

Using Ownership Incentives in China

TEACHING NOTE

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Case Synopsis

A Silicon Valley startup called PeriRaden (not its real name) has built a new product in the mobile consumer space. Over the last two years, the founder and CEO Roy Weber funded the startup through personal savings and an angel round of investment. A dozen employees receive varying levels of salary and equity in the new company, which is a common practice for new ventures in Silicon Valley. Roy would like to expand PeriRaden's operations into the Chinese market. With the support of the board, he plans to open a Chinese office and extend the ownership culture to the new staff in order to better motivate and retain them. Could he transplant Silicon Valley's model of employee ownership without alienating his American team and complicating emerging operations in China?

Courses and Levels

This case is suitable for use in an upper-division undergraduate, graduate, or executive education course in small business/entrepreneurship, organizational development and change, or high-technology management, as well as in a course module on startup financing, forms of broad-based employee ownership including employee stock ownership plans (ESOPs), or international operations.

Teaching and Learning Objectives

After studying and discussing the case, students should be able to:

- Describe the central issues in employee ownership facing PeriRaden's founder-CEO and his investors
- Understand the general history of Silicon Valley and China in regards to corporate equity and ownership practices
- Generate and evaluate options for maintaining a high involvement ownership culture among workers, while achieving revenue and profitability growth
- Identify the stakeholders in an organizational decision and determine their interests in a multi-cultural context

Research Methodology & Funding

This case is based on field research conducted at PeriRaden (not the company's real name) as part of a broader research program. All identifying details were removed at the request of company management. The author interviewed the founder-CEO, two investors,

Case Teaching Note: Using Ownership Incentives in China

and five employees. She also toured the company's facilities in Silicon Valley, California. The company made available numerous internal documents.

Funding for development of the case was provided by the Foundation for Enterprise Development (FED). The foundation's mission is "promote the concept of broad-based, participative employee ownership and entrepreneurship." Further information about FED is available online at: <http://www.fed.org>. The author is grateful to FED for their support.

Additional case review was provided by Ken Megill, advisor of organizational work and worker practices; Loren Rodgers, executive director at the National Center for Employee Ownership; Rebecca Weiner, a member of the National Committee on U.S.–China Relations and of the U.S.–China Business Council; and Xie Yu, co-founder and general manager of Shanghai Xuhua Optics, Co., Ltd. All final errors remain with the author.

Teaching Plan

A teaching plan for a standard 75-minute class follows. The plan adopts the case method format, which encourages students to actively discuss and reflect on a real-world issue facing an actual company based on facts summarized in a case study.

Following the instructors' facilitation, students may respond as individuals or break up into teams for small group discussion. A class taught by the case method is only as good as the quality of the discussion, which depends on several factors: how well students have prepared the case, how much experience they have, how many students are in the class, and how the instructors manage class time.

Students must not merely summarize the case. The case presents enough information so that students can understand the basics of the problem, analyze contributing factors, and suggest potential solutions. Students who are new to case analysis should take the following steps:

- Identify the most important facts surrounding the case
- Identify the key issue or issues
- Specify alternative courses of action
- Evaluate each course of action
- Recommend the best course of action

Case Themes

Several dominant themes emerge in the case, which are as follows:

- **Entrepreneurship:** Entrepreneurship is the process of starting and running one's own business. Silicon Valley is considered to be the global leader in innovation, ranking #1 in nearly all regional reports (often measured by patent filings). Rates of entrepreneurship are high in Silicon Valley, particularly in high-tech industries, in which most new businesses are funded by venture capital. In contrast, China is often considered state-directed capitalism, in which government regulation is a huge barrier for new business creation. In practice, multiple small enterprises have been steadily flourishing in China; however, entrepreneurship in China takes many

Case Teaching Note: Using Ownership Incentives in China

different forms, ranging from self-employed street vendors to state-owned enterprises (SOEs).

- **Risk and opportunity:** As we know from experience, different people view risk and opportunity differently. In Silicon Valley, there is a willingness to celebrate failure and to both embrace and minimize risk in pursuit of a compelling opportunity. The prevailing belief is to see failure as a sign of success, as entrepreneurs learn from their mistakes. Workers in Silicon Valley are open to working at startups because they see the potential for great reward. In other parts of the world, risk is seen negatively, and failure in business can stall careers and even lead to public shame.
- **Organizational culture:** Organizational culture sets the tone of the workplace environment. Formed by the shared values and behaviors of management and employees, organizational culture is created, maintained, or transformed by people. Culture directly affects a company's strategy, hiring practices, and the personality of its products. In startups, work culture is often defined by the founder and then reinforced by the founding team. Common adjectives used for a startup culture include: "highly dynamic", "focused execution", and "obsessed".

Summary of Discussion Questions

The closing questions from the case are summarized below with possible answers. Additional questions may be raised among students to help them understand the issues in the case.

