Asialink Business

China's New Economic Crisis: Keeping the family business

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China is facing a new economic crisis, and it is not about mounting local debt or even a rapidly slowing property market. The crisis in the making is about family business succession in the world's second-largest economy.

Why is family succession so important? What implications does it have for the business communities in both China and Australia?

We have to start by debunking one of the most enduring misunderstandings about the Chinese economy. Many people think it is dominated by state-owned enterprises, but this could not be further from the truth.

"Cultural differences between first generation entrepreneurs and their children could not be greater."

Nicholas Lardy, a leading China economist at the Washington-based think tank, the Peterson Institute for International Economics, estimates private enterprises in China account for two-thirds of total output, up from zero a few decades ago when private business was outlawed.

Chinese official statistics tell a similar story. The country has 7.4 million private enterprises and family businesses account for 85.4 per cent of them. More than one third of China's listed companies are family controlled, not to mention China's 34 million strong family-based individual businesses.

The state sector only accounts for between one third and one quarter of GDP. In manufacturing, which represents about 41 per cent of GDP, state-owned enterprises only account for 20 per cent of output.

These privately-owned family businesses are facing succession issues roughly at the same time – an unprecedented phenomenon in the world of family business. All private businesses started more than three decades ago, when China abandoned its Maoist ideological craze in favour of market reform. Those brave entrepreneurs who embraced the market are fast approaching retirement age.

According to a white paper released by *Fortune Generation*, a magazine affiliated with China Relay, an exclusive club made up of children from the country's most powerful and richest private sector tycoons, Chinese family business faces a looming succession crisis in five to 10 years' time.

Chinese authorities also estimate there are about three million family businesses that are either facing the problem of succession or will face the challenge soon.

The succession crisis is happening at a time when China's privately-controlled manufacturing sector is under unprecedented pressure to move away from its labour-intensive production model, which is unsustainable in the light of soaring wage increases.

Mao Li Xiang, the chairman of Fotile Group, the country's leading producer of kitchen appliances, warns that the succession crisis has the potential to be more destructive than the global financial crisis. *Fortune Generation*'s white paper estimates that only 8 per cent of family companies have successfully managed to pass on the baton to the next generation.

Family succession is not an easy issue to deal with anywhere in the world, and the problem is particularly acute in China. Fewer than 30 per cent of family businesses around the world survive the third generation as family-owned businesses, according to a 2010 McKinsey study.

Cultural differences between first generation entrepreneurs and their children could not be greater.

Nearly all of China's elder business people grew up during the turbulence of Maoist China, when there was a shortage of everything. Many endured starvation and years of languishing in the countryside for so-called "re-education". Many of these early entrepreneurs don't have much formal education. Their successes have relied on their drive, instincts and entrepreneurship.

But, in sharp contrast, 88 per cent of their children have university degrees and 52 per cent of them have studied overseas, including at many leading institutions such as Harvard, Wharton and the London School of Economics.

Members of the overseas-educated second generation often clash with their parents over the management of their companies. The children are keen to introduce advanced Western management systems to their family businesses, against the wishes of their parents. The children's push to modernise these businesses is often viewed with suspicion, as the parents believe many Western practices are incompatible with the reality of doing business in China.

The first-generation entrepreneurs also operate under a very different value system than their children, who have grown up only knowing affluence. Many Western-educated second-generation children also don't like dealing with government officials, which is a necessary evil in the Chinese business world.

Kelly Zong, the only child and heiress to the multi-billion-dollar Wahaha fortune recently publicly criticised China's social ills. "I think we lost our soul. In the US, they have beliefs: Christianity and Catholicism. China has Buddhism, but I don't think people really believe it in their heart," she told The Guardian.

Two days after the interview, her father Zong Qinghou, one of China's most powerful tycoons, rebuked his daughter in the Chinese media, saying she was influenced by foreign culture when young and was not clear about the present situation in China.

The painful transition is particularly evident in the manufacturing industry; many children who are educated abroad shun the manufacturing sector and prefer to seek opportunities in finance and other "cool" areas.

Fortune Generation estimates more than 65 per cent of children whose parents own manufacturing businesses don't want to be involved in the industry.

This could potentially evolve into a large problem, with economy-wide significance, if China's family-dominated manufacturing sector fails to find enough successors to carry on the businesses.

However, it is not all doom and gloom, and there are examples where second-generation business people have risen to the occasion, taking on the challenge of running a family business.

"The family succession issue has broader implications for the Australian business community as it seeks to engage with China."

One such person is Australian-educated Chen Danxia, who is expected to lead the Guangzhou-based Liby Group, the market leader in selling consumer goods such as cleaning agents and personal care products.

She has acquired and rejuvenated an ailing cosmetic brand in Shanghai, adding it to the family fortune. The heiress also took advantage of the global financial crisis to acquire Western brands, including those from Australia.

The family succession issue has broader implications for the Australian business community as it seeks to engage with China. Many heirs and heiresses to China's family businesses are looking to get out of traditional manufacturing in favour of new and emerging industries.

The white paper has identified 10 emerging industries that are widely popular with the second generation of young business people. These include 3D printing, the entertainment industry, e-commerce, organic farming, software development and branded fashion.

Australian businesses in these sectors should seek more proactive engagement with those in the second generation of Chinese business people who are looking for ways to diversify family businesses. This is a unique opportunity to get a foothold in China's most dynamic sector.

The easiest and best way to start is at Australia's higher education institutions. A considerable number of second-generation business people are either studying, or have studied, in Australia. Cultivating school ties with future Chinese business leaders is an effective way of building relationships or 'guanxi'.

A good example is Chen of Liby Group, who is a graduate of Sydney University. Her Australian connection has led her to become a distributor for local boutique cosmetics brands in the world's largest consumer market, using her family business's vast distribution network.

The heiress to one of China's largest real estate fortunes, Central China Real Estate Limited, is also an Australian graduate and a long-term resident of Sydney. Though she is not interested in succeeding her father at the helm of the company, she is nevertheless interested in philanthropic works furthering bilateral relations.

The looming succession crisis also presents an opportunity for the Australian financial services industry. For people who are not interested in succeeding their parents, wealth preservation will become a top priority. There is already intense competition for their money among Hong Kong-based private bankers.

Given that Australia is a favourite destination for business people to relocate their families as well as part of their assets, Australian banks and wealth management companies can expect to play a more active role in managing the fortunes of Chinese family businesses.

Chinese family businesses are also increasingly drawn to the idea of creating family offices to manage their money, especially when children are not interested in working in their businesses.

According to a recent survey by Eureka Report, Australia has 250 family offices that manage about $230 billion in assets.

Australian family offices could very well play a role in managing estate planning and family governance, as well as generational succession for Chinese family businesses and especially those with strong connections to Australia.

The challenge of Chinese family succession is unprecedented in modern business history. It is taking place at a time when the economy is undergoing fundamental restructuring as the country's demographic dividend dries up. There is a considerable risk that intergenerational succession could disrupt the restructuring of the manufacturing industry, which is largely family-owned.

At the same time, better-educated (including Western-educated) second generations could bring fresh new ideas and international connections to their family businesses. This is where Australia's business community has a role to play in helping them to meet the challenges.

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