ISCTE Business School
Instituto Universitário de Lisboa

Social Capital and Management Innovation: The Case Studies of two Chinese Private SMEs

QIN Lang

Thesis submitted as partial requirement for the conferral of

Doctor of Management

Supervisor:

Professor Virgínia Trigo, Associate Professor of ISCTE-IUL, Departamento de Recursos Humanos e Comportamento Organizacional

Co-supervisor:
Professor ZENG Yong, Full Professor of University of Electronic Science and Technology of China, School of Management and Economics

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Abstract

China's small and medium-sized private enterprises play a vital role in promoting economic growth, technological progress and social development. This thesis investigates the survival environment of China's small and medium-sized enterprises, discusses their responses to various market risks and systemic obstacles and more deeply explores why they have become the main drivers of Chinese economic growth.

Firstly, this thesis systematically reviews the development history and relevant research of China's small and medium-sized enterprises. Secondly it reviews theory on small enterprises' corporate governance, social capital theory and incentive theory. Thirdly, we analyze two cases of Chinese private enterprises with the purpose to illustrate emerging problems, devise possible solutions and seek clarification from the theories reviewed.

The first case concerns an entrepreneurial company set up by Mr. and Mrs. Y, a couple who has worked and studied abroad. The company is engaged in the pavement construction of highways and in the sale of relevant road high-tech materials. The second case concerns a poultry and pig-breeding enterprise built by a peasant family.

The main conclusion of this thesis is that private enterprises in China not only have to deal with risks caused by industry, but also have to face policy volatility and overcome financing difficulties through social capital and social networks. In national capital monopolized sectors, policy volatility will make it hard for private enterprises to survive and social capital will be faced with limitations. So private enterprises have a larger room for development in industries where state capital is less prevailing. The key reasons for the rapid development of private enterprises in China have been innovation spirit and management innovation. This is the main innovation method of the above-mentioned two enterprises.
Key words: Chinese Private Enterprises; Entrepreneurship; Corporate Governance; Case Study

JEL: G32; D21.

Resumo

As pequenas e médias empresas (PME) privadas na China têm desempenhado um papel vital na promoção do crescimento económico, no progresso tecnológico e no desenvolvimento social. Esta tese analisa a envolvente em que as PME chinesas operam, discute a forma como respondem não só aos mais diversos riscos de mercado mas também a obstáculos sistémicos e explora as razões pelas quais se tornaram nos principais motores do crescimento económico chinês.

Em primeiro lugar a tese apresenta uma perspetiva histórica do desenvolvimento da iniciativa privada na China através da literatura mais relevante. Em segundo lugar faz uma revisão teórica da governação aplicada às PME e da literatura sobre capital social e incentivos. Por fim analisa os casos de duas empresas privadas chinesas com o objetivo não só de ilustrar os principais problemas, mas também de procurar caminhos para a sua solução e de encontrar clarificação através das teorias estudadas.

O primeiro caso diz respeito a uma empresa fundada pelo Sr. e pela Sra. Y, um casal que trabalhou e estudou no estrangeiro. A empresa dedica-se à construção de vias de comunicação e à venda de materiais de alta tecnologia para pavimentação.No segundo caso é estudada uma empresa de produção animal iniciada por uma família de camponeses.

A principal conclusão desta tese é que as empresas privadas na China têm não só de enfrentar as barreiras próprias dos setores onde atuam, mas também de lidar com a volatilidade das políticas e de ultrapassar dificuldades de financiamento utilizando para tal o seu capital social e as suas redes de relacionamento. Em setores dominados pela presença de monopólios estatais a volatilidade das políticas é um fator que dificulta a sobrevivência das empresas e onde o capital social se defronta com as suas próprias limitações. É precisamente em setores onde o capital estatal está menos presente que as empresas privadas têm mais espaço para se desenvolverem e prosperarem. Como estes dois casos bem representam as razões principais para o rápido desenvolvimento do setor empresarial na China têm sido o espírito de inovação e a inovação em gestão.

Palavras chave:Empresas Privadas Chinesas;Empreendedorismo; Governação Empresarial; Estudo de caso

JEL: G32; D21.

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List of Acronyms

ABC: *Agriculture Bank of China*

CCCPC: *Central Committee of Communist Party of China*

CGWR: *Chinese Government Work Report*

CPC: *Communist Party of China*

CPPCC: *Chinese People's Political Consultative Conference*

CSRC: *China Security Regulatory Commission*

GEM: *Growth Enterprise Market*

GM: *General Manager*

MICO: *Modified Bitumen Emulsion*

NDRC: *National Development and Reform Commission*

NPC: *National People's* Congress

PRRS: *Porcine Reproductive and Respiratory Syndrome*

RCC: *Rural Credit Cooperatives*

SARS: *Severe Acute Respiratory Syndrome*

SMEs: S*mall and Mediate Entrepreneurs*

UIC: *University of Illinois at Chicago*

ZYRHB: *Zhengzhou Yellow River Highway Bridge*

Chapter 1: Overview

1.1 Introduction

1.1.1 The Development of China's Private Enterprises in Recent Years

According to the "Analysis Report of Private Economic Situation in the Tenth Five-Year Plan Period" issued by the National Federation of Industry and Commerce in March 2006, China's private economy has made up more than half of the country's GDP. The report mainly quotes data[1] from the State Statistics Bureau. In 2005, domestic private economy accounted for 49.7% of the GDP while foreign investment economy and Hong Kong, Macao and Taiwan's investment economy made up about 15% to 16%. Their sum constituted about 65%. The Report shows that the so-called private economy is a joint name for diverse forms of ownership except the state-owned and state-holding enterprises. The above data of private economy include that of collective ownership economy, but not the private part of state-holding enterprises. On the basis of more strict classification, non-public sector accounted for about 61% that very year, deducting the collective economy part (about 8%) and adding the private part of state-holding enterprises (about 4%).

In three decades of reform and opening up, the private enterprises' contributions to Chinese economy are in the following aspects. According to the data[2]announced by the State Statistics Bureau, in 2008, non-state-owned enterprises made up for 61.09% of tax revenues and accounted for up to 70.34% of total profit. In recent years, the private economy has contributed to China's economy in several aspects. The first contribution is its role in promoting economic growth. The private economy has become the main force of economic growth in our country and 70%-80% of the incremental part of Chinese economic development comes from the private economy.

[1] Data not specified are all from the State Statistics Bureau Website and related publications in this section.
[2] Data of the All-China Federation of Industry & Commerce.

Secondly, private economy has become the main channel to increase employment opportunities. Jobs created in the private economy have already made up about 80% of non-agricultural jobs and 90% of all new jobs. Thirdly, in terms of independent innovation, medium-sized and small enterprises have contributed 70% to the technological innovation, 65% to domestic patents and 80% to the new products in the new age. More than 95% of the SMEs are private enterprises. In 2009, there were already 150,000 private science-technology enterprises, and they accounted for more than 70% of the enterprises in the 53 national high-tech development zones.

During the Eleventh Five-Year Period（ from 2006 to 2010, although the private economy also achieved excellent performance, the speed of development could not match that in last Five-Year period. Table 1.1 shows some brief statistical data of China's Private Economy from late 1999 to 2010, which go across two Five-Year periods. We can see from the table that the growth rate of private enterprises during the Eleventh Five-Year Period was about half of that during the last Five-Year period while the overall growth rate of the state economy during the two periods remained the same.

Table 1-1 Brief statistical data of the private enterprises development status (1999 to 2010)

Item	Total in the end of 2010	Total in the end of 2005	Average geometric growth rate from 2005 to 2010	Average geometric growth rate from 1999 to 2005()
Enterprise Number	8.1888 million	4.7195 million	11.65%	25.61%
Registered Capital	17.73 trillion	6.13 trillion	23.67%	42.92%
Employees	91.8389 million	58.24 million	9.53%	27.94%

Source: State Statistics Bureau Website

The Chinese Private Economic Yearbook 2006.6-2008.6 published by the National Federation of Industry and Commerce states the causes of the decline in the growth of the number of private enterprises, the registered capital and the growth rate of employees. Part of the reason is that the base of many indexes has become very large or larger, and it is difficult to maintain the growth rate after years of development. At the same time, it is directly related to a series of changes of the external environment of private enterprises development in recent years.

The most direct cause of the slower growth of the private enterprise is the financial crisis. From 2008 to 2009, under the stroke of international financial crisis and insufficient foreign demand, many export-oriented private enterprises experienced a sharp fall of export orders. Small enterprises particularly underwent capital chain tension. With insufficient domestic demand, the private enterprises experienced difficulties in production and management and lower investment desire. Private enterprises including foreign-investment enterprises suffered from efficiency decline and some industries experienced output reduction, production halts, bankrupt, suspension and increase of unemployed migrant workers. These phenomena are most prominent in the eastern coastal areas where the non-public sections of economy concentrate. For example, in 2008, the added value of the non-state owned industrial enterprises which were above designated size (including private enterprises and foreign-invested enterprises) declined rapidly3. In that very year, the added value of non-state owned industrial enterprises which were above designated size increased 13%, down by 6.1% over the previous year. Specifically, the added value of private enterprises dropped 6.3%, and that of foreign, Hong Kong, Macao and Taiwan investment enterprises dropped 7.6%. However in 2009, the added value of the non-state owned industrial enterprises which were above designated size increased 10.8%, but the amplitude dropped down by 2.2% over the previous year compared to the same period To be specific, the added value of private enterprises fell 1.6% while that of foreign, Hong Kong, Macao and Taiwan investment enterprises fell 3.7%.

The financial crisis led to the so-called "Guojinmintui"(the state advances as the private sector recedes) in the economic fields. After the financial crisis, the Chinese

[3]Corporate enterprises whose main business income reaches 5 million are in the scope of statistics of the industry, which could be in the list of governmental routine statistics.

government launched 4 trillion yuan for a bailout plan and 10 trillion new credits4, which provided abundant and low-interest funds supply for the state-owned enterprises, leading to their strong expansion. In 2009, among the social fixed assets investments, the private sector investment increased 25.3%, down by 0.6% over the previous year. At the same time, the growth rate of the non-state owned investment was 4.8% lower than that of the social fixed asset investments, and was 16.6% lower than that of state-owned investments.

Another reason for the slower growth rate of the private enterprises is financing difficulty. In the first half of 2009, among the 7.3 trillion yuan of national new loans large enterprises got 47%, medium-sized enterprises occupied 44% and small businesses which had fewer than 300 employees only got 8.5% (Min Tang, 2009). In China, enterprises which have 300 to 3000 employees are medium-sized enterprises while those that have fewer than 300 people are small and medium-sized enterprises. In comparison with companies abroad, China's medium-sized enterprises can be regarded as large ones in foreign countries in accordance with the classification of employment figures. Small businesses with fewer than 300 employees make up about 98% of China's enterprises and most of them are private enterprises. Small businesses contribute with about 90% to new jobs, but only get 8.5% of the loans. The loan structure in the short term, according to the 2009 statistics, showed that the non-state sector accounted for 15.1%, and the proportion was up 1.8% over the previous year. To be specific, township enterprises amounted to 8.4%, the private enterprises accounted for 4.7% and the foreign-investment enterprises occupied 2%. However, the 15.1% loan meant a rapid growth compared to that of 2008, having increased 67.1%, up 18.8% over the previous year.

1.1.2 Difficulties Faced by Private Enterprises

[4]One typical case of the state advances while the private sector recedes is that state-owned business invest government's bailout money into the real estate market which is already fiery-hot. On 17th March in 2010, China Ordnance Equipment Group Corporation got the lands of residential and commercial project in Dongsheng village of Haidian district at the price of 1.76billion. Previously, some other state-owned corporations whose main business isn't related to real estate also got lands in the market, which include China Electron and China Tobacco. The entrance into the real estate market of these corporations put another fire to the lasting fevered market, which objectively results in the increase of price of land in 2009.

Private enterprises in China go through the same challenges as global private enterprises: they have to face all kinds of impacts from the market since their birth. For example, the export-oriented enterprises in China's coastal areas are sensitive to the changes of international market products and prices of materials and thus cannot resist the financial crisis. As we will see in Chapter 5, one of the companies studied, the Eagle Company, engaged in pig breeding and directly faced impacts from fluctuations in prices of pig and grain. However, the private enterprises, especially small and medium-sized ones are hard to receive help of the state. They cannot get various national capital and policy support like the state-owned enterprises. Indeed the main difficulties that private enterprises face are mostly caused by China's economic system.

During three decades of reform and opening up, the national economy has become more market-oriented. However, the government still plays the leading role of allocating resources. The government or related interest groups set obstacles for the private capital to enter in many industry fields. First, the fields of finance, telecommunications, railway, petroleum and petrochemical or infrastructure construction have not yet been open to private enterprises. Even the fields which were open to foreign capital still set limits to the private enterprises. In view of industry monopoly having become an important obstacle that impedes economic development, the State Council issued the "Certain Opinions on Encouraging to Support and Guide the Individual Private and Other Non-public sectors Economy" in February 2005. This is the first central government document in which the theme is to promote the development of the non-public sector since the founding of new China. Since there are 36 regulations in the document, it is often called as the "Non-State-Owned 36 Clauses" for short. The main guiding thought of "Non-State-Owned 36 Clauses" is that private capital can enter all the investment fields except those the law specifically prohibits and relevant departments cannot set obstacles. However, the implementation is not ideal. According to statistical data of 2009 quoted by Wang Y. L. (2011)5, the

[5]Wang (2011) didn't point out the source of the data, but Professor Wang has served as the vice-director and researcher of the institute of international finance in China Bank, his data has rather authenticity.

proportion of private capital in monopolized industries in China was less than 20% at present. Among more than 80 industries in the whole society, there are 72 industries allowing the state capital to enter freely, 62 industries allowing foreign capital to enter and only 41 allowing private capital to enter.

The second difficulty is the so-called “Glass Door” and “Swing Door”. The “Glass Door” actually means implicit obstacles for private investment, which seem to be able to enter certain industries with no dominant obstacles, but these industries are unavailable when they really want to enter. The so-called “Swing Door” means the private enterprises are allowed to enter and they enter indeed, but they have to quit in the end for a variety of reasons. For example, in the case of the highway engineering faced by Company Z studied in Chapter4 of this thesis encountered the case of “Swing Door” when the Henan Province Government changed the road projects bidding rules, which were to the benefit of highly capitalized companies such as state-owned enterprises and against private enterprises. As a result, company Z had to survive in trouble. During three decades of reform and opening up, the state-owned economy has formed powerful interest groups in many industries. Due to lower operation efficiency in relation to private enterprises, they have to prevent the entrance of private enterprises through the monopoly and various restrictive ways.

