives to work hard and responsively, thus increasing the company's competitiveness in the market. Yet he could not force motivation. He knew that the employees themselves heavily determine successful employee ownership. They have to be responsible and competent participants in their companies. Data and experiences from American companies—including his father's stories about Science Applications International Corporation (SAIC), which rapidly became an $8 billion business due to broad-based employee ownership before its public offering in 2006—clearly indicated that employee ownership alone does not lead to competitive performance, but employee ownership with effective employee participation usually does. Could this lesson also apply to China?

History of Chinese Worker Ownership

Roy knew the practice of employee ownership had a mixed history in China, and he did some more research. Since the 1990s, a model of employee ownership had helped restructure and reform Chinese state-owned enterprises (SOEs), and subsequently, SOEs owned completely or partially by Chinese workers had proliferated, according to the Ohio Employee Ownership Center.[2] By 2001, employee ownership was adopted by about 17 percent of China's large-scale SOEs, based on data from the National Statistical Bureau. This success soon influenced business practices as part of China's transition to a more market-based economy through the next decade.

Employee shares in a company became so popular that they earned a specific name of "internal staff shares" (*neibu zhigonggu*), which soon became dubbed "collective enterprises" (*jitiqiye*). This situation created several problems quickly, including government corruption and illegal trades, often on black securities exchanges, due to the potential to generate short-term returns.

Subsequently, Chinese government policies became more restrictive, and national legislation left little room for stock-based employee ownership to develop in either listed or non-listed stock companies. Further, recent regulations from the State Administration for Foreign Exchange Control (SAFEC) limit Chinese citizens from holdings funds or equities overseas.[3]

Despite the lack of support from the central government, research by a team of Canadian scholars found that Chinese employee shareholders have higher levels of job satisfaction, perceive greater degrees of participation in enterprise decision-making, display stronger organizational commitment, and have more positive attitudes towards the privatization process than non-shareholders in privatized firms.[4]

Further, half of the multinational companies that responded to a 2006 National Association of Stock Plan Professionals survey said that they provide options or other equity awards to most employees in China, based on research by the Australian Employee Ownership Association.[5] Starbucks Corp. is a leading example, extending its "Bean Stock" options program to its Chinese workforce. Large Chinese companies have taken some steps in this direction as well. The Bank of China and the China Construction Bank, two of the four largest banks in the country, have implemented employee share purchase plans, while Huawei, China's top multinational, is employee owned.

A culture of business entrepren-eurship, as understood by Western standards, has grown steadily in the last decade.[6] In response to new opportunities in technology, the Chinese government has begun promoting the value of high-tech entrepreneurship and also established multiple industrial parks throughout the country.

Some obstacles remain today. Chinese entrepreneurs rely on funding mainly from personal savings, family, and friends. Bank loans remain rare, and venture capital is a fledging industry. Entrepreneurs are not accustomed to the idea of writing business plans and approaching VCs. Many of the high-tech ventures are foreign-funded or seek foreign funding due to limited capital resources in China. Also, political uncertainties and an unstable social environment cause many Chinese entrepreneurs to emphasize short-term profits and opportunism instead of long-term strategy.

Moreover, until recently, private business was often perceived negatively within Chinese society, so some preconceptions linger. Scholars Debbie Liao and Philip Sohmen note that traditional Confucian principles often discourage Chinese entrepreneurs in accepting money and sacrificing equity control to strangers.[7] Certain entrepreneurial attributes—such as self-initiative, flexibility, creativity, and a profit-orientation—either do not exist or appear to be in conflict with dominant Chinese values in society. Many entrepreneurs have adapted by relying on interpersonal harmony and personal influence (*guanxi*) in their business relationships to help reduce risk and build trust among their investors, partners, and customers.

Decision Point

With all this in mind, Roy considered providing the same equity structure and policies for all company employees, regardless of office location. He could demonstrate a strong commitment to creating a global organizational culture by valuing each international team on the same equitable terms from the start of the Chinese office's opening.

Over his beer, Cheng Wang told Roy about his past experience and impressions of Chinese workers. Generally, Cheng said that Chinese workers see job opportunities from American and European companies as coming from rich areas, so the workers might have additional demands. The salary packages from these jobs tend to be two to three times higher than similar jobs from private Chinese companies. However, Cheng said that an important distinction exists among the Chinese in terms of their views of compensation. The average worker is focused more on short-term needs, so he would be probably wary basing his package on stock options. Along with salary, these workers prefer other direct cash measures in hand, such as health insurance benefits and subsidies for travel and housing. In contrast, senior employees with more operational experience would be more likely interested in compensation and growth opportunities over time.

Within China's high-tech industry in particular, Cheng noted that it was becoming increasingly common for companies to reward key employees with stock ownership, as well as higher degrees of autonomy and more control of their own work. Cheng said that the Silicon Valley way of working was familiar to many "sea turtles" (*haigui*)—Chinese nationals who studied or worked abroad and then returned back to China. These employees often either helped establish Chinese branches for American or European companies or launched their own competing ventures in China.

Cheng also warned Roy about some related challenges. A high rate of turnover was still common at all job levels, especially among low-to mid-level managers. Many of them would not appreciate the long-term value of equity because they were focused on the practical considerations of the "here and now". Another concern could be that Roy's Chinese team might perceive him as taking an American-dominated approach, neglecting the unique business values and management styles in China.

Cheng's advice left Roy considering what other options he could take and their respective implications to growing PeriRaden's business in the coming years.

Discussion Questions

1. How could PeriRaden's founder and CEO export a local culture of employee ownership to China?
2. What factors affect Roy Weber's decision to offer the Chinese team similar company ownership as the Silicon Valley team?
3. Does an ownership culture necessarily require stock ownership by employees?
4. What questions should Roy ask, and also of whom, to better evaluate this opportunity?
5. How should Roy prepare his American team, who've worked diligently to build PeriRaden to this point?
6. Were there any concerns in expanding an employee ownership culture, emblematic of Silicon Valley startups, overseas to China?
7. Lastly, how might Roy's decisions look in five years or more?

References

[1] Blasi, J., Kruse, D., & Bernstein, A. (2003). *In the Company of Owners: The Truth About Stock Options (and Why Every Employee Should Have Them)*. New York, NY: Basic Books.

[2] Zhang, G., & Logan, J. (2003). Employee ownership Chinese style: Gradualism, regionalism, and market-oriented reform. Working paper for the Ohio Employee Ownership Center, Kent State University, Ohio. Available at http://cog.kent.edu/lib/Logue&Zhangesopchina.htm

[3] R. Weiner, personal communication, November 28, 2010.

[4] Dong, X., Bowles, P., and Ho, S. P. S. (2002). Share ownership and employee attitudes: Some evidence from China's postprivatization rural industry. *Journal of Comparative Economics, 30*: 812–835.

[5] Australian Employee Ownership Association. (2008). Employee ownership around the globe. Working paper for the Australian Employee Ownership Association, Sydney, Australia. Available at http://www.aeoa.org.au/docs/0024/Employee%20Ownership%20Around%20The%20Globe.pdf

[6] Liao, D., & Sohmen, P. (2001). The development of modern entrepreneurship in China. *Stanford Journal of East Asian Affairs, 1*: 27-33.

[7] Ibid.