1. *How could PeriRaden's founder and CEO export a local culture of employee ownership?*

Multiple options exist, and not all options require equity compensation for foreign employees. Four different options are as follows:

- a) The founder provides the same equity structure and policies for all company employees, regardless of office location. In this option, he demonstrates a commitment to creating a global organizational culture by valuing each international team on the same equitable terms from the start of the office's opening. One drawback is that his Chinese team may perceive him as taking an American-dominated approach, which neglects Chinese business values and management styles.
- b) The founder modifies the equity structure based on regional location. In this option, he can efficiently accommodate local tax regulations and cultural needs, as well as establish a flexible ownership structure when PeriRaden opens additional offices in other countries. One drawback is that he increases the complexity of his company's accounting and tax reporting.

Case Teaching Note: Using Ownership Incentives in China

- c) The founder offers stock options only to the American staff and relies on different mechanisms to build a culture of loyalty and ownership among the Chinese staff. In this option, he separates financial ownership from psychological ownership and relies on the local team instead to propose and develop their group’s own incentive structure. One drawback is that the American team may react with its own demands.

- d) The founder decides not to hire local staff immediately and instead transfers several of his employees temporarily to launch a new Chinese office. These American employees will hire, train, and gradually build a Chinese team who understands how to work with them. While workers are empowered to influence office strategy and decisions, no equity options are offered in PeriRaden. In this option, the founder addresses his limited experience in China by relying on staff he already knows and trusts. Some drawbacks are that the American employees are equally, if not more, inexperienced with Chinese business operations and culture, and their time in China takes away from their efforts to develop other markets.

Of course, other options are possible. As the discussion proceeds, the instructor may wish to summarize the key points for the three options noted above on the board. Sample board work follows:

OPTION	PROS	CONS
a) Apply same equity structure for all company offices	<ul style="list-style-type: none"> • Shows commitment to a global company culture • Values each country team on same terms 	<ul style="list-style-type: none"> • Seen as U.S.-centric management approach
b) Modify the equity structure based on regional location	<ul style="list-style-type: none"> • Accommodates local tax regulations and cultural needs • Establishes a flexible ownership structure for other future offices 	<ul style="list-style-type: none"> • Complicates accounting and tax reporting
c) Use different ownership mechanisms for the Chinese staff	<ul style="list-style-type: none"> • Separates financial from psychological ownership • Relies on local team to define own incentives 	<ul style="list-style-type: none"> • May provoke U.S. team to react with own demands
d) Transfer several U.S. employees temporarily to launch a new Chinese office	<ul style="list-style-type: none"> • Relies on existing staff to build a complementary team and culture in China 	<ul style="list-style-type: none"> • Denies similar equity rights to global staff • May be limited by U.S. staff experience of China • Takes staff away from other company business

Case Teaching Note: Using Ownership Incentives in China

2. *What factors affect Roy Weber's decision to offer the Chinese team similar company ownership as the Silicon Valley team?*

The founder's decision depends on several factors, such as:

- Long-term and short-term business goals
- Available company revenues and expected growth
- Support from PeriRaden's Board of Directors
- Tax and legal regulations for equity compensation in the U.S. and China
- Number of employees expected to hire
- Job responsibilities and expertise levels of new hires
- Expected reactions of current employees

3. *Does an ownership culture necessarily require stock ownership by employees?*

No, giving stock options and grants does not automatically foster deep commitment in staff. How people think about their stock options (and grants) affects how they think about the company, too. In academic terms, financial ownership needs to be matched by psychological ownership.

Building an ownership culture relies on employee participation in work decisions. At its most basic level, participatory management is the practice of empowering employees to contribute to decision making within the company. These decisions are not executive decisions because soliciting employee input at this high level has limited impact in building an ownership culture. Instead, the issue is about how much control employees have on decisions about how their work is done more than what the company does strategically. As employees become more involved in work-related decisions, studies show that they feel more vested within their respective company.

Moreover, not all employees wish to be shareholders, even within a startup environment. Employee ownership requires a greater sense of personal responsibility, and not everyone desires extra commitment or will buy in at the same degree. Strategic employees are willing to do more to grow the company and, subsequently, could be rewarded accordingly by the startup's founders and management. General employees may simply desire job security. This observation is consistent with scholarly research, which shows that 22 percent of employees simply prefer a classic worker's contract.¹

4. *What questions should Roy ask, and also of whom, to better evaluate this opportunity?*

As part of his decision-making, PeriRaden's founder could ask himself:

- How much of the company's stock pool (either in a reward range or a percentage of total equity) should he share with new employees?
- What combination of merit, salary, or some other formula should the new equity awards be based on?
- Should all employees or only "key" performers receive stock options upon hire?

