The Deal

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Crumbling wall

by Shu-Ching Jean Chen

The cradle of Chinese entrepreneurship rocks in an unlikely location. Amid hilly landscapes of tea plantations and scenic lakes nestled in a corridor where the Yangtze River meets the South China Sea, a group of indigenous entrepreneurs have thrived in the shadow of a state-dominated economy.

Arthur Giron

In the nearly three decades since Deng Xiaoping set China on a blazing path toward economic liberalization, the densely populated Zhejiang province on China's east coast has created the country's largest private economy. Zhejiang, about the size of Maine but with a population of 46 million, is a microcosm of the market-led economy that Beijing is increasingly attempting to foster across China.

The province has lured Western investors such as Warburg Pincus and J.P. Morgan Chase & Co. It has its homegrown stars, such as Alibaba.com Corp., China's largest online marketplace, founded and presided over by local businessman Jack Ma — which last year received a $1 billion investment from Sunnyvale, Calif.-based Yahoo! Inc. — and China's largest privately automaker, Zhejiang Geely Automotive Co., whose showing at the Detroit Auto Show earlier this year underlines its audacious attempt to break into the North American car market.

But for every giant, there are thousands of small and medium-sized enterprises churning out shoes, textiles, leather, electronics gadgets and other manufactured and high-tech goods.

Zhejiang also illustrates a dark side to Chinese liberalization: the widening gap that separates it and other entrepreneurial hotbeds such as nearby Jiangsu, Shandong in the north and Guangdong in the south, from poor, mostly rural provinces. Zhejiang's economic output is fourth behind these other provinces, but it boasted the nation's highest per capita income of $3,363 in 2005, more than triple the national average, placing Zhejiang at least a decade ahead of much of the rest of China.

Once considered an economic backwater for its lack of natural resources, Zhejiang is best known as home to one of China's ancient capitals and its long line of classical writers and poets. It has never been on Beijing's radar in locating strategically important state-owned enterprises, the lifeline of China's local economies until the socialized system began crumbling a decade ago. Zhejiang's success was largely unintended, since Beijing's policies have been aimed at creating special economic zones in the south, where foreign investors are given tax incentives to manufacture products for export, rather than in fostering homegrown entrepreneurs.

Beijing's neglect turned out to be Zhejiang's blessing because it allowed local government leeway to encourage private and foreign investment. Its reform-minded governor, Lu Zushan, is even tipped as a possible successor to China president Hu Jintao. In the past eight years, Zhejiang has topped the country's 31 provinces in having the highest production value from private enterprise. Private companies were responsible for more than 90% of employment and 71.5% of the province's 956 billion renminbi ($118 billion) economic output in 2005, a proportion far higher than any other Chinese province and administrative region.

Along the way, Zhejiang's entrepreneurs have evoked awe and fear in Communist China for their relentless pursuit of capitalist dealmaking. Chinese bookstores even feature popular books aimed at deciphering their success. And in April, a delegation of Beijing officials visited Zhejiang in an effort to lure the province's businessmen into investing in the capital's state-owned entities.

What began as scores of small and medium enterprises until a few years ago have now ridden China's sizzling economic growth to become some of the country's biggest conglomerates. They also serve as the main drivers behind China's domestic M&A scene in recent years and have been at the forefront of testing offshore boundaries. In 2001, for instance, Holley Group Co. Ltd., the country's largest utility meter maker, acquired the code division multiple access, or CDMA, mobile phone design operation of Philips Semiconductors Inc. For several years, auto parts maker Wanxiang Group Co. has been buying U.S. Midwestern counterparts as a way to gain insights into Western technologies and management. Wanxiang is setting its sights on more targets, including the distressed assets of U.S. auto parts giant Delphi Corp., which is operating under bankruptcy protection.

In 1998, Feiyue Group Co. Ltd., a sewing machine maker, bought a small bankrupt Japanese peer and a Zhejiang province-based rival to form China's largest sewing machine company. And in April, Feiyue, which aspires to be the world's largest sewing machine maker, agreed to buy 50% of Italy's Mifra Srl, an electronic knitting machines maker, for an undisclosed price.

Meanwhile, Hisun (Group) Corp. Co. Ltd., a conglomerate spanning the textile, electronics, electrical and mechanical industries as well as real estate with more than 20 subsidiaries, invested $5 million in 2005, buying Germany's brand-name textile machinery maker Grosse JAC Webereimaschinen GmbH.