Another system problem that private enterprises face is financing difficulties. Banks and the capital market were set up initially to serve state-owned enterprises in China. During the 1980s to 1990s, there was a strong discrimination against private enterprises in the whole banking systems because of social ideology. Private enterprises were hard to obtain state-owned bank loans. But even in the 21st century, the phenomenon of “State-owned Preference” in the commercial bank system led by the state-owned banks has not changed yet. State-owned enterprises have double advantages of credit opportunities and costs. Reduction of information asymmetry risks caused by state-owned property rights and larger operational scale lead state-owned enterprises to get loans with lower cost and fewer risks. That means the state will suffer from the losses caused by failure of state-owned banks when they lend to the state-owned enterprises. Qian (1994) and Qian & Roland (1998) named this the *Soft Budget Constraint*.

In recent years, although the "Non-State-Owned 36 Clauses" encourages financial institutions to lend to small and medium-sized private enterprise, the effect is not good. Statistics of the PBC (People's Bank of China) (*quote from* Wang Y. L. 2011) show that the proportion of GDP that private enterprise loans occupy changed from 6.3% in 2000 to 15.04% in 2007. The average annual growth rate was around 1.24%.The growth rate was not only slow, but also plummeted to 13.88% in 2008. The proportion of GDP that private enterprises short-term loans occupy increased from 1% in 2000 to 3.4% in 2008. Two sets of data obviously did not match the growth rate of 20% or more of the private enterprises at the same time (as the registered capital growth speed showed in table 1.1), and did not match the status that private economy had already made up 50% of GDP in 2005. It is worthwhile to note that when discussing the private enterprises' financing difficulty here, private enterprises do not include foreign capital enterprises and the collective ownership enterprises.

It is doubtful whether the financing difficulties of private enterprises is a phenomenon unique to China or whether it is actually caused by their own distinctive features of high risk. Although the risk of medium-sized enterprises is one of the most important factors that leads to financing difficulty, SMEs should be supplied with corresponding financial resources since there are credit demands in the market. If there are many contradictions between the private enterprises' loan demand and supply, China's credit market is proved to have structural problems (or system problems).

Specifically, four commercial banks highly monopolize China's banking system, and they are reluctant to lend to small and medium-sized enterprises. According to Stein (2002), the complex organizations of big banks makes managers prefer to lend to the large and medium-sized enterprises, because their financial information is easier to report to the examination departments. Meanwhile, in small and medium-sized banks there are fewer levels and, managers can make decisions flexibly, so they are easier and more willing to lend to small and medium-sized enterprises. So are small and medium-sized financial institutions the main supplier of private enterprise credit? According to the statistical data of the People's Bank of China[6], the proportion of private economic loans provided by Chinese small and medium-sized financial institutions showed a downward trend from 2000 to 2008, and it went up slightly from 2007 to 2008. The proportion was 27.7% in 2000, 25.8% in 2007 and 26.5% in 2008. By the end of 2008, small businesses' loan balance of small and medium-sized financial institutions was 1.17 trillion yuan, accounting for 70.6% of the whole loan, up 18.6%. This shows again that, the big Banks are not the main ways for private enterprise loans and small and medium-sized financial institutions' support is far from enough though they are definitely the main sources of small business loans. There is a trend that the organization and loan approval procedure of small and medium-sized banks are moving towards big banks. This will mean a loss in flexibility.

It is in this contextual framework that the two case studies in this thesis will be explained in Chapters 4 and 5. In both cases the two enterprises coincidentally faced financing difficulties at the initial stage of their development.

1.2 Research Issues and Framework

1.2.1 Research Issues and Research Objectives

As mentioned above, Chinese private enterprises not only face market competition and the impact of complex factors but also the discrimination caused by the economic system and financing difficulties caused by credit market structures. The difficulties that private enterprises face also get central government's responses and policy adjustments. However the implementation is not ideal. The basic problem is how do these difficulties affect the development of the private enterprises? How is

[6] See All-China Federation of Industry & Commerce (2009).

their living status? How do they encounter “Glass Door” and “Swing Door”? What causes their financing difficulties?

In what way do private enterprises deal with these problems? What significant influences will they have on the management of private enterprises? Actually, in research, it can be found that China's private enterprises actually use social capital and social networks to deal with problems of market access and financing difficulty. However, what problems can be solved through social networks? In the rapidly changing economic transformation period, what is the limitation of social networks? How can they explain the reality of high-speed development of private enterprises in China? What is the key factor that supports the high-speed development of private enterprises?

To find answers to these questions is the main objective of this thesis. We argue that the innovation spirit in corporate governance or the entrepreneurial spirit is the key force to support the development of private enterprises. So, are these innovations beneficial to completely change and optimize the surviving condition of enterprises? In what type of environment can innovation contribute to speed up the development of enterprises?

1.2.2 Research Contents and Framework

This thesis takes the theory of corporate governance as a basis, and comprehensively uses financial theory, social capital theory and the theory of contract to research on systematic discrimination of market access against private enterprises and private enterprise surviving condition and development within financing difficulties. Through deep analysis of the anatomy of the two cases, this thesis studies how private enterprises overcome limits and difficulties through social capital and social networks and how can they develop through corporate governance and management innovation. The structure of the thesis is arranged as follows.

Chapter 1expounds the research background, puts forward the research issues, draws the outline of the framework and research method.

Chapter 2 draws the outline of the development history of private enterprises in China since the reform and opening up, and reviews the related theories and empirical studies involving private enterprises. In terms of the development history of private enterprises, this thesis mainly outspreads views according to the economic status of private enterprises which is decided by China's central government. Central government divides the political statements of private economy into three stages: (1) the private economy is the complementary strength of socialist market economy; (2) the private economy is an important part of the socialist market economy; and (3) the non-state economy should be encouraged, supported and guided. With regard to related theories and empirical research of private enterprises, this thesis summarizes the research on private enterprises' corporate governance and discusses how private enterprises respond to market discrimination and inefficient protection of property rights, and how to deal with financing difficulty.

Chapter3 reviews the relevant theories which account for the understanding of the cases in chapters 4 and 5. The first part reviews the theory on corporate governance including financing theory, especially literature review of small and medium–sized enterprises governance and value-maximum of stakeholders. The second part covers the literature review on social capital theory. Social capital theory and social networks can be used to explain how private enterprises avoid the restrictions set by government or some other interest groups and get the investment opportunities and how private enterprises deal with the problem of financing difficulty. Finally the third part reviews the contract theory (mainly incentive contract theory), which serves for explaining how to motivate employees and stakeholders (e.g. study of farming cooperation agreement in chapter 5) and explaining management innovation of private enterprises.

Chapter 4 contains the case study of company Z. This case study includes the case background, case content and case analysis. This case concerns the couple Mr. Y and Mrs. Y (overseas students) who set up company Z with five other shareholders in 2004. Mr. and Mrs. Yang were the largest shareholders, owning 30% share and other six shareholders owned the stocks dispersedly. The main business of the company was to supply high technology materials for expressway construction and pavement and the Y couple took charge of the company. Company Z usually obtained construction projects opportunities through shareholders' social networks, which also helped to get financing for the company. The company mainly provided foreign advanced materials for domestic road projects and put forward innovative construction plans of these road projects. In terms of business performance, the management efficiency of company Z was high with most favorable financial indicators (except financing capacity) exceeding that of listed companies in the same industry over the corresponding period. Company Z also established a harmonious labor relationship. However, in 2008, Henan Province Government changed the highway projects bidding rules to favor highly capitalized companies such as state-owned enterprises and this change led to capital chain tension in company Z, as well as to suspicions and contradictions among shareholders. Company Z also had problems of corporate governance as it heavily relied on social networks. In other words, every shareholder had veto power, which cannot ensure the company to cope with the rapidly changing environment. As a result, the Y couple took over the company Z in June 2010 and paid other five shareholders with some assets of the company as their return of investment. Therefore, couple Y became the only shareholder of the company.

In sum, the key problem of operation and management in company Z is a “swing floor” in the market access as well as financing difficulties. Although social capital contributed to investment opportunities and to the capital of company Z, the restriction and risk of social capital could be great in this rapidly changing environment. The company would be unable to survive in difficult situations without the introduction of innovative products and high efficiency in every stage of management. This case shows how the company formed a closed ownership structure from an open ownership structure with the intensifying competition and changing local industry policies and displays Chinese private enterprises' struggle to survive and entrepreneurs' persistence.

Chapter 5 examines the case study of company Eagle. This case study also includes the case background, case content and case analysis. In the winter of 1988, Mr. H, 22 years old failed his college-entrance examination, borrowed 200 yuan from his relatives and used the money to build a chicken farm. Until now, the chicken farm has overcome two epidemic disease strikes, including 1988's fowl plague and 2003's market depression due to SARS, with strong family support. Clearly, Mr. H could not further develop his business without external financing. However, Company Eagle was unable or unwilling to get a loan from local credit cooperative during a long period (1988-2001). Company Eagle did not establish a good cooperation relationship with local credit cooperative until after 2001 due to company integrity showed in the repayment of the loan, which was offered by the credit cooperative and the reform of the credit cooperative after 2004.

The central government has provided many support policies for businesses related to "agriculture, countryside and peasantry" that benefited company Eagle. The local government also awarded the entrepreneur with political status and many honors due to his contribution to increasing farmers' income. But "arbitrary charges and levies" of company Eagle still existed in low-level local governments. The biggest difficulties of breeding businesses owned by peasant households including Mr. H's were market price shocks, fowl plague risks and capital insufficiency. This made Mr. H to have a deeper understanding of the survival situation of peasant households. At first, Mr. H sold the gallinaceous, feed and drug to farmers and then bought broiler chickens raised by farmers. The broiler chickens were bought with the market price when market price of broiler chickens was high and bought with protective price(breeding cost price) when the market price was low.

Actually this pattern prevented farmers from being affected by market price fluctuation risks and also helped Mr. H gain farmers' confidence. As a result, his breeding firm became increasingly bigger. Mr. H set up company Eagle officially in 2003, focusing on raising pigs, and put the pattern of "company + workshop" and "company + farmers" into practice step by step. Moreover, company Eagle promised to compensate farmers once the farmers failed in the breeding process so that farmers could avoid the shock of fowl plague and risk of misoperation themselves. In 2004, Mr. H cooperated with local rich farmers to build hoggeries. Rich farmers were responsible for seeking land and build hoggeries that would be leased out to company Eagle once the construction was completed. Company Eagle would be the guarantor of credit cooperative loan used for hoggeries construction. After five years of search (from 2001 to 2006), Mr. H finally explored a way of cooperating with farmers, which he called “Pattern Eagle” as it will be explained in Chapter 5. With the development of company Eagle, cooperant farmers had achieved great economic benefits and doubled their income. After enhancing the capital and enlarging the stock in 2008 and 2009, company Eagle successfully appeared on Growth Enterprise Market in September 2010.

This research analyzes the company’s financing difficulties in its early stage. The reason why company Eagle was unable to get a loan from credit cooperative lies in management disorder of the credit cooperative system, which made money flow to the cities. However Chinese credit cooperative underwent a reform in 2004. Due to such environment, Mr. H ‘s social relationships, political status and integrity of his company in bank-enterprise relation, Mr. H and credit cooperative gradually built up tight partnerships from2001 on. Stein (2002) refers that medium-sized or small enterprises can develop and expand with medium-sized or small financial institutions together. As a matter of fact, company Eagle cooperated with credit cooperative (rural cooperative bank after 2008) to offer financial guarantees for farmers and became a shareholder of rural cooperative bank while the company itself achieved rapid development.

This thesis uses social capital theory and value-maximum of shareholders theory in corporate governance to analyze the cooperative relationship between company Eagle and farmers. As the case analysis demonstrates the cooperative relationship was first established because of village neighbors’ trust, but more formal contract relations must be built as cooperation circle expansion. This thesis further explains “Pattern

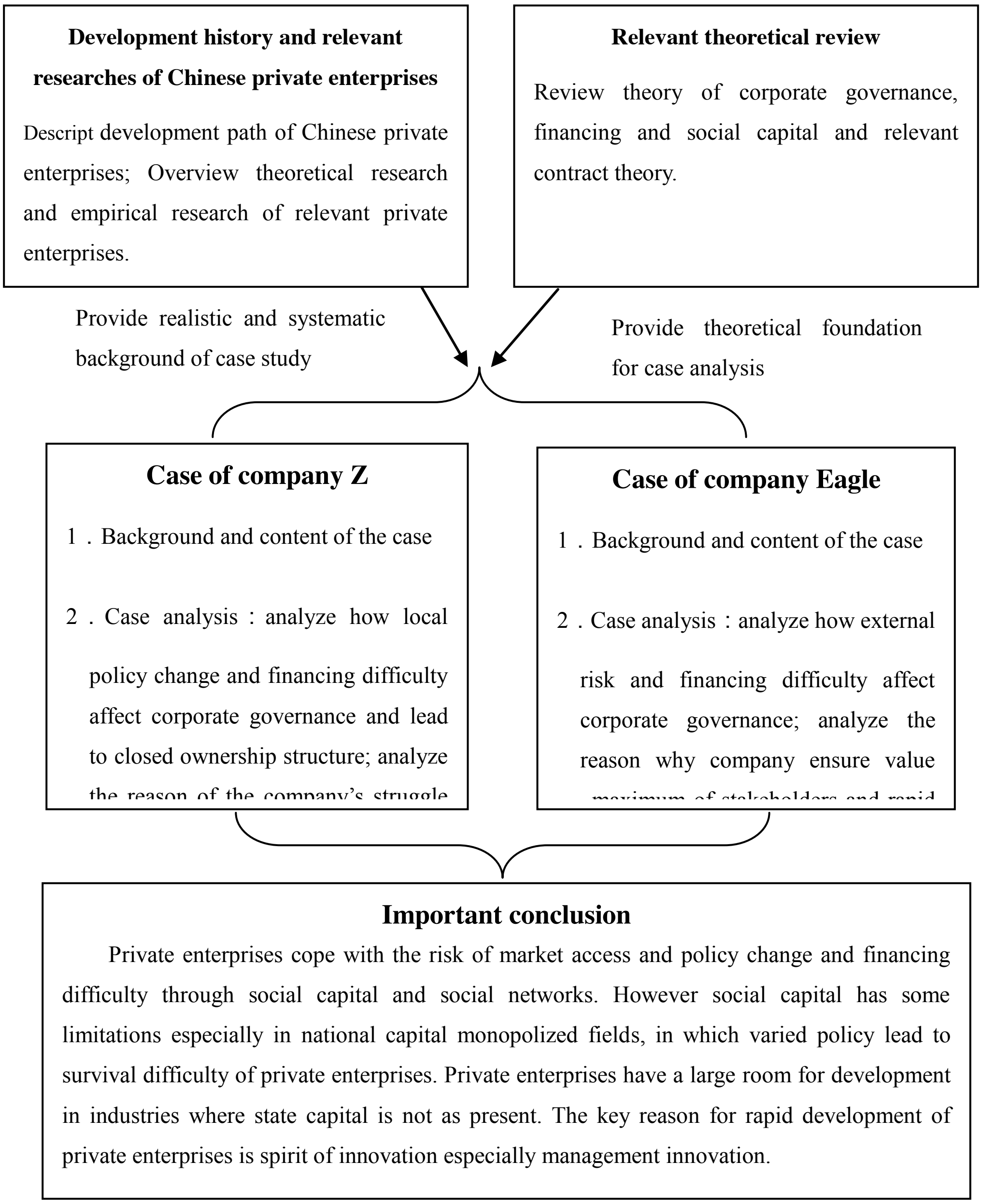
Eagle" using property right theory and summarizes that this pattern succeeded since it not only kept the high intensive trait of market transaction pattern "corporation + farmers", but also preserved the trait of complete employment relationship which contributes to supervise opportunistic behavior of farmers. Finally breeding cooperative contracts of company Eagle and farmers helped company Eagle to succeed and we can thus intuitively think that the creativeness of the contracts lies in profound understanding of Chinese farmers' behavior characteristics. However, this thesis analyzes this contract from contract theory angle and finds that this contract conforms to prediction of relevant contract theory on several levels. This contract is also in accordance with economy rules and has a strong theoretical foundation for its success.