Case Teaching Note: Using Ownership Incentives in China

- After each employee's start date, how frequently should stock options be offered and at what intervals?
- Even if many employees buy shares, will the distribution of ownership be enough to create a real stake in the outcome for most people?
- Who within his company will monitor and track employee compensation, and does the current employee handling hiring procedures have sufficient knowledge and skills?

The founder could ask his investors the following questions to ensure their support:

- What does an ownership culture mean to them?
- Do they have about any concerns about non-U.S. employee shareholders?
- What performance metrics would they like to see for new hires in China?
- If specified performance targets are met, would they support accelerated vesting for employees?
- Have they worked previously with professional advisors in employee ownership?

He may also consider turning to experts in Chinese business and ask them:

- What do Chinese employees typically expect and also receive for a total compensation package, and does that package change by job level?
- What would Chinese employees consider fair ownership stakes in a startup?
- What type of hiring guidelines should he develop for Chinese managers who would champion a positive culture of employee ownership?
- As a form of reverse exporting, should the founder bring the early employees of his Chinese office to the company's headquarters?

5. *How should Roy prepare his American team, who've worked diligently to build PeriRaden to this point?*

In order to build a lasting and healthy culture, studies show that the values of employee ownership must be embedded in a company from the start. Even as staff priorities change, the management team is responsible for communicating the importance of employee ownership, so that it becomes a perpetual message. Not only should employees be rewarded financially at regular intervals, they should also hear continually from management about the other rewards of ownership, including intangible benefits. Open communication is critical to sustaining effective ownership cultures within organizations.

The founder could begin with any combination of these communication tactics:

- Informal or formal staff meeting
- Email announcement
- Information pamphlet
- Company-wide voice mail
- Open door policy for impromptu questions

Case Teaching Note: Using Ownership Incentives in China

- Employee training sessions
- New employee orientation meetings
- Employee role-play exercises

Overall, communication messages should be simple, straightforward, and genuine. The founder should speak in clear concise terms so employees understand the situation. Employees talk with one another, so it is important they communicate accurate information. In particular, if the ownership plan is designed to engage employees in improving PeriRaden's business as mutual shareholders, then the founder's communication goals should include some basic business education. The content will depend on how well employees already understand core issues, such as business strategy, financial statements, and performance improvement goals.

6. *Were there any concerns in expanding an employee ownership culture, emblematic of Silicon Valley startups, overseas to China?*

The founder should note a variety of potential concerns, including:

- Stock options are often difficult to value.
- Silicon Valley has its own unique business culture, which may not work well out of context.
- China's business culture is complex with strict and changing tax regulations.
- Chinese managers and workers may perceive the equity structure for Silicon Valley startups to be excessive risk taking.
- Employees' loyalty might last only until their stock options mature.
- Individual effort is typically dependent on the collective output of all employees and management for a bonus.
- The amounts of stock options may vary year to year for reasons possibly unrelated to employee performance and more generally to overall market growth, which can be difficult to link to individual performance metrics.
- Dilution can be very costly to shareholders over the long run.

7. *How might Roy's decisions look in five years or more?*

The future scenario will depend, of course, on which option PeriRaden's founder select. Some considerations will include the rate of stock growth, potential dilution among employees (creating the perception of "haves" and "have not's"), integration between American and Chinese employees, and actual market growth for China.

Additional Readings

Those teaching about employee ownership, or specifically entrepreneurship in China, may find the following resources helpful, as they plan to teach this case:

Case Teaching Note: Using Ownership Incentives in China

Equity Planning

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Ownership Culture

1. Beyster, J. R., & Economy, P. (2007). *The SAIC Solution: How We Built an \$8 Billion Employee-Owned Technology Company*. Hoboken, N.J.: John Wiley & Sons
2. 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.
3. Rosen, C., Case, J., & Staubus, M. (2005). "Every Employee an Owner. Really." *Harvard Business Review*, 83(6): 122-130.

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1. Gongyun, S. (2001). "ESOPs in a transitional economy: The China case." Working paper for the Ohio Employee Ownership Center, Kent State University, Ohio. Available at <http://cog.kent.edu/lib/SituConferencePaper.htm>
2. Liao, D., & Sohmen, P. (2001). "The development of modern entrepreneurship in China." *Stanford Journal of East Asian Affairs*, 1: 27-33.
3. Sull, D. N., & Wang, Y. (2005). *Made in China: What Western Managers Can Learn From Trailblazing Chinese Entrepreneurs*. Boston, MA: Harvard Business School Press.
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Case Epilogue

As of the case writing, PeriRaden's founder and CEO was reviewing different options with his company's investors and advisors in tandem with the next round of investment.

References

¹ Kruse, D. L., Blasi, J. R., & Park, R. (2010). Shared capitalism in the US economy: Prevalence, characteristics, and employee views of financial participation in enterprises. In D.L. Kruse, R. B. Freeman, & J. R. Blasi (Eds.), *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-Based Stock Options*. Chicago, IL: University of Chicago Press.