In other foreign investment developments, Singapore's United Overseas Bank Ltd. is seeking to buy into a Zhejiang bank, sources say. The Hong Kong International Airport last year paid Rmb1.9 billion for a 35% stake in Zhejiang's main airfield, Hangzhou Xiaoshan International Airport, a transaction still being vetted by regulators.

And the World Bank's private investment arm, International Finance Corp., agreed to invest up to $30 million in 2004 to take an equity stake in China Green Energy Ltd., a power plant developer.

Foreign private equity investors are also taking notice, albeit at a slower pace than in Guangdong and Jiangsu, both of whose economies are powered by foreign multinationals rather than domestic enterprises.

In January, New York-based J.P. Morgan Partners LLC joined Stark Investments Ltd., a British investment firm, in investing $150 million in Zhejiang's largest real estate developer, China Greentown Group.

Warburg Pincus, the most active financial investor in the province, invested $22 million in 2003 for an undisclosed stake in Zhejiang-based Kasen International Holdings Ltd., China's largest maker of leather furniture and car seats. The New York private equity investor floated Kasen on the Hong Kong stock exchange, selling HK$775.8 million ($99.5 million) worth of shares in October. And last year, Warburg invested $12 million for a 40% stake in a Zhejiang department store, Intime Department Store Group Ltd.

Zhejiang's emerging private sector is at a crossroads as it hits the limits of domestic Chinese resources. China's accession to the World Trade Organization, which has eased foreign access to China's domestic markets, is also forcing Zhejiang's entrepreneurs to look abroad. "Foreign companies are coming to our markets. We also have to expand overseas," says Huang Yong, vice director at the Zhejiang Development and Reform Commission. "We have very limited natural resources here, which make it all the more important for us to tap international markets."

That's why a government-led investment promotion delegation is scheduled this month to meet investors in New York following a similar trip last year to Paris. The meetings are sponsored by Citigroup Inc., Goldman, Sachs & Co. and the Nasdaq, which has been eagerly courting Chinese companies to list.

Zhejiang's "Go Out" policy echoes the state-sponsored push for China's big state enterprises in the energy and telecommunications industries. Both on the central and local levels, the policy is aimed at tapping foreign natural resources, developing overseas distribution channels and obtaining foreign technology through joint ventures and mergers and acquisitions.

"It's been tough for private companies to develop on their own, particularly because banks can recall their loans anytime," says Ding Minzhe, director at the Zhejiang provincial finance affairs office.

The rise of Zhejiang's private sector is most evident in banking, a sector Beijing considers strategic and guards from foreign control. Most of the province's banking sector is already in Chinese hands. Among local groups that have acquired all 26 local cooperative banks from local Zhejiang governments in recent years is China Guangsha Group, a conglomerate with interests in real estate, hotels, tourism, media, energy, education, healthcare and finance.

Of Zhejiang's eight city commercial banks, only two are still controlled by local governments. One, Hangzhou City Commercial Bank, has found a strategic investor in Sydney-based Commonwealth Bank of Australia, which owns a 19.9% stake, the maximum allowed to a single foreign investor. The other, Ningpo Commercial Bank, is in talks with foreign investors, officials say. "Our next medium- and long-term goal is to push for stock market listings for the best local banks at the best possible timing," Minzhe says.

It's not just banks that aspire to go public. Some 107 Zhejiang companies are listed, 19 in Hong Kong and Singapore, the rest on mainland China's two exchanges. About a dozen other Zhejiang companies have applied for IPOs in Hong Kong and Singapore. "The pattern is for them to have strategic investors first, followed by an IPO," Minzhe adds.

Zhejiang's private sector tends to cluster around a city or township, each typically with its own specialization. There are about 600 such economic clusters in Zhejiang, 200 more than a decade ago, each generating annual average revenue of about Rmb100 million, with 35 of them taking in 10 times that much.

There is an entire town between Wenzhou city and Shanghai devoted to making low-voltage electric transformers for use in electricity distribution grids. Another town produces buttons for clothing, while Shaoxing city specializes in manufacturing men's ties. This concentration of labor has helped Zhejiang set records; it is the world's largest production base for cigarette lighters and textile fabrics, for instance.

Zhejiang's 359,000 officially registered private companies comprise mainly bricks-and-mortar industries. Two companies, both based in Zhejiang's provincial capital city of Hangzhou, are looking abroad for new prospects: Holley Group, a conglomerate with more than 20% of the national electricity meter maker market and the world's largest meter maker by quantity, and Insigma Technology Co. Ltd., a computer software maker and distributor built from a series of mergers and acquisitions.