Chapter6 summarizes the whole text and provides conclusions while discussing possible implications. Research framework of this thesis is as Figure 1-1.

As described below, against the background of a transition economy, private enterprises are not only impacted by various market risks but also encounter difficulties and hazards brought by the system. However, private enterprises make efforts to avoid risks and achieve development in various ways. Therefore, corporate governance of Chinese private enterprises combines both traits of medium-sized or small enterprises and the uniqueness of an economy in transition.

Therefore the corporate governance of Chinese private enterprises concerns not only the efficient use of financial capital and human capital but also the ownership and effective utilization of social capital. Usually enterprises use social capital in two ways: getting investment opportunities through social capital networks and getting resources, especially financial resources.

Figure 1-1 Thesis framework



As per Chapter 2 previous research has pointed out that private enterprises obtain investment opportunities in fields in which resources allocation was dominated by government, namely breaking through the “Glass Door”, by establishing social networks abroad and protecting their rights and interests from being damaged by building political relations with government. For instance, in chapter 4, company Z got construction projects opportunities through social networks of its shareholders and in chapter 5, the entrepreneur of company Eagle protected his property from being damaged by establishing political relation and gaining political status and various honors such as “People’s Deputies” and “Model Worker”.

However, investment opportunities obtained through social networks cannot last after all because networks tend to be broken depending on changes in the government. Or in some industry fields open to private enterprises, rules will be changed due to political climate shifts or intervention of interest groups like state-owned companies. This is called “Swing Door” and company Z encountered such difficulty since the bidding rules changed. Anyway, against the background of transition economy, private enterprises face industry access obstacles which are set by government and hard to predict and control.

The case of company Eagle shows that, in fields with rare national capital like agriculture which is called “sunset industry”, private enterprises have a great space for development because of national industry policy supports, this kind of industry has a low level of average profit margin and high market risks.

Confronted with financing difficulties, private enterprises receive financial support by means of family power or social networks established by shareholders’ relatives and friends. In the two cases of this paper, company Z obtained capital through social networks of shareholders and raised funds from shareholders’ relatives and friends. It is easy to raise funds from shareholders when business runs well but social networks fail to function when the company does not have promising development prospects.

The family of the entrepreneur of company Eagle, however, plays a role of “capital impounding reservoir” which reserves the funds when business runs well and “draws off” the funds to save the company once crises emerge. After a period of development, company Eagle had accumulated certain capital and on the other hand got loan support from local credit cooperative. Once expanded, company Eagle entered into financial area and established a good cooperative relationship with credit cooperative.

Also, if Chinese private enterprises do not act as “sweatshops”, they must have relied on their innovation spirit to survive and develop and on entrepreneurship to obtain such brilliant achievements.

In the face of fierce market competition, various risks and discriminations caused by policies and systems, many private enterprises have to lower the wage level in order to survive and make a profit. According to the "8th Private Enterprises Sample Survey" which was conducted by the National Industrial and Commercial Bureau in 2008[7], the average wage of private enterprises was still 8,208 yuan less than that of state-owned enterprises. The ratio is 1:1.45 which means the gap became bigger compared with that of two years ago. The 9th survey conducted in 2010 showed that the average wage of private enterprises was 17,017 yuan, a decline by 1,395 yuan (7.5%) from 18,412 yuan in 2007. And in 2009, the average wage was only 16,645yuan, down 2.2% year on year. Among these respondents, people who earn less than 1,000yuan monthly account for 36%, and those who earn around 1,200 yuan make up 50%. But disposable personal income of Chinese urban citizens was 17,200 yuan in 2009. The decrease in wages to some extent demonstrates the "sweatshop" syndrome and reveals the worsen survival environment of Chinese private enterprises.

However, two cases in this thesis do not involve any thing like "sweatshop". The income of employees in Company Z increased constantly and the income of farmers who cooperate with Company Eagle far exceeded that of other local farmers. This reflects a fact that both Company Z and Company Eagle rely on innovation to achieve development. According to data analysis of the "9thPrivate Enterprises Sample Survey" in 2010 (data source: Wang, M, 2011), 22.5% Chinese private enterprises cut down investment, 49.2% remained the same and only 28.3% increased investment in 2008. In 2009 the data did not change too much, with 21.3% decrease, 45.2% remaining the same and 33.5% increasing. Although the financial crisis made 70% enterprises decrease or remain at the same investment level, 33% enterprises contributed to the main part of Chinese economic increase.

Mr. Bao Yujun (source: Wang, M, 2011), Contract Research Fellow of Counselor Office of the State Council and Chairman of Institute of Chinese Private

7 Source: All-China Federation of Industry & Commerce (2009).

Economics, relates the achievements of private enterprises to: structure and system innovation (enterprise reformation to corporate system), management innovation, technology innovation, operation innovation and risk-control innovation.

In fact, both cases in this thesis refer to these innovations. Chinese enterprises innovation has two sources: one is the introduction of foreign advanced technology and products; the other is that local enterprises develop endogenous innovative technology and operation modes. The innovation of company Z lies in constantly introducing foreign innovative products and putting forward innovative construction plans in project construction field. Meanwhile, company Z has a higher efficiency in most management links compared with listed companies in the same industry over the corresponding period and sets up a good incentive system among employees. In turn, the innovation of company Eagle lies in achieving “value maximum of stakeholders”, namely succeeding with its innovative “Eagle pattern” concept.

1.3 Research Method

This thesis studies the survival condition and corresponding measures of medium-sized or small private enterprises and mainly adopts the research method of case study analysis. The reasons are as follows:

(a) Large scale statistic empirical research needs a great quantity of data but information related to corporate governance of these enterprises is difficult to collect if not through personal networks, as the information involves business secrets;

(b) On the other hand, our purpose is to evaluate how system difficulties affect corporate governance and how enterprises achieve management innovation. Therefore we need analytical narratives about company strategies and practices that may provide us with relevant information, which is also sensitive and that entrepreneurs tend to keep private from others or just give out limited information;

(c) On the contrary, in the two cases portrayed in this thesis the researcher had ample access to both people and documents. The empirical study was carried out in a two-step process. First, case studies on the trajectories of small and medium-sized private enterprises conducted by other researchers were reviewed and synthetized to get company-level background information. Then we used personal interviews, media retrieval and company documents to understand the actual process under which private SMEs in China operate, obtain financing and ultimately develop, struggling to survive a variety of crisis;

(d) The cases were selected because they are representative of two different sectors where private enterprises may exist but under different institutional conditions. The company in the first case operates in a sector dominated by large state owned companies (construction of infrastructures); in the second case the company operates in the farming and animal breeding industry, a sector where the state is not much present in China. From the analysis we may find commonalities but also differences that emerge from the different settings..

Therefore, following the two-step process in the case study method, this thesis first elaborates at length the case background and case content and this elaboration involves unfolding the whole stories on timing notes. Since reform and opening in 1978, China has witnessed rapid development in politics, economy and culture, with an amazing transformation pace in human history. Generally, Chinese economy experiences transformation from public ownership to private ownership. The case study method is the best way to observe and evaluate the transformation and explore the key elements, which promote Chinese economy transformation particularly because it allowed us to investigate enterprises with rich experiences.

Moreover, from the methodology angle, the case study follows Yin (1989) who pointed out that case study is one empirical research method that mainly applies:(i) to investigation of current phenomena against certain real background; (ii) when the boundary between phenomena and background is vague and problem is complicated;(iii) evidences of various sources are needed to analyze the problem.

Eisenhardt (1989) differentiates two types of case studies: those that intend to generate or build theory from data presentation (new concepts, models, conceptual frameworks/propositions/theory) and those, such as the ones we are using in this research, that offer insights of a specific context.

According to Stake (1995), case studies may serve two different research purposes: *intrinsic* case studies are conducted for the case’s own sake; and *instrumental* case studies are used whenever we need to understand something beyond the case. In this research, we use the case studies as a *mechanism* to seek clarification from relevant theory and illustrate a problem.

Chapter 2: Development History and Literature Review of Chinese Private Enterprises

This chapter includes two parts. The first part discusses the development history of Chinese private enterprises, elaborating how private enterprises have developed from nothing, why private economy has expanded to be an indispensable part of national economy and why private enterprises experience discrimination. The second part reviews relevant domestic and foreign research about industry barriers and financing problem encountered by private enterprises. In brief, this chapter can provide a better background knowledge for studying the two cases examined.

2.1 Development history of Chinese Private Enterprises

2.1.1 First Stage: 1978-1992

In 1978, the Third Session of the Eleventh CCCPC (Central Committee of Communist Party of China) opened a new history period of reform and opening. After new China was founded, China learned and copied the Soviet Model, deploying centrally planned economic systems with regard to the allocation of resources. In terms of ownership of the means of production, China adopted state ownership, namely the “Yi Da Er Gong” (large in size and collective in nature) concept, urban collective ownership and the rural people’s communes system. In these systems individuals were not allowed to hold private properties and all of the work achievements should be divided. With regard to external relations, China almost adopted a closed foreign policy. Due to above-mentioned reasons and the Great Cultural Revolution catastrophe, China was on the edge of economic collapse before 1978. Chinese average GDP ranked second last (only 2/3 of India’s) in 1978 while average GDP ranked 40th in 1948 before New China established. At the Third Session of Eleventh CCCPC, which uncovered the prelude of the reform and opening, Chinese Communist Party pointed out that the new period historical task of the party was to make China socialistic modernization powerful nation.

Chinese reform and opening started with rural reform and construction of the special economic zones. Initially 18 peasant households in Xiaogang Village, Fengyang Country, Anhui Province implemented the "household contract responsibility system" which spread and was promoted comprehensively in rural areas in 1983[8]. The CCCPC and the State Council authorized Guangdong Province and Fujian Province to adopt "Special Policy, Flexible measures" in foreign economic activities and determined to set up special economic zones in Shenzhen, Zhuhai, Xiamen, Shantou in 1979. Guangdong Province and Fujian Province thus became the first zones to be open to the outside world.

On the premises that state-operated economy plays the leading role, China took a series of positive measures to develop various forms of economy in cities and towns, enlarge self-management right of factories, improve the circulation system in urban and rural areas and play the driving effect of central cities around 1979. Chinese private economy then gradually came into being and developed. The unemployed population in cities and towns made up 19% in 1978 (Zou & Ouyang, 2009) and government had to encourage self-employment and issue individual service licenses on a large scale. The private economy thus grew rapidly with permission of government and finally became one of the legal ownership elements. Unemployed youth could not find jobs in state-owned enterprises, which suffered from low operation efficiency, heavy losses[9] and overstaffing and thus provided little new job opportunities. After reform and opening, light industrial goods production closely related to daily life, as well as urban and rural trade and market, began to recover. So self-employed entrepreneurs, originally unemployed youth, were mainly engaged in commodity trade and service industry at that time. The most common type of self-employed entrepreneurs at the time was the so-called "Daoye" (profiteer) most of whom transported clothes from south to north and "Daoye" was then a hot profession. The main transport means of "Daoye" was train full of profiteering goods on luggage carriers. But this did not get

[8] "Household contract responsibility" means rural collective economic organization contract (workers, expenses and yield) out crops on cultivated land, stockbreeding, livestock and poultry raising and sideline production to farmers. The organization will reward farmers while yield increases and compensate for farmers while yield decreases. In 1983, "household contract responsibility" was officially conducted throughout the country. The lands belong to collective in form but actually are operated by farmers themselves.

[9] Government work report in 1983 states that one-third of enterprises suffered from losses the same year. The government work report including the following each year reports can be founded in The Successive Central People's Governments of The People's Republic of China (2009).

recognition of government at all levels since at that time only physical labor was regarded as respected “Labor”. “Daoye” were treated as exploiters because they made substantial profit without corresponding endeavors. Under the criminal code in force in 1979, a “Daoye” would be put into prison if he committed a crime called “Crime of Speculation”. For example, “Daoye” would be considered guilty if he transported goods from Guangdong Province to north areas and made a profit. This accusation was not abolished until 1997.

Individual businesses grew dramatically during this period. According to CGWR (Chinese Government Work Report) in 1983, employees of enterprises under urban collective ownership increased by 6.03 million in four years (since 1979), the value of industrial output grew by 49% and urban individual workers increased to 1.47 million from 0.15 million. Until now, most state-owned industrial enterprises and merchandising enterprises have implemented management responsibility system in different forms. Some state-owned small businesses, catering services and small enterprises began to conduct collective management or be contracted out to staff or individuals under the state ownership.

The state began to promote various forms of contract system step by step. For example, factory director could be awarded “The factory director contract system”[10]if he obtained favorable operating results. The CGWR in 1984 officially acknowledged the authorization of small state-owned enterprises to be contracted out or leased out to collectives or individuals and to pay taxes as collective enterprises. This became another important source of Chinese private economy. Until after the 1990s those contracted small enterprises were not sold to individuals in different ways. In order to reform low–efficiency state owned enterprises, the central government put forward in the CGWR in 1986 that state-owned enterprises would be responsible for their own profits and losses and some enterprises running at a loss constantly would be closed down, have their operations suspended or else be merged with other

[10]This reform was called “allowing rights and profits” which was first experimented in enterprises in Sichuan Province and Shanghai and then promoted throughout the country. “Allowing rights and profits” means on the premises that the ownership of state-owned enterprises are still in the leading position, the state will change Soviet-type rigid management system and give the autonomy of enterprises in operation. It has two aspects: one is to give a certain proportion of the retained profits to enterprises; one is to allow enterprises some authorities of production plans, purchase and sale and capital application in order to break down the old system in which enterprises were affiliated to the government and “we all eat together in the canteen”. Basic train of thought is linking up workers’ interests with operation of enterprises and arousing the enthusiasm of enterprises and workers.

enterprises or switched to the manufacture of other products. Enterprises that were contracted out were the breeding ground for many future private entrepreneurs and many unemployed people of those enterprises running at a loss began their self-employment. In consideration of unemployed workers' livelihood, government rarely shut down but contracted out enterprises instead and workers' state ownership identities did not change. Generally, contracted enterprises need to turn in contract fees to upstream authorities while there were written or unwritten agreements between them that operation decisions were made by contractors although the enterprises were state-owned or collective in name.

Another source of Chinese private enterprises has been the rapidly developing rural enterprises in the mid and late 1980s (Trigo, 2005). The State Council's Government Work Rreport in 1988 stated that: "rural businesses, various socialized services and part-time businesses have obtained great achievements while household contract responsibility system is being perfected". "Rural enterprises" refer to enterprises set up in villages or towns and invested by rural collective economic organization or farmers. It is a joint name of rural regional cooperation enterprises (enterprises invested by peasant collective) and individual enterprises. In order to classify and manage rural enterprises, government divided them into five types: town enterprises, village enterprises, farmers associated cooperative enterprises, other cooperative enterprise and individual enterprises which company Eagle one of the case studies in this thesis belonged to at first. Rural enterprises involve many kinds of industry categories, including agriculture, manufacture, transport, architecture and commerce. In 1980s, rural enterprises mushroomed in coastal provinces along with foreign-funded enterprises, like textile manufacturing in Jiangsu, petty commodities in Zhejiang and "Three to one up" (processing and compensation trades)[11] in Guangdong. If the enterprises were set up by villages and towns, they belonged to collective businesses under state ownership. In 1980s, rural enterprises were encouraged because they absorbed a large number of surplus labor force, improved Chinese industrial layout and bridged the gap between urban and rural areas

[11] "Three to one up" refers to processing, sample processing, component assembly and compensation trade. "Three" means foreign merchants provide materials, technology, equipments and Chinese enterprises process, assemble products according to required standard, quality and style to foreign merchants who should pay service fees.

and the gap between workers and peasants. At that time, many private enterprises operated under the name of rural enterprises collective economy. This was called “Wearing the red hat”.

In the whole 1980s, private economy was discriminated due to “Left thought”, but was gradually recognized as CPC tried to breakthrough ideological shackles. However the recognition was limited and before 1992, private economy was still considered nothing more than one of the beneficial supplements to the state-owned economy, playing the supporting role.

In 1979, a peasant named Chen Zhixiong in Gaoyao County, Guangdong Province contracted 8 acres of fishpond and made a profit after a year’s effort. Chen contracted 141 acres of fishpond the second year and both him and his wife were so busy that they had to hire a fixed worker and temporary workers for400 workdays. In the third year, Chen continued to broaden his business with 497 acres of fishpond, 5 fixed workers and more temporary workers in a total of1000 workdays. Chen’s business would be considered normal economic behavior today but at that time it was questionable to hire and “exploit” employees in socialist country.

An enquiry was raised and the official newspaper “People’s Daily” discussed in a special column “How to view the phenomenon of Chen’s contract of fishponds”. This discussion lasted for three months, ending on 30th October in 1981 with21 articles having been published during the discussion. The most important achievement was a conclusion by the economist Lin Zi through a computational example in “Capital” by Marx: Workers less than 8 should be called assistants who are not exploited and workers more than 8 should be called employees. The “8” is the boundary line of “Small Owners” and “Capitalists” in “*rate of surplus value and surplus value*”, as per Karl Mark *“Das Capital”*,*Volume1*, *Chaper9*, *Sheet3*.

Guangdong Province government continued to insist in the legality of the employment system and Ren Zhongyi, then secretary of the Provincial Party Committee, gave an official name “Private Economy” to the individual economy involving with employees.

Then the case of a 42 year-old business man Nian Guangjiu was proclaimed to the public while the debate over Chen’s fishponds was still ongoing in 1983. Nian and his “Fool melon seeds" were well known in Wuhu, Anhui Province in late 1979. But he had 12 "employees" in 1983, which means Nian was definitely an exploiter according to the "8" boundary line of the orthodox political economics discourse system of the period. "Fool" Chen then became theoretically, albeit unintentionally a "Capitalist".

Absorbing Chen's lessons, some private owners at the bottom of the society made great efforts to equip themselves "with red hats" to avoid political risks and being "class enemies". In other word, they affiliated their private businesses to enterprises under other ownership or falsely claimed these enterprises' licenses as their own. These enterprises were often cooperative organizations or rural enterprises. This kind of behavior could cause many misunderstandings in spite of its "legality". For example, peasant Yang Yutian in Fuyu, Jilin Province organized "Transportation Cooperatives" to absorb unemployed youth. He owned all the equipments, workshops and capital although the enterprise was in the name of cooperatives. But in 1986, he was said to "embezzle" collective property worthing 70 thousand yuan, which was actually his personal wealth. Another example was a store operated by Feng Liany in Handan Hebei Province. Feng owned the capital and management right of the store which was affiliated to sub-district office "with red hats". However, he was unexpectedly sentenced to death with charges of fraud and embezzlement when he paid back loans with his own 47 thousand yuan. It was not until three years later that Feng was declared innocent by the Supreme Court. The misunderstandings also made it difficult for private enterprises to clarify property rights and take off "red hats".

In 1980s and 1990s, the government discriminated and deliberately made things difficult for private economy. Industrial and commercial bureau and tax bureau also fined private enterprises with all sorts of designations. As a matter of fact, many start-ups did not have sound accounting information, which might be a reason for the penalty. In addition, tax bureau was strict with cost accounting of private enterprises, requiring wage of private economy lower than a specified level. This unreasonable requirement lasted for a long time. Tax bureau adopted the management method of national economy to private economy, ruling that wage higher than the specified level could not enter into cost account. One reason was that factory directors paid salaries generously in order to make workers continue to vote for them, which might cause losses of state assets. Another explanation was that people were generally poor in 1980s and were not used to the high profits of any enterprises. Individuals were hard to register enterprises (note: at the time enterprises were totally different from today's private businesses). A company that had a few employees and no workshop was called "bogus company" sociologically instead of enterprises. So it was difficult to register an enterprise even within a year because of governmental resistance.

Deng Xiaoping proposed to "Look first and don't give a conclusion immediately (that the employment is not compatible with the socialism)", when Chen Zhixiong's event happened. After years' of "observing", the CCCPC finally put forward in the Thirteenth Congress of CPC that private economy is also a "necessary and beneficial supplement to state-owned economy". The CCCPC's File 5 in 1987 removed restrictions concerning the number of employees and the guiding principle was summarized as "To allow the (private economy) existence, strengthen control of it, develop the advantage and curb disadvantage of it, and lead it gradually (into the socialism)". In April 1988 the first session of the seventh NPC (National People's Congress) approved *constitution amendments* adding that "Private economy is allowed to exist and develop within the law. Private economy is a supplement to state-owned economy and legal rights and interests for private economy will be protected by the state which also guides, supervises and manages private economy". This clause obviously confirmed the legal and the economic status of private economy. In June, the State Council issued "The Interim Regulations of Private Enterprise of The People's Republic of China". The Fourteenth Congress of CPC pointed out clearly that the target of the economic system reform of China is to build a system of socialist market economy and put forward that "we will follow the basic economic system to keep public ownership, including the state-owned sector and collectively owned sector, in a dominant position and have diverse forms of ownership, including individual economy, private economy and overseas investment economy, to exist and develop side by side for a long time".

2.1.2 Second Stage: 1993-2002

After 1993, state-owned enterprises accelerated the speed of reform from which private enterprises benefited. Two sorts of enterprises grew together. Reform of state-owned enterprises in 1990s was the theme of Chinese economic system reform as the state had let go of commodity price limits since 1980s. The economic system reform mainly included two aspects. One was called “Seize the big and free the small”, which meant large state-owned enterprises would maintain their state control position while medium-sized or small enterprises would be encouraged to strategically reorganize in various forms. Private enterprises were involved in this process. Another aspect was the property right system reform, which clarifies the investor identity of the state in state-owned enterprises and introduces the joint-stock system reform of state-owned enterprises. Influenced by the trend, many private enterprises also implemented the joint-stock system.

In September 1995, CPC explicitly pointed out in the Fifth Session of the Fourteenth CCCPC that, China should focus on the state-owned economy, and implement strategic restructuring of state-owned enterprises through the flow and restructuring of stock assets. The reorganization should take market and industry policy as the guidance, develop the big enterprises well, give up the control of small enterprises, combine the optimization of the structure of state-owned assets to obtain optimization of the structure of industries and investment. In the late 1990s, compared with the rapid development of non-public economy, the state-owned enterprises got into developing predicament due to high debt ratio, overstaff, heavy social burden, arbitrary levies and low enthusiasm of employees (Zou & Ouyang, 2009). The efficiency declined year by year and loss increased year by year. According to incomplete statistics (Zou & Ouyang, 2009), in the first half of 1996, about 43.3% state-owned enterprises suffered from heavy losses and in the first quarter of 1998 there existed nationwide deficit with increase of the loss of state-owned assets year by year. By the end of 1997, in terms of “develop big enterprises well”, the state formulated the scheme of specific guidance to 1,000 key enterprises. With regards to “give up the control of small enterprises”, each local government adopted various forms such as reorganization, conglomeration, merger, joint stock partnership, lease, contract and sale to directly brought small businesses into the market. Ultimately these enterprises were privatized.

To be specific, the government defined property rights of enterprises in the way of selling enterprises of collective ownership to the staff or the factory director, and selling the state-owned enterprises or workshops to workers or factory directors later on. Areas such as Zhucheng in Shandong, Yibin in Sichuan, Bin County in Heilongjiang, Shuozhou in Shanxi and Shunde in Guangdong first explored ways to enliven small businesses and attained considerable achievements. In addition, a large number of new-type private enterprises participated in the reform of state-owned enterprises because of their own development needs. With the reform measures of merger, acquisition, investment holding, contract, leasing and entrusted management, private enterprises merged the management concept and management methods of non-public sector economy with state-owned economy operation, revitalizing the large quantities of state-owned assets.

Especially after the Fifth Congress of CPC when CPC approved joint-stock cooperative system and put forward the ownership structure adjustment in May of 1997, small and medium-sized state-owned enterprises in China speeded up the reform, leading to the rapid rise of the proportion of restructured enterprises. Through an empirical study, Zhu (2004) found that the main reason for the widespread restructuration of public-owned enterprises was the driving effect of the local finance. In the 1994, the tax-sharing reform caused financial pressure and budget constraints hardening local governments and the increase of proportion of non-state-owned economy obviously improved the ratio of self-financing of local governments.

Another important way for the nation to solve the plight of state-owned enterprises is the Joint Stock System Reform. In 1980s, the main ways for the reform of state-owned enterprises in China were contract responsibility systems. By the end of 1987, almost all the national large and medium-sized state-owned enterprises implemented the contract responsibility systems but the disadvantages of the contract system were soon to be displayed. In the same year, the report of the Thirteenth Congress of CPC pointed out that the stock system was a kind of organization of enterprise property and the experimental units could continue to execute. By the end of 1988, the whole country had 3,800 joint-equity enterprises in total, of which 800 came from the restructuring of state-owned enterprises, 60 issued stocks, and the rest 3,000 were collective enterprises at first. In 1992, the State Council issued the

Pilot Procedures of joint-stock Enterprises, the Opinions on Regulating Incorporated Company, the Opinions on Regulating Limited Liability Company and so on a total of 11 regulations, to guide joint-stock pilot to standardization.

In 1994, the State Economic and Trade Commission, the NDPC (National Development and Reform Commission) and some other relevant departments chose 100 different kinds of large and medium-sized state-owned enterprises to establish experiments of modern enterprise systems. Then, in the light of the local actual situations all over the country, relevant departments selected over 2500 state-owned enterprises to participate in the pilot of the modern enterprise system. Under the requirement of clear property rights, well-defined of power and responsibility, separation of government and enterprise, scientific management, the pilot enterprises gradually established a system for investors of state assets, built the organization framework of modern enterprise system and initially formed enterprise legal person's harnessing structure on the base of verification and evaluation of assets and clear enterprise legal person property.

At the same time, the development of China's private economy steamed into the fast lane. The view of China on private economy gradually came clear and no longer was regarded as a complement but as an important part of the national economy. In 1997, the Fifth Congress of CPC established the system of taking the public ownership as the main body and developing the diverse forms of ownership at the same time as a basic economic system. It also put forward that the non-public sector of the economy was an important part of the socialist market economy. The constitutional amendment announced by the Second Meeting of the Ninth NPC in 1999 regulated that the non-public sectors of the economy such as individual economy and private economy, which were within the limits by law were the important parts of the socialist market economy.

It is because of the special economic transformation in China that the conditions of the development experience of private enterprises in China can be described in three sentences:

- In the 1980s, it was borrowing a “red hat” to manage. In order to protect its own private property, or in order to be able to operate smoothly, the private enterprise often hung the name of the country or the collective economy.

- In the 1990s, it was taking off the “red hat” to separate stock right and wearing the “red hat” to cooperation equity. In the 1990s, the state and government at all levels gradually relaxed their attitudes to the private enterprise. At that time, the private enterprises also dared to claim their rights, many of them began to claim their own property and take off “red hats” by making use of the state-owned enterprise reform process of grasping the big while quitting the small and stock system reform.
- Then, when private enterprises participated in the state-owned enterprise reform and became shareholders of state-owned enterprises, it was called wearing the “red hat” to cooperation equity.

Chinese private enterprises originated in market economy and giving up public ownership status and starting business was known as “plunge into the commercial sea” in the 1980s. Therefore private enterprises positioned themselves and operate businesses differently from state-owned enterprises. Lin et al (2010) compared the mission statements of state-owned enterprises and private enterprises, and discovered the differences between the two types of enterprises. The so-called mission statement is the clear definition of the business aim and mission, such as describing “what kind of enterprise it is, what kind of enterprise it should be, what kind of enterprise it should be in the future”. Lin et al (2010) found that state-owned and private enterprises all focus on the company philosophy and public image, but the state-owned enterprises paid more attention to the products while private enterprises paid more attention to the customers. The explanation might be that it was easier for the state-owned enterprises to get the national support and social support than private enterprises, so the state-owned enterprises tend to face less challenges and threats especially large state-owned enterprises which were in monopolized markets and were not worried about the impact of the market too much. But due to shorter development history of private enterprises in China and the relatively smaller overall size, enterprises directly faced the market and thus focusing on customer's demand was particularly essential to their survival and development.

According to the data from China’s State Statistics Bureau, from 1992 to 2002, the private enterprises increased from almost 140,000 households to 2,435 million, a growth of 17 times, the average annual growth was 33%; the registered capital increased from 22.1 billion to 2.4756 trillion, an increase of 112 times, the average annual growth was 60%; employees increased from 2.32 million to 34.09 million, a growth of nearly 15 times; tax increased from

450 million to 94.56 billion, an increase of 208 times, with an average annual growth rate of 70%. From 1992 to 2002, the individual industrial and commercial households increased from 15.43 million to 23.78 million, the amount of the funds increased from 60.1 billion to 378.2 billion, employees increased from 24.68 million to 47.43 million in the whole country.