A classic Zhejiang success story, Holley has built a sprawling empire with 13,000 employees, $1.5 billion in 2005 sales in no less than eight businesses ranging from electricity metering, pharmaceuticals, telecommunication, real estate, mobile telephone manufacturing and financial investments.

But the group, which chairman Richard Wang carved out of a 36-year-old, money-losing state enterprise making bamboo umbrella backbones, has been losing its way, and its first-generation management team is now aging.

The company is halfway through a three-year revamp kick-started when Wang brought in a 43-year-old Canadian Chinese, Kate Qiu-Yi Zhang, who took a three-year break from PSA Peugeot Citroën SA to serve as chief strategy officer. "We want to be China's GE," Zhang says. "In 10 years, we'd like to be a multisector worldwide holding company with diversified industrial interests based in strong financial and investment management."

Holley also recently hired Baker & McKenzie LLP to advise on the legal aspects of its foreign investments and partnerships. It's been in talks with foreign investment banks to cash out of maturing operations in real estate, mobile handset manufacturing, printed circuit boards and chemicals by selling stakes to foreign investors. It has chosen the Chinese herbal drug business as a core business and has begun investing in emerging business opportunities in oil, mining and financial services, both in China and abroad.

Holley's goal: to derive as much as 30% of $3.5 billion in sales from overseas by 2010, up from 20% now.

Holley's metamorphosis underlines the transition currently under way at many other indigenous private Chinese companies. "In the past 20 years, Holley had no problem marketing as long as there were good products. There were times when trucks lned up outside waiting for our meters," says Zhang. "Now the competition is coming, and the rules are different from what they were in the purely domestic market of the past."

With little access to Chinese bank loans, which generally focus on consumer rather than corporate lending, Holley relies on cash flows from real estate for funding investments. But that has become insufficient, and it wants to tap international capital markets.

"We need to get access to capital markets. To be a good worldwide holding company, we need to be a great player in the capital and investment markets," Zhang says.

Across town, Insigma is building international credibility by supplying its products to well-known foreign clients, including Boston-based financial services provider State Street Corp., in a direct challenge to Indian rivals that dominate that market. The fully liberalized software market in China lured giants such as IBM Corp. and Ingram Micro Inc. more than a decade ago, presenting stiff competition to homegrown technology companies. "We have to have an impressive track record in the international markets before we can come back to China and win important clients," says Sun Jianhua, an Insigma vice president. Higher margins in foreign markets such as the U.S., almost double that in China, also provide a more lucrative source of income than China, he adds.

The company entered the software outsourcing industry in 2002, when it acquired three Beijing-based companies that export to Japan, making it a top player overnight. It now counts the Tokyo Stock Exchange Inc., Nomura Securities Co. Ltd. and Fuji Electric Systems Co. Ltd. as customers.

Insigma was created in a 2001 merger of nearly 20 ventures founded by Zhejiang University. It soon launched an audacious takeover of a listed company, a Zhejiang-based feather down maker, then used it as an acquisition vehicle to build up in software. In September 2005, it caught the attention of Tang Industries Inc., a private Las Vegas-based diversified group founded by a Chinese immigrant, which bought 20%.

Insigma, too, is considering various arrangements with foreign partners, including sales of an equity stake in its software distribution agency business. It is negotiating with Japanese companies, including Hitachi Ltd., to take a stake in an affiliate outsourcing company, Beijing Innovation Software Technology Co. Ltd. It also has formed two joint ventures with Fuji Electric Systems Co. Ltd. in Tokyo and Hangzhou.

With hundreds of Chinese software companies, consolidation is expected, and Tang's purchase reminds Insigma that it may itself be a target. Insigma, with Zhejiang University owning less than 16%, worries about falling victim to a hostile takeover. Jianhua says it is trying to enlist the group's more than 20 subsidiaries to take a stake in Insigma that would mimic Japan's watertight cross-shareholding model.

Zhejiang is betting on companies like Insigma and Holley. Fu Duer, vice director general at Zhejiang's Foreign Trade and Economic Cooperation Bureau, says the province already has direct trade with 200 countries. It's set a 15% economic growth target in 2006.

As the economy grows, Zhejiang is refining its focus. Duer says the government is encouraging entrepreneurs to move up the economic food chain to high-tech industries such as software. A state-sponsored software park is already home to 14 listed companies.

Duer says the province is also discouraging polluting industries such as printing and dying from setting up in Zhejiang. "Our strategy to go global is not just because of our own aspirations and ambition. Rising competition at home is forcing us to go out and be strong," says Duer.