2.1.3 The Third Stage: from 2003 to now

The most positive signal during the third stage of the private enterprises development was that the Constitution finally announced to protect private property rights and the party and the government promised to eliminate institutional obstacles. In October 2003, the Third Congress of CPC proposed to eliminate institutional obstacles and loosen the market access of the non-public sector of the economy. In March 2004, the constitutional amendment of People's Republic of China passed by the second conference of Tenth NPC stipulated that the state should protect the legitimate rights and interests of individual economy, private economy and other non-public sectors of the economy. The state shall encourage, support and guide the development of the non-public sectors, and supervise and manage the non-public economy according to law. In 2005, the State Council promulgated the Certain Opinions on Encouraging to Support and Guide the Development of Individual Private and Other Non-public Sectors of Economy, which was the Non-State-Owned 36 stated in the first chapter of this paper. In October 2007, the Seventeenth Congress of CPC put forward that property rights should be protected equally, the new pattern for all the ownership economies should compete equally and promote each other. Moreover, fair access to resources, breaking the system obstacles and promoting the development of the individual and private economy should be advanced.

As Trigo (2003) put it, the development history of private enterprise is also the reform history of China's economy system. The private enterprise is still calling for substantial liberalization in various institutional barriers and market access, and this is also the key direction to the reform of economy system in the future. The contributions that private enterprises have made to the economy of China, and their problems in the new century can be seen in the first chapter of this paper.

2.2 Related Theories and Empirical Research on Private Enterprises in China

2.2.1 Research on Market Barriers that Private Enterprises Face in China

The institutional obstacles private enterprises face and that were expounded in Chapter 1 are the barriers to entry for the industry, but even if the industry is open to foreign capital, it may be banned to the private enterprise. One of the classic examples is the Geely automobile[12] owned by Li Shufu. Wang & Shi (2004) studied the development case of Geely and found that Li Shufu encountered barriers to entry for three times during the entrepreneurial process. The first time was in 1989, when Li Shufu's refrigerator fittings factory had been producing for five years, but had not entered yet the country designated production enterprise list and ultimately Li had to release the enterprise - that had reached the value of 100 million yuan - to the local government. In 1994, Li Shufu decided to enter the motorcycle industry by using the funds accumulated from another enterprise operation, but he still could not produce motorcycles in the name of his own enterprise. Lee had to joint venture with Chongqing Jialing Motorcycle Factory, under the so-called shares cooperation with a "Red Hat". By 1998, the motorcycle production of Geely reached 350,000 units. In 1997, the Geely Group began to involve in the car industry. It invested 500 million in Zhejiang Taizhou to start the research and development of economical and family cars. By 1999, Geely still had not obtained a national car production license and could not sell cars although its economical cars had already formed the batch production ability, and therefore the enterprise faced a difficult position. At the same time, the German company Volkswagen had been manufacturing Santana cars for 16 years in China. Today most of the cars on the streets in China are foreign-brand cars, which is due to policies concerning the restriction of private enterprises' car manufacture.

In 2001, Geely Group finally obtained the car production license due to political influence of Li Shufu. During the approval process of car production, Li received the support of both the State Economy and Trade Commission and Zhejiang Province Government, which

[12] Geely Automobile Group purchased the world famous auto brand Volvo in March 2010.

especially submitted a report to the State Council. It is worthwhile to note that Li Shufu was one of the members of the 10th (having been elected in February 2003) and of the 11th (having been elected in February 2008) National Committee of CPPCC (Chinese People's Political Consultative Conference), member of Federation of Industry and Commerce of Zhejiang Province, Zhejiang Province CPPCC Member and member of the Zhejiang Province People's Congress.

Li Shufu's experience was typical. In order to protect his assets, or in order to gain access to the chance of an industry, the private enterprise wore the "red hat" in the 1990s, and began to use the influence of the relationship since the 21st century. Political connection is the most important of all relationships (Guanxi). Since the government at all levels controls the licenses to access, even if the private enterprises have begun to invest and produce, they may also be banned overnight. Governments at all levels also control the allocation rights of all kinds of resources, so the private enterprises have to pay attention to build relationships with the government.

Zucker (1986) and Redding & Hsiao (1990) found that personal relations were more important in the economic environment in which laws and rules were not stable. If no fair judiciary, the managers had to deal with the individual of power departments to keep good relationship, though they didn't trust them indeed. Xin & Pearce (1996) studied the aim and motivation of private enterprises in China to build networking at an early time. They collected the interview data and did the empirical research and finally found that private enterprises operators depended more on the relationship than those in state-owned enterprises or mixed companies. Private enterprises thought that relationships were more important and that they need more protection. They operated many government relations and gave out more feedback gifts to gain trust. Interviewees thought that this result was mainly due to a lack of protection of private property rights in China and to the fact that laws and rules are not perfect. Luo &Tang (2009) depicted the political associations of private listed companies from 2002 to 2005, explored the influences that the region property protection level, degree of government intervention and differences of financial development level did to the political participations of private listed companies. They found that the worse the local property protection was, the deeper the government intervention was; the worse the financial development level was, the more enthusiastic private listed companies were to form political connections with government.

Zhang (2001) summarized three ways in which private enterprises protect their assets. The first one was wearing a “Red Hat”. The private business enterprises used the name of state-owned or collective enterprises in order to achieve the government's protection. The second one was to be involved in politics, such as manouvering to become a member of NPC or a member of CPPCC. The third was bribing officials, through the way of buying protection directly to realize the purpose of self-protection. In addition, private enterprises also tried to improve their own social status by the way of donating, and through all kinds of relationships, and achieved the purpose of protecting private property rights. According to the statistics, the number of the tenth NPC Members was 3000 members, the number of the Chinese People's Political Consultative Conference was 2238 members, and among them, there were 233 in total that came from the private enterprises.

The main way for the private enterprises to break entry barriers is political association, but empirical research on how to break them through political association is still few. On the one hand, different industry performs differently while breaking the industry barriers. On the other hand, the related data is not easy to collect. Faccio (2006) studied the relationship between political relation and enterprise value in 37 countries and found that in the countries with unsound law system and widespread corruption, entrepreneurs were likely to establish more political relations. Establishing political relations indeed increased the value of the enterprises and especially helped enterprises to solve the “market access” problem. Another finding is that political connection functioned only when the leader of the enterprise became member of the state administration rather than member of the Congress. However the sample of his study did not include information about China.

There is however empirical evidence to support that the political relations of Chinese private enterprises are helpful to break industry barriers. Hu (2006) took the data of Zhejiang Province Top 100 Private Enterprise as a sample, and discovered that the political identity of founders of private enterprises helped enterprises enter the financial industries that were controlled by the government. Deng (2011) made use of the private listed company data from 2002 to 2005, and comprehensively investigated the influences that the political relevance and the diversity had made to corporate performance. The diversity of private enterprises meant that the enterprise entered into other industries except its own main business. He found that, the diversification and performance of an enterprise that had no political connection showed the U shape, that is, diversification dispersed the attention of the enterprise, the more extensive the diversification was, the poorer the performance would be. In turn, the diversification and performance of an enterprise that had political connections presented the inverse L, showing that the enterprise entered into some lucrative industries that were controlled by the government; private enterprises with political association were more likely to implement diversification strategies, especially the non-related industry diversification.

However, Joseph et al (2007) studied the relationship between the political relations of Chinese listed state-owned company CEO and the enterprise performance from 1993 to 2001. It can be inferred from their results that 27% CEOs of the 790 enterprises were former or current government officers, but these enterprises performed relatively worse than those without any political connections. The main reason for this was that most of the officers arranged to be CEOs did not understand technology and business. The study also clearly reflected the reality of state-owned enterprises operation difficulties in the 1990s.

2.2.2 Research on Financing Difficulties in Chinese Private Enterprises

The discrimination against private enterprises of the financial system in China, especially the loan difficulties of small and medium-sized private enterprises has two reasons. One concerns ideology and the second concerns the system. In the 21st century, the loan difficulties of small and medium-sized private enterprises are mainly due to the system obstacles. The loan difficulty and its reasons have been explained in section 1.1.2 of this thesis, and this section will focus on the review of related research.

It is worthwhile to point out that loan difficulties of small and medium-sized enterprises have not only been caused by the great external uncertainty of the enterprises and information asymmetry with investors, but also by the loan ways of current banks and bank industry structure. The traditional bank loans were based primarily on the credit of the enterprise and the main sources of repay were the enterprises themselves and their development ability as business entities. However bank loans often require companies to provide collateral (such as tangible or fixed assets) as a second reimbursement source. Generally speaking, it is difficult for small and medium-sized enterprises to provide collaterals. The highly monopolized bank industry structure in China is also harmful to the small and medium-sized enterprise loans, mainly because the big banks are hard to provide enough incentives for the account managers to lend to small and medium-sized enterprises and the loan information of small and medium-sized enterprises cannot be effectively conveyed to the manager (as mentioned in 1.1.2).

However, the state-owned banks do have discrimination against private enterprises. Qu et al (2005), who once worked in the People's Bank which is the central bank of China in Weihai, Shandong Province, reported that state-owned banks in Weihai basically lent to enterprises in the following ABCDE order:

Table 2-1 Customer choice behavior of state-owned banks

	Large-sized	Middle-sized	Small-sized
State-owned enterprise	A	B	No
Company limited	C	D	No
Private enterprise	E	No	No

The so-called *company limited* includes the company jointly invested by state-owned and private capital. The above table reveals that state-owned banks basically do not lend to small businesses, especially to private small and medium-sized enterprises. The same work shows that new business loans in Weihai city, from 2001 to 2003, were 2.169 billion yuan, 3.683 billion yuan and 5.417 billion yuan respectively and the private enterprise new loans were 188 million yuan, 309 million yuan and 251 million yuan, accounting for 8.67%, 8.39% and 4.63% respectively. The private enterprise loans had been shrinking while state-owned companies occupied the major shares of the credit market. The calculation made by Qu et al (2005) according to the almanac of China's finance data, showed that China's four major state-owned commercial banks accounted for 60.9%, 59.6% and 56.8% of the whole RMB deposits from 2001 to 2003, and the assets accounted for 72.2%, 63.6% and 61.5% of the total assets of commercial banks. In addition, Weihai in Shandong, a coastal area of China located in Jiaodong Peninsula, belongs to China's economic developed regions.

Project Group of Ningbo Prefecture Sub-Branch of the People’s Bank of China (2002) found that the existing credit management system of banks limited private enterprise to gain technology loans. If it has been so difficult for private enterprises in coastal areas to get loans, we may just guess the situation inland. Project Group of Ganzhou Prefecture Sub-Branch of the People’s Bank of China (2001) found that the financial support to non-public sectors of the economy was far behind public economy in Ganzhou, Jiangxi, an inland area of China.

The loan situation of small and medium-sized enterprises in Guangdong Province is better and even so Lin et al. (2005) found that most loans obtained by small and medium-sized private enterprises took the business owner personal property as a mortgage rather than the assets of the enterprise. Thus the loan was not actually a relationship between the bank and the enterprise under the limited liability system. The authors analyzed the financing situation of 491 private enterprises in Guangdong Province through questionnaires and found that small and medium-sized enterprises occupied the majority of the enterprises, large enterprises were only 7. They found that, by the end of 2004, SME’s got funds of 36.48 billion yuan through internal financing, accounting for 42.8% of the total amount of financing, followed by bank credit with 31.38 billion yuan; and trade credit accounting for 16.62 billion yuan. The proportion of internal financing and equity capital financing (through the equity capital and profit retention for investment) is higher in small and medium enterprises and they also depend more on trade credit. Meanwhile, large enterprises mainly relied on external financing and debt financing, and the proportion of external financing and debt financing of enterprises which assets were over 100 million yuan exceeded 50%.

Even if the enterprises already have considerable assets, the capital market continues to discriminate against private enterprises. Zhu & Lu (2011) studied the stock dividends issue behavior of listed companies from 1998 to 2004 and found that state-owned and private enterprises had been differently treated. The ratio of private enterprise to issue stock dividends is lower and the ratio of the implementation of stock dividends is lower too. This is not because private enterprises need more external financing, but because state-owned enterprises have priority when securities department examines and approves the stock dividends. Further studies have showed that, the future investments of private enterprises which were approved to implement stock dividends grew faster, and the state-owned enterprises which implemented stock dividends were more likely to change the expected use purposes of the capitals. This meant the partiality that the supervision department made to the state-owned enterprises in the process of stock dividends examination and approval, which harms private enterprises, impacting the market resource allocation efficiency.

How then have small and medium-sized private enterprises raised funds? They have done so in three main ways. One is from the enterprise's capital accumulation and support from relatives and friends, as reflected in the two case studies in this thesis. Among the 29 private enterprises that were surveyed by Luo & Song (2004) in Zhejiang Ningbo, 12 companies had got 100% of their initial capital by themselves; five admitted that they had borrowed from friends and relatives; two had relatives as shareholders; six companies had other groups lending (enterprise fund, membership and township); and only seven relied on the bank loans or credit cooperatives. The studies of Lin et al (2005) also supported these findings.

The second important way is the trade credit. Company Eagle in this thesis survived from the crisis of 2003 mainly by the advance payments of other enterprises. The so-called trade credit was that small and medium-sized enterprises generally had higher accounts receivable, getting funds through the deferred payment to the big suppliers. Demirguc-Kunt & Maksimovic (2002) studied the relevant data of the largest listed manufacturing enterprises of the global 39 developing countries from 1989 to 1996, and found that the enterprises widely used trade credit instead of bank loans. Since in these countries there was generally a weak law protection environment, small and medium-sized enterprises were hard to get the support of banks and other financial intermediary organizations. Fisman & Love (2003) studied the effects of financing between enterprises, in the countries which financial systems were less developed, and found that the industries that depended more on trade credit financing grew faster. The majority of these industries were small and medium-sized enterprises, in general, they were also difficult to get support from banks and other traditional financial intermediary organizations. Fisman & Raturi (2004) used the trade credit data of Ghana, Kenya, Tanzania, Zambia and Zimbabwe in the years of 1992 to 1995, and empirically pointed out that the competition between enterprises led to the provision of trade credit. McMillan & Woodruff (1999) also found that small businesses in Vietnam usually got trade credit from big enterprises. Summarizing the research above, in emerging market economies, the less developed financial system makes small and medium-sized enterprises rely mainly on the trade credit between enterprises in order to get financing. In fact, earlier research by Petersen & Rajan (1997) also found in the financial system of less developed areas of America, that small and medium-sized enterprises used trade credit very often.

During the economic transformation period, China had a system background similar to the rest of many developing countries: the legal system was not perfect and the financial system was vulnerable. A few Chinese scholars launched preliminary empirical studies of the trade credit financing status of small and medium-sized enterprises in China. For example Ge & Qiu (2006) depended on a survey made by the Chinese Academy of Social Sciences and took the 332 state-owned enterprises and 238 non-state-owned enterprises as their samples. The empirical study found that: first, in relation to the state-owned enterprises, the non-state-owned small and medium-sized enterprises tended to use more trade credit, and their trade credit balances (namely the balances of accounts payable and debt receivables) were positive; second, the inspection of overdue trade credit[13] distinguished the motivations of the two types of trade credits of transaction financing. Because it was difficult to obtain loan capitals from the banks, non-state-owned enterprises used trade credit more for financing purposes. Zhang & Shang (2006) used the financial data of 79 small and medium-sized manufacturing enterprises from 2003 to 2005 and found that small and medium-sized enterprises usually got short term and high financing costs trade credit through the accounts payable and other payables, making it a substitution of bank short term credit. At the same

[13]The receivable that has expired but still did not be pay, including the long-term trade credit after the arrival of the goods.

time, the banks provided loans to small and medium-sized enterprises mainly according to the enterprise fixed assets rather than to business incomes or business potential. Contrasted with the financing way of small and medium-sized enterprises in China, the small and medium-sized enterprises in the United States got their short-term credit funds mainly through bank loans with 70% of their short-term loans based on the mortgage or pledge of inventory and debt receivables. Hou et al (2011)'s research also found that China's high-tech venture enterprises widely used the financing mode of trade credit.

The third way for business owners to get financing is to get bank loans through political relations. For Allen et al (2005) this is the key reason for the high-speed growth of China's private sectors. These authors thoroughly discussed the reasons for private enterprises in China to have a larger scale and faster growth rates than both state-owned enterprises and listed companies. China's economy was as well as other developing economies, do bear deficiencies in protecting investors, but the development speed of China's private sector does not seem to bear the adversity caused by the lack of investor protection like in other developing countries. That is because China has an effective, alternative financing channel and governance mechanism, such as the one provided by reputation and relations, and it has indeed supported the development of the private enterprises.

Cull & Xu (2005) inspected influential factors of Chinese enterprises' reinvestment. They found that although the protecting degree of intellectual property is an important explanatory variable, enterprises' capability of getting loans is in proportion to the amount of investment. And the capability of getting loans mainly depends on the ability to establish political relations.

However, most private enterprises that can effectively establish political relations are large enterprises. Since information of medium-sized or small enterprises is unavailable, the following research basically concerns with listed companies. Bai et al (2005) also found that it is easy for entrepreneurs who have high political position or who substantially donate to social welfare to get loans. Yu and Pan (2008) took listed companies (1993-2005) in Shanghai stock exchange as a sample and found that enterprises with political relations tended to get more loans and a longer loan period compared with enterprises with no political relations.

In rapidly developing China, long-term liabilities can compensate insufficient capital fund and therefore all enterprises hope to increase the proportion of long-term loans. Sun (2005) studied the connection between political relations and debt levels. The author found that entrepreneurs' political status like being a NPC member and political advisor indicates a certain economic strength and the scale of enterprises and their contribution to economic and social development raises governmental admiration. As it can be inferred from listed companies from 1999 to 2003, state-owned enterprises tend to have longer loan period and enterprises with political relations tend to get long-term liabilities easier than those with no political relations because government can intervene in the loan decisions of banks. Huang & Wang (2011) found that listed companies from 2004 to 2008 that even poorly performed, if they had political relations they were easier to continue to get loans rather than better performing enterprises

2.3 Brief Summary

This chapter first reviews the development history of Chinese private enterprises. They developed from nothing and became an indispensable part of the national economy along with all sorts of reforms in China. Chinese enterprises encountered discrimination due to left thought at the beginning of the reform and then systemic obstacles in early 21st century.

Through relevant domestic and foreign literature this chapter reviews the main entry barriers and financing problems that Chinese private enterprises face.. Industry entry barrier problems mainly originate from resource allocation and industry entry permission of Chinese government. There is already research pointing out the governmental restrictions faced by private enterprises, but research concerning *how* private enterprises were restricted is still scant. Financing problems are characterized by systemic difficulties, namely due to the state monopoly of the banking system that does not make itself available to private enterprises. However if private enterprises have political relations, these can serve as collateral and the barrier can be broken to some extent. Political relations are therefore the most important and essential relations for a private company to survive and prosper as it was documented in the literature reviewed in this chapter.

Chapter 3: Relevant Theoretical Literature Review

This chapter mainly reviews the theoretical study of corporate governance, social capital and agency problem in medium-sized or small enterprises. These theories apply to the study and analysis of the two case studies in this thesis.

3.1 Theoretical Framework of Corporate Governance and Small Enterprises' Corporate Governance

Works by Shleifer & Vishny (1997), Tirole (2001) and Becht et al (2002) refer that mainstream economists consider "corporate governance" as a situation where "capital providers in a company are certain to achieve their return of investment". Corporate governance mainly explores how to solve the principal-agent problem caused by separation of ownership and control power in modern corporate system. The principal can be an "Investor" or "Outsider" and the agent includes "Manager", "Entrepreneur" or "Insider". The agent may take certain actions to harm the principal's interests because of information asymmetry. Basic agency problems include adverse selection and moral hazard. Take agency relationship between shareholders and manager as an example. The purpose of corporate governance is to choose the most capable manager and motivate him to take optimal action and be responsible for investors. This is also called shareholder value viewpoint.

Two types of principal-agent problem have been extensively studied. One is the internal agency problem in an organization which is called "Category 1" principal-agent problem by Jensen & Merkling (1976). Principal is generally a "shareholder" while the agent is a "manager". Moral hazard behaviors of the agent are mainly manifested by "inadequate effort", "self-dealing" and similar behaviors. For instance, the agency problem of Z company described in chapter 4, needs to be solved with the project manager, and the agency problem of company Eagle in chapter 5 needs to be solved with farmers. The second category of principal-agent problem refers to the issues between "investor" and "entrepreneur" or issues between "large shareholder" and "minority shareholder". This type of agency problem mainly concerns with research on investment and financing relationship. Take the two enterprises in the case studies described in chapters 4 and 5 as an illustration. Both belong to the category medium-sized or small enterprises and there exists prevailing information asymmetry between them and external investors.

Two mechanisms are needed to maximize shareholder value. One is inner governance mechanism, which means that the principal and agent together formulate contracts to distribute their cash flow rights or establish effective allocation of authority. The other is external governance mechanism, which means the law can ensure contract enforcement successfully and protect property rights effectively and the state can provide a well-performed financial market.

The maximization of shareholder value viewpoint is questioned recently. Many politicians, managers, consultants and scholars deem that the concept of corporate governance should be broadened and revised since employees, community, suppliers, customers and other stakeholders all invest various kinds of capital in corporate development and their interests should be internalized.

According to Blair (1995, p.214), this viewpoint was put into practice in 1960s and 1970s in America where the viewpoint of maximization of stakeholder value was not so easy to accept as in other developed economies. For example, enterprises often gave charity donations and paid employees who left the company temporarily to do public welfare work. According to Shleifer & Summers (1988), the wave of corporate hostile takeover in 1980s sparked a fierce debate and people began to suspect whether takeovers which increased shareholder’s wealth should be at the cost of interests of employees and community.

However, taking interests of stakeholders into consideration does not mean that mainstream economics accept this viewpoint. Friedman (1970) was clearly objected to the idea because he thought that the maximization of shareholder value and of stakeholder value were in conflict and this might sacrifice the interests of shareholders and thus lead to less investment. In this thesis we argue that totally objecting to maximization of stakeholder value is shortsighted. What if two views can merge together? They should not be contradictory. The case study of company Eagle in chapter 5 demonstrates that the reason why they achieved great success is because they pursued an adequate consideration of farmers' interests demand.

Enterprises studied in this thesis have three characteristics. First, they are medium-sized or small enterprises, which face financing difficulties and the basic agency problem of these enterprises concerns with outside investors and inner investors. Secondly the enterprises are family businesses, which need to balance interests of family members or shareholders (different families). Finally inadequate investor protection and immature financial system will affect corporate governance of these enterprises in the transition economies. The third characteristic has been discussed in chapter 2. In the following section basic theories will be reviewed and relevant empirical analysis of financing difficulties and corporate governance of family enterprises will be discussed.

3.1.1 Agency Problem and Financing in Medium-sized or Small Enterprises

Chapter 2 discussed institutional factors related to financing in medium-sized or small enterprises and this chapter will illustrate how the features of these enterprises themselves affect their financing ability.

The key feature of minor enterprises is great uncertainty and information asymmetry, which should be inspected to explore determinant factors of financing. First, in theory, Myers & Majluf (1984) thought that information asymmetry might lead a company to finance in a specific sequence. The company will pay adverse selection costs and thus face market value underestimation due to information asymmetry between the company and outside investors while carrying on outside financing. Therefore, the reasonable sequence should be inner financing first and then outside financing. Moreover, in terms of outside debt and outside equity offering, high-quality enterprises also tend to choose credit financing that has lower value underestimate degree instead of equity financing. Innes (1990) studied equity financing under the circumstance of moral hazard and he thought that moderate debt level would help entrepreneurs to perform best. Secondly, with regard to risks, real option is analysis tool of optimal investment timing. Real option will have greater value when a company is with high risk and the investment decision timing is when external conditions change enough for a company to compensate the giving up of the real option after investment. Jensen & Merkling

(1976) pointed out in their study that in enterprises that have debts and are on the edge of financial crisis or bankruptcy, shareholders may increase credit financing and thus damage creditors' interests in the way of over-investment. This is because company has a high-valued real option that does not belong to creditors. The entrepreneur will obtain benefits when the company succeeds and investors' benefits will be harmed when the company fails. Therefore, in an analysis by Jensen & Merkling (1976), agency problem between shareholders and creditors becomes the key obstacle of minor enterprises' financing. In other words, high risk and high information asymmetry lead to investors' concerns about their benefits being damaged by over-investment.

In an empirical research, Rajan & Zingales (1995) used the enterprise data of seven industrialized countries (the G-7 countries) from 1987 to 1991 in the Global Vantage database, and completely compared the influences that the proportion of tangible assets, growth, enterprise scale and profits of enterprises did to the horizontal levers of enterprises. The empirical results showed that: in addition to a few countries the regression coefficients symbols were unusual and the levels of significance were bad, the proportion of tangible assets, the scale of enterprises and leverage ratio(measuring the enterprise uncertainty) were positively related, and growth, profits (measuring the enterprise quality) and leverage ratio were negatively related. Gaud et al (2005) made use of the panel data of 104 listed companies in the Swiss Stock Exchange during 1991 to 2000. The empirical research found that: enterprise scale and tangible assets and leverage ratio were positively related, supporting the viewpoint of balance theory; and growth and profits had negative influence on horizontal level, respectively supporting the views of agency theory and optimal sequence financing theory. Kuo &Wang (2005) empirically tested the determinant of capital structures of 450 multinationals, and emphatically investigated the degrees of internationalization, whether high-tech enterprises and the influences that the Asian financial crisis in 1997 had on the capital structure of multinational corporations.

Kim, Heshmati & Aoun (2006) made use of the data of 617 manufacturing listed companies in South Korea from 1985 to 2002and, introducing two virtual variable regressions concerning the Asian financial crisis in 1997 showed that the financial crisis had had significant negative influence on leverage ratio. Eldomiaty (2007) took 99 Egyptian enterprises as a sample in 2007, and the empirical research found: the effects of tax, bankruptcy risk and target leverage supported the viewpoint of balance theory; the effects of growth and attaining supported the point of optimal sequence financing theory. Mazuer (2007) took the 238 listed companies of Warsaw Stock Exchange from 2000 to 2004 as a sample, empirically researched influences that the liquidity, attaining, product uniqueness, enterprise scale and asset composition had on enterprise leverage ratio. The studies suggested that, in comparison, optimal sequence financing theory better explained Polish financing behavior than balance theory.

Brav (2009) studied the financing differences of Britain's private enterprises and listed companies. He found that private enterprises depended more on bank capitals and leverage ratio was sensitive to performance changes, while listed companies was more dependent on equity financing. He thought that was mainly due to the fact that‘s asymmetric information and risk led private enterprise financing costs to be higher. When a private enterprise faces private equity the financing cost is higher than public equity, and this is an important reason for private enterprises' high leverage ratio.

3.1.2 The Governance of Family Enterprises

Worldwide, family enterprises are widely existant. Whether listed or not, family enterprises present a high ratio in relation to the universe of all enterprises. For example, a study by Schleifer & Vishny (1986) found that 149 enterprises of Fortune 500 were controlled by family enterprises. In a study by Laporta et al (1999), 30% of the 27 richest economies were controlled by families or individuals; Classes et al. (2000) studied family businesses in East Asia and found that 2/3 of enterprises were belonging to families; Faccio and Lang (2002) found that nearly 40% of enterprises in the 13 Western European countries were family control.

The family control enterprises were considered to have two kinds of management problems. One was the connection between private interests of family members and control rights, which led to the contradiction between the enterprises and the investors. For example

Aghoin & Bolton (1994) analyzed how the family having private interests configured control rights in relation to other investors, as family interests made them worry that their investment capitals could not get protected and be rewarded. If enterprises face serious financing constraints, they may have to give up their control rights. Villalonga & Amit (2006) stated agency problems of family enterprises were the second agency issues, namely those arising between the outsider and the insider, which can lead to the so-called entrenchment effect problems. For example, a family business may have cross-shareholdings with other enterprises in order to prevent a takeover, or be contented with the status quo and act conservatively, thus lacking enterprising spirit.

Stulz (1988) considered that family shares and the value of enterprises may form a U pattern, namely with the increase of the proportion of family control, the value of the enterprise first rises and later falls. Empirical research by Mock et al (1988), McConnell & Servaes (1990) and Demsetz & Villalonga (2001) confirmed this theory and more recent empirical research further separated the value change effect which was caused by the enterprise ownership and control rights. Claessens et al (2002) and Cronqvist & Nilsson (2003) found that the enterprise shares rose when the family cash flow went right up, but if the control rights of the family exceeded the cash flow rights it had, then the value of the enterprise would fall down.

The second was the internal management problem of family enterprise. If the family enterprise is controlled by a person and the interest of the family is represented by the founder of the enterprise, this would help the enterprise value rise. But when the enterprise passed to the younger generation, if the design of the separation mechanism of ownership and control had not been good enough in the transition process, the value of the enterprise may fall down because of the poor management ability and power struggle of offspring. Empirical researches conducted by Anderson and Reeb (2003), Barontini and Caprio (2006) and Andres (2007) further supported the fact that the founder control of the enterprise would be helpful to improve the enterprise value. Anderson and Reeb (2003), Barontini and Caprio (2006) and Villalonga and Amit (2006) confirmed that passing the enterprise to the second generation frequently leads to negative effects.

In this thesis, the stock equity of Z Company was decentralized at the beginning, and when the enterprise was faced with a severe external situation, this kind of decentralization led to conflicts of interest and slow decision-making of shareholders, a situation similar to the internal friction of family members. In Eagle Company, Mr. H was the general representative of family interests and other members of the family only made contributions to the enterprise

3.2 The Theory of Social Capital

3.2.1 The Basic Conception of Social Capital

The concepts of trust and norms of civic cooperation build up a notion of social capital. The theory of social capital studies how the trust and norms of civic cooperation affect the economic and social performance of nations and areas（Coleman, 1990）. Social capital is viewed as a manifestation of cooperation among people and some of policies linked with social capital may have economic effects. Putnam (1993) used the concept of social capital to explain the difference in the economic and government performance of northern and southern Italy. The better performance of northern Italy is because people are more willing to cooperate with each other, and to participate in administration of state and social affairs.

There are two theories to explain the trust and cooperation between people. One is the repeated prisoner model, which considers trust as the common expectation that has evolved in the long time of cooperation behavior. Once a player takes up a non-cooperation action, he will induce other players always to act against him in the future. This theory stresses the dependence as the base of cooperation behavior, and also if there are incentive compatible institutions, the players will work together. Another explanation is based on experimental economics, which finds that cooperation behavior exists in the game of one period time indeed, so the economists and socialists think that the trust is somebody’s nature characteristics.

The seminal work of Putnam (1993) has attracted great academic attention mainly in what regards the relations between social capital and economic performance. Knack & Keefer（1997）present evidence that “social capital” matters for measureable economic performance, using indicators of trust and civic norms from the World Values Surveys for a sample of 29 market economies. They find trust and civic norms are stronger in nations with higher and more equal incomes, with institutions that restrain predatory actions of chief executives, and with better-educated and ethnically homogeneous populations.

Granovetter (1985), a scholar of social capital theory believed in the hypothesis of the rational man which completely disregards the social relations of decision-makers in one extreme, while the belief that decision-makers give all considerations to social norms and values is another extreme. Therefore, Granovetter (1985) held that analysis of the economic behaviors and the institution shall be from the so-called "embeddedness" perspective, that is, when making decisions, individuals with inalienable connections to the social network will internalize and consider other people's appeal for benefits and make a difference between close and far relations (which is called as ongoing relationship by Granovetter). To be more vivid, the so-called "embeddedness" means that individuals will partly bring the interest of other people in their closely related social network into consideration when making decisions for their maximal benefits; with relationship network spreading out further and further, the individual decision making will be more and more rational. Granovetter (1985) held that decision makers in his close social network will be committed to building up trust relation, while with the network extending out, the individual behaviors will possibly be more opportunistic (Williamson 1975)[14]".

China's financial system is still immature and weak, the private property right is protected insufficiently, the contract enforcement is poor, the relevant rules are irrational and unstable. These are typical features of China's transitional economy, which make the trading market become very uncertain and costly. The case studies in this thesis illustrate that when the formal rules and institutions are not established, or not rational, the resource allocation is not effective. Then the trust between individuals and the social networks play a very important role in ongoing economic activities.

3.2.2 The Theoretical Explanation for the Use of Social Capital in Financing

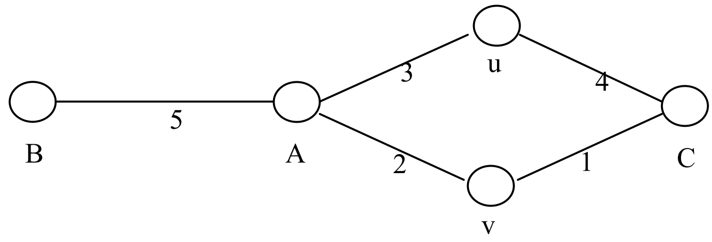
[14]It refers to when individuals set principles or others' benefits aside, and seize every opportunity to maximize their benefits. Granovetter (1985) names this behavior as malfeasance.

The theory of social capital explores the social relationships in which entrepreneurs have a social contact with people who may be of interest to their economic activities. The social relationships can be divided into two kinds: direct social ties and indirect social ties. As the name suggests, direct social ties describe those that directly link people with the entrepreneur. They may be classmates, former comrades, colleagues and so on. Indirect ties are those established with entrepreneur through another direct ties. As figure 3-1 shows, persons A and B are direct tires, and persons A and C are indirect ties linked through two indirect ties u and v.

Shane & Cable（2002）examined the effects of direct and indirect ties among entrepreneurs and studied 202 seed-stage investors on venture finance decisions in 50 high-technology ventures. They found that those who were more willing to invest in the venture had previously established a direct link with the entrepreneur. The investors invest in the venture mainly because they recognize the entrepreneur’s past performance and therefore they must know about that performance.

Granovetter（1985）and Uzzi（1996）examine the differences of economic transactions between social networks and market-based transactions. Unlike market-based transactions which are governed by norms of self-interest, social relationships are governed by norms of fairness and equity. Moreover, direct social ties between parties transfer expectations about people’s behavior from a prior social setting to the new business transaction. Gulati （1995） believes that the economic transaction with direct ties is characterized by: (a) motivate both parties to maintain the relationship in a fair and trusting manner; (b) generate a sense of obligation between the parties, which causes the parties to behave generously towards each other.

Figure 3-1 Social Collateral in Simple Networks



Source: Karlan et al (2009)

Karlan et al（2009）developed a secure informal borrowing theory which is based on social network connections between individuals and affirm that the network-based trust predicts informal borrowing. They predict that dense networks generate bonding social capital that allows transacting valuable assets, whereas loose networks create bridging social capital that improves access to cheap favors such as information. They emphasize the benefits of dense networks with high closure, where connected agents share many common friends that facilitates the enforcement of cooperation. In contrast, they also argue that loose networks, namely, low closure, are better, because they provide greater access to information and other resources. An individual who wants to join a network will identify a trade-off between trust and access, which implies that the relative benefit of high or low closure depends on the value of the assets being transacted.

3.3 Relevant Theories about Moral Hazard and Linear Contract

3.3.1 Moral Hazard Problem

The standard moral hazard issue can be described as follows: the principal and the agent sign a contract and the principal ensures the agent to carry out an assignment; the agent makes his efforts at the level of a, and a will affect the contract's performance q; and what the principal cares is only the performance. The agent enforces a private cost for his efforts, while the principal needs to compensate for the cost. He must then select a signal that measures the efforts of the agent and, generally speaking, economists believe that performance q is such signal. Typically, the compensation scheme for the agent (a compensation scheme is contingent on the symmetric information) would lead to part of the loss; in economic words, the social welfare will be reduced. There are two main reasons: first, performance is the outcome of the agent's efforts combined with uncertain external factors, and so the efforts of the agent cannot be measured perfectly; second, the compensation scheme will be structurally constrained to satisfy some rules. For example, the compensation for the agent can never be negative, which means there is limitation on the punishment of the agent's fault, a situation that is not beneficial to optimal incentive.

The moral hazard issue widely exists among all kinds of economic relations, and many economists have conducted initial research on it and extended it to a wider scope. For example, Arrow(1970) and Spence & Zeckhauser (1971) pioneered in investigating the moral hazard issue in insurance contracts; Alchian & Demsetz (1972), and Jensen & Meckling (1976)researched into the incentive issues in corporate governance; Stiglitz (1974) and Newbery & Stiglitz (1979) studied the profit sharing contract in the share tenancy theory; and Stiglitz & Shapiro (1984)investigated the efficiency wage theory.

In theory and practice, the contract design about moral hazard is rather complicated. First, it is hard to find a variable to precisely measure up the efforts of the agent. It is hard for economists to find a contract solution to a given issue and, moreover, the contract in practice may encounter all kinds of problems. Holmström & Milgrom (1987, P 1-2) pointed out, "*Optimal incentive contracts tend to be complicated even in the simplest situations, making the models hard to work with in extended settings, Indeed, very few restriction can be placed to the shape of contracts, even such a basic property as monotonicity may be hard to assure*[15], *..., Optimal contracts respond directly to the strength of this information, which may vary in a rather arbitrary way with the outcome*."

The complexity of incentive contracts also lies in the contradictory aspects of incentives and insurance. In practical employment relations, the important point is to what extent the employees shall be insured to survive poorer performance. The fundamental economic issue is how much risk given by the business life cycle shall be shared by the employer and the employee respectively. Insurance means that the income of the agent is not heavily susceptible to his performance; for example, to keep the income of the agent invariable to performance is a good insurance plan. The incentive is called the "carrot and stick" philosophy (Mirlees，1999; Holmström, 1979); rewards come hand in hand with punishment;

[15]The so-called monotonicity means that the contract between the principal and agent shall be non-decreasing proportional to the performance, and better agent performance means higher rewards; this way the agent can be optimally motivated and the principal is also willing to enter into such a contract.

the bigger the gap between the “incentive” and “punishment" in the compensation scheme given to the agent is, the stronger the incentive effect will be.

3.3.2 Linear Contract

Holmström & Milgrom (1987) did research under a multi-period repeated moral hazard framework and found that the optimal contract to the risk aversion agent is a linear function about the overall performance. This thesis puts forward two assumptions: a) the agent persistently selects his optimal efforts during several periods, which means that the efforts selected by the agent are not susceptible to the previous performance records; b) during each period, the agent is able to observe the outcome of his efforts. Suppose the performance can be described by the Brownian motion process (a physical phenomenon in which some quantity is constantly undergoing small, random fluctuations) with positive drift rate, and the income of the agent can be described as:

$$R = a + bq \tag{1}$$

Where,

$$b = 1/1 + \eta c \sigma^2 \tag{2}$$

Formula (1) means that the income of the agent is a linear function of the accumulated performance *q,* without consideration of individual performances during each period in between. The coefficient a means the fixed wage paid to the agent, and, in the assumption that the agent is risk averse, the fixed bottom wage meets the demand for insurance. *b* refers to the profit sharing proportion between the incomes of the agent and the principal: first, it is inversely proportional, that is, according to the Arrow-Pratt risk aversion measurement, the higher the risk aversion the agent has, the lower his profit share will be. In fact, the optimal contract is a linear function of the performance, which means that the agent needs to assume certain corporate operation risk. Second, *b* is also the decreasing function of the agent’s efforts cost factor *c;* the bigger *c* is, the less the productivity of the agent will be; higher share rate means that the principal is more willing to give a larger share to those who are more efficient and productive. Finally, the share rate is a decreasing function of the

Performance-Risk Measurement σ^2 (the standard deviation of performance), which means that the principal will have to assume higher risk, while the agent's income is not very susceptible to the risk factors which he has difficulty to control.

Holmström & Milgrom (1987) fundamentally concluded that, as long as the output is supervised by the principal and measurable, the principal and the risk aversion agent can share risks under the framework of long-term agreement, and the income of the agent is a linear function of his accumulated output.

Capacity classification and piece rate agreement

Lazear (1986) made more careful analysis on the difference between agent piece rate contract and wage (basically fixed income agreement), and the thesis elaborates the applicable scopes of the two agreements. The peace rate contract is dependent on some visible output, while the salary relies on the investment of the agent, for example the time investment of the agent. Since the salary is not dependent on the output, the output of the agent does not need to be measured, so the principal saves the cost of supervision. The agents with fixed wage however would not be easily classified in accordance with their productivity, so some agents of low efficiency might be among them. Under the following circumstances, the profit-sharing contract will be frequently employed: (1) in case of a lower output measurement cost; (2) when, for the principal, the lower output rendered by the fixed wage scheme as the formulation cost is too high; (3) when the different capacities of the agent can be effectively told with the piece rate agreement; (4) in cases when the output can be precisely measured with less deviation.

The most important difference between the models of Lazear (1986) and Holmström & Milgrom (1987) is that the latter found that the principal can devise schemes of higher piece rate for the agent or rely more on the performance contract to tell agents of different capacity apart. Hagerty & Siegel (1988) pointed out the similarity between the Screening Model of adverse selection problem and the moral hazard model, that is, to tell apart different consumers via different prices and consumption, or to tell apart different types of workers via different output and efficiency wages.

Multitask setting contract and job designing

Holmström & Milgrom (1991) conducted in-depth research on the multi-task setting contract design for the agent. In most employment relations, multi-task always clearly features the job of the agent. For example, teachers work their way to help students to master some knowledge and cultivate their creative thinking, while in the factory, the workers are working to increase the product output and ensure the product quality. A widely observed phenomenon is that for many job types of high complexity, the performance of one aspect might be easier to meter, while other aspects are harder; if the incentive wage favors only one aspect, the incentive mechanism might be easily twisted. For example, if the reward of teachers is only based on the test results of students and their enrollment in higher schools, and these are the indexes considered to be closely related to their mastery of knowledge, the teachers may be attracted and forget about their efforts to cultivate talents of real ability and creativity. Holmström & Milgrom (1991) put forward two ideas to address the multi-task principal-agent relation: first, appropriate incentive mechanism shall be designed without occurrence of twisted incentives; second, the job and tasks shall be designed so that the performance of the agent can be observed and respectively measured, so as to control the direction of incentives.

First, Holmström & Milgrom (1991) pointed out that if it is difficult to measure one aspect of performance of the overall job of the agent, it would be better for the agent to obtain fixed income, so that the incentive scheme will not be twisted. For example, the teachers can be given fixed wages, so that they can invest more efforts in cultivating the creativity of students.

If it is hard for us to measure the performance of teachers in cultivating the creativity of students, the poor measurability of performance is also rendered by the difficulty to measure the changing value caused by changing production assets. For example, the output is obtained out of the value consumption of equipment; it is hard to measure the decreasing value of machines with the passing of the time, which makes the measurement of the overall performance of workers difficult. If the workers' income is highly dependent on the output, the workers may try harder to increase output at the expense of shorter machine service life.

In such a case, when the principal owns the gains out of his assets, the optimal incentive contract would be to basically disconnect the income and the output of the agent, in order to prevent misuse of assets (equipment) and prevent poorer caretaking, for example, the workers can be given relatively fixed wage. On the other hand, if the agent owns gains out of the assets, the optimal contract would be to provide stronger incentives to make the agent stay focused on his production to prevent the reverse problems, that is, in this way the agent would not be too prudent in using the assets, or make too much effort on maintaining the machine. As observed by Williamson (1975) higher incentives may be easier to occur as arranged by the market transaction rather than by the enterprise. Thus, Holmström & Milgrom (1991) believe that they also have contributed to the assets ownership theory, and the situations that are beneficial to the agent ownership of the assets are when: "(1) the agent is not too prudent in risk aversion; (2) the assets income risk is small; and (3) there is little deviation in measuring other aspects performance of the agent."

Second, in terms of job design, Holmström & Milgrom (1991) believed that the principal can divide a major task into some smaller ones to enhance efficiency. They found that the ways to enhance efficiency are: first, each agent only needs to be responsible for one task. Second, those jobs of measurable performances shall be allocated to one agent, while other jobs shall be allocated to other agents. This theory points out that even if the agents have the same features before their job, the principal shall devise different measuring features for the job.

Long-term relational contract

The type of the above-mentioned contract is short term, that is, to investigate the completion of a task or one phase of a task. Holmström & Milgrom (1987) surveyed the multi-phase repeated contract relation, and the principal measures the performance of many phases before rewarding the agent. If this kind of cooperative relation experiences multi-phases, what would be the optimal contract? For example, if one performance piece rate is done after each pig-raising phase, how can the longer-term contract be arranged?

Levin (2003) named the longer term contract a relational contract. For both sides have difficulties in describing the future occurrences, which might be hard for the court to attest, the relational contract is maintained based on the credibility of the parties involved. This type of contract features a simple structure, i.e. the principal promises that they would have the same incentive schemes for the agents on each phase, while the agent on each phase will make the same efforts (to be measured by performances); if one party fails to honor their promise, the future deals will be twisted and even the contract will have to terminate. This means that in face of changing outputs, the relational contract only needs to be adjusted in price, for example, adjustment of the basic level of the incentive system, not the whole incentive system.

The concept of relational contract is different from the standard incentive theories made by Mirlees (1999), Holmström (1979) and Holmström & Milgrom (1987). The standard incentive theory can only need to meet the demand for incentive compatibility constraint and participation constraint, which will exert impact on the specific structure of the agent contract[16]; thus the bigger the gap between "reward" and "punishment" in the agent contract is, the better the incentive effect will be. The relational contract meets the demand for incentive compatibility constraint of the agent, and at the same time meets the demand for inter temporal participation of the agent (i.e. each party shall have the right to terminate the contract on each phase), while the constraint has imposed impact on the contract structure, which requires that the gap between "reward" and "punishment" should not go beyond the total present value of the relational contract.

This kind of constraint also restrains the incentive effect of the contract. When the principal and the agent have asymmetrical information that leads to the adverse selection problem of hidden information, the cost condition for the agent on each phase is his private information, and would not require the agent make more effective efforts. When the asymmetric information action is of unobservable moral hazard problem, the optimal relational contract has a simple structure, i.e. the fixed income and bonus for each phase shall be paid to the agent, and only when the agent has his performance above a certain threshold for that phase would the principal pay him the bonus.

Risk neutrality of the principal

[16]For example, many contracts require that the income of the agent need to be of limited liability, i.e. the income of the agent cannot be negative, which is the impact on the contract structure.

Most incentive theories assume that the principal is risk neutral. Under such an assumption, most incentive theories predict that the principal takes most risks during commercial operations when, for example, the enterprise instead of the employee absorbs the risk of price change during operation. It is easy to assume this way theoretically; in practice, it is required that the enterprise has the capacity of absorbing the risk, which is done by the corporate risk management strategy. If the enterprise has different businesses, it can decentralize the risk; the enterprise can have large-scale economy to reduce the risk of faulted machine during the output process; it can also extend the supply chain to obtain the overall industrial profit, and establish some sort of monopoly profit to ease the risk of cost change. It can also make use of the financial market to transfer risks, and practice the risk management strategy of insurance and hedging in order to ease the risk caused, for example, by changing prices.

3.4 Brief Summary

This chapter mainly reviewed relevant theoretical literature that will be used to analyze and explain the case studies in chapters 4 and 5. First this chapter reviewed the theory of corporate governance, pointing out that corporate governance deals with both the maximization of shareholder value and the maximization of stakeholder value. The main principal-agent problem of small enterprises is the agency problem between insiders and outsiders. High risk and information asymmetry are the basic determinant factors of financing difficulties in small enterprises. Moreover, family businesses often have interest conflicts among family members and between these and other investors. If an individual can represent the family interest, the value of the company tends to be higher. However the value of family companies may decrease when passed to descendants.

Secondly, this chapter also reviews the theory of social capital. Social capital theory mainly discusses how to build trust in interpersonal relationship, which helps to protect own interests and thus get investment opportunities in the unsound law system and mechanisms. Social networks can be used to explain small enterprises' financing. Shareholders can funnel resources from their social networks on the premise that expected return gained from shareholders' social networks should be greater than that gained from other networks.

At last, this thesis introduces moral hazard issue and linear risk sharing contract. The structure of linear risk sharing contract has been discussed from the perspective of risk aversion, ability classification and stratification, multi-task principle-agent and work design and long-term relational contract.

Chapter 4: Survival in Difficulties: The case of Z Company

This chapter introduces the case of Z Company and discusses it at the light of the theories presented in the previous chapters.

On one morning of October 2010, holding his beloved Zisha Teapot cup, Mr.Y looked out of the company's huge windows but his thoughts could not be calmed down for a long time. He had been troubled by the company’s equity dispute for nearly a year and finally it was settled. Mr. Y could save his business fruits, so he felt much relieved.

Mr. Y’s company is located in one tall building of the CBD (Central Business District) of Zhengzhou, the capital of Henan province. Facing the north, the office of the company is sunny and bright. Looking out from the office, what comes into view are the Henan Art Center, a futuristic oval construction, and Zhengzhou International Exhibition Center, an ultra-modern building that is built along the artificial lake. Recently, the National Agricultural Machine Exhibition was held in Zhengzhou and the CBD was crowed with various kinds of trucks and farm machinery, which shows Henan province’s prosperity and vitality. The real estate of CBD is the most expensive in Henan. Mr. Y believes in traditional Chinese Feng-Shui, and that is why he chose CBD to create his company.

4.1 The Background and Process of the Case

4.1.1 The Foundation of the Company

Mr. and Mrs. Y is a couple who once studied overseas. After their return to China, they founded Z Corporation in 2004. This company mainly engages in highway construction and sales of high-tech products of road materials.

Mrs. Y graduated from high school in 1992, then she went to work and study in Japan and Singapore. During that time, life was hard for her, but her ability got improved quickly. In September 1995, Mr. Y was living in Singapore as a student. Through the Macau Open University's MBA program, he met Mrs. Y. In 2000, they went to the UIC (University of Illinois in Chicago) to pursue an MBA degree. After a year's study, the couple went to the Silicon Valley. Mrs. Y soon found a job in the human resource department of a semiconductor design company, and within three months she became one of the company's seven decision-makers. Mr. Y worked for a fiber optic R & D department, and also soon became one of the key management personnel.

During the time in Silicon Valley, they began to think of going home because of China's economic rise and rapid development. When they saw some of their Taiwan compatriots, who had been living in America for many years, go home and seek a better future, this thought became more and more strong, because what was then happening in the mainland was like Taiwan's economic booming over 1980s.

In September 2002, Mr. Y and his wife returned to his hometown, Zhengzhou. Mr. Y cooperated with his old friend Mr. A and some other friends to create a joint enterprise featuring real estate and automobile battery production. Mr. A is the company's largest shareholder while Mr. Y is the second-largest shareholder and the company's general manager as well. Before going abroad, both Mr. Y and Mr. A worked in a tobacco company. Mr. A was the vice president, and Mr. Y was a middle-level cadre and a good friendship was built between them. Mr. Y invested nearly 6 million RMB in the company, from his and his wife's accumulated overseas personal income. At the end of 2003, due to Mr. A's health problems and family conflicts, the business became worse and worse. In that case, other shareholders' interests were undermined. So, after deep thinking, Mr. Y and some other friends left the original company and co-founded Z Corporation.

Z company's business is mainly divided into two areas: one is highway construction and maintenance of road construction and the other is the agent selling of high-tech road materials. Table 4-1 shows the ownership structure of the company on January 8, 2004, the day of its foundation. Z Company's registered capital reached 20 million yuan. Mr. Y was responsible for the overall management of the company, and the other five shareholders helped the company to get projects and to provide financing and technical support. For example, Mr. Rj is a shareholder and also the company's technical director. Mr. Rj once worked in a large company engaged in highway road construction in Shenzhen, and was familiar with the industry. As early as 2004, Mr. Rj was introduced to Mr. Y through friends. Mr. Rj suggested projects in highway road construction, and this suggestion was soon recognized as an opportunity by Mr. Y who has a sharp business mind.

Table 4-1 The share structure of Z company at the time of foundation

Shareholder	Investment （mil. Yuan）	share（%）
Mr. Y	6	30
Mr. Wq	4	20
Mr. Rj	3	15
Mr. Lw	3	15
Mr. Jf	2	10
Mr. Zm	2	10

Considering the traffic situation of Henan Province, it is not difficult to understand why Mr. and Mrs. Y started their business in highway road construction. “*Henan, located in the central plains, linking the east and the west, the north and the south, is one of the most important transportation hubs on land. The Chinese government is planning to build 12 main national highways which is called 'Five Vertical and Seven Horizontal' project. Two of the roads -- Route of Beijing to Zhuhai, Route of Lianyungang to Horgos will cross Zhengzhou. According to the "National Expressway Network Plan" issued by the State Department in early 2007, seven out of the thirty national key trunk roads go through Henan*.”(*http://www.moc.gov.cn/st2010/henan/hn_jiaotonggk/201009/t20100906_748275.html*). Henan province's highway total mileage had reached 3000 km following the breakthrough of 2000 km in 2005. By the end of 2006, it had reached 3439 km, rising to the first place in the country.

4.1.2 The Performance of Z Company

Table 4-2 shows Z company's operating results from 2004 to 2009.

Table 4-2 The performance of Z company

Year	Earnings of projects (thousand Yuan)	Profits of projects (thousand Yuan)	Administrative expense		Net Profit	
			Value (thousand Yuan)	Proportion to earnings	Value (thousand Yuan)	Rate of growth
2004	2,529.07	782.07	530.46	20.97%	252.26	
2005	3,677.81	888.65	527.74	14.35%	362.56	43.72%
2006	8,860.00	2,365.22	768.57	8.67%	1,598.09	340.77%
2007	12,183.16	3,704.86	881.11	7.23%	2,825.41	76.80%
2008	8,675.63	2,316.39	940.13	10.84%	1,377.61	-51.24%
2009	6,238.65	1,665.72	555.24	8.90%	1,121.74	-18.57%

Source: Financial statements of Z company (2004-2005)

Z's operating profit grew rapidly from 2004 to 2007, but in 2008 there was a substantial decline that further accentuated in 2009. Section 1.7 describes why Z's profit declined in 2008 and 2009. Z Corporation distributed a cash dividend of 500,000 yuan in 2007, but Table 4-2 does not include this information. As can be seen from Table 4-2, the company's administrative expense is high, reaching 21% of the gross income in 2004, and the average administrative expenses reach about 10% ever since. As for L Company (Lu Xiang Co. Ltd) and S Company (Sichuan Road & Bridge Co. Ltd) two listed companies in the same industry, the administrative expenses are below 5% of its gross income. For a private business enterprise, why are the administrative fees so high?

It is difficult to assess Z's operating performance only from its financial statements. Table 4-3 compares the company's financial results with L company and S company and makes a summary of the three companies' return on total assets (ROA =

EBIT/total assets), return on sales (ROS = EBIT/sales) and return on equity (ROE = net profit/net assets). ROA measures the profitability of assets. From 2004 to 2007, Z company's ROA continued to grow and even surpassed L in 2007 by nearly 3%. Although Z declined from 2008 to 2009, its business was not inferior to L’s, and was much better than S.

Table 4-3 The comparison of performance between Z and two listed company

Year	ROA			ROS			ROE		
	Z	*L*	*S*	*Z*	*L*	*S*	*Z*	*L*	*S*
2004	8.35	8.66		9.97	6.47		0.84	13.45	
2005	1.58	12.45		9.86	10.08		1.19	21.71	
2006	6.58	17.34	3.44	18.04	12.05	4.94	5.1	26.40	1.83
2007	10.66	7.85	2.69	23.19	12.00	7.19	8.28	12.39	1.99
2008	5.09	5.93	2.37	15.88	6.89	5.71	4.32	6.39	2.48
2009	4.19	3.56	2.49	17.98	5.34	5.11	3.05	6.34	3.86

Source: Financial statements of Z Company (2004-2009); two listed companies from (http://finance.sina.com.cn/)

ROS measures how much profit a company can earn out of each yuan. On average, Z’s ROS is twice that of L’s and three times more that of S's. ROE reflects the company's ability to make net profit for the shareholders. It is the combined result of business strategy and financial strategy. From 2004 to 2007, Z company's ROE continued to grow. Although this figure is far more than S, it is less than L Company. It is difficult for Z to obtain loans from banks, so the company cannot use financial leverage to obtain greater benefits for shareholders. The leverage of Z company is no more than 15%, while L and S's are 50% and 80%.

Table 4-4 Comparison of asset turnover between Z and two listed company

Year	Receivables Turnover			Asset Turnover		
	Z	*L*	*S*	*Z*	*L*	*S*
2004	0.57	3.60		0.12	1.34	
2005	0.90	3.19		0.16	1.23	
2006	5.83	7.91	5.66	0.36	1.44	0.70
2007	7.04	1.76	2.33	0.46	0.65	0.37
2008	7.05	2.42	2.78	0.32	0.86	0.41
2009	7.49	1.89	3.12	0.23	0.67	0.49

Source: Financial statements of Z Company (2004-2009); two listed companies from (http://finance.sina.com.cn/)

Table 4-4 shows the statistics of Z's and the two listed companies' operating efficiency indicators, accounts receivables turnover ratio (revenue/accounts receivable) and total asset turnover (operating income/total assets). Z's receivables turnover increased steadily at the beginning, and remained seven times higher after 2007. The data is much higher than for L and S companies. As for asset turnover, there is an obvious turning point in Z company. Asset turnover rose steadily from 2004 to 2007 while it declined from 2008 to 2009. Z's dramatic decline in business is consistent with the decline in its revenues and profits as shown in Table 4-2.

4.1.3 The First Business and Introduction of New Material

Z Company was established on January 8, 2004, and in April, Z obtained the first important business, "the maintenance and repair projects of ZYRHB (Zhengzhou Yellow River Highway Bridge) Deck and Pavement Distress at North lead." Linking the southern Zheng-Hua Highway and the northern Zhengxin highway, ZYRHB is the transport hub of the route from Beijing to Guangzhou and the transport center of Zhengzhou as well. The total length of the bridge reaches 5,549.86 meters, which is the nation's longest highway bridge. How could such a new company like Z get such an important project?

This bridge had been built by Henan Zhongyuan Expressway Company and was regarded as "a key project in Henan Province," The project was managed by the Transportation Department of Henan Province. All key projects must go through the following procedures: feasibility studies, project assessment, evaluation, check and acceptance. For example, an innovative engineering solution should be proposed in the feasibility study, and the technical test and economic feasibility report issued by a third party research institute should be submitted to the Department of Transportation experts. Only after the report and the proposal get approved by those experts can the project be carried out.

When Z Corporation learned that ZYRHB needed maintenance and repair it soon proposed a plan based on Mr. Rj's work experience in a road construction company in Shenzhen. According to the plan, the United States Bokan M210 and VSS slurry seal truck would be used for the road maintenance of micro-surfacing process while the Shell polymer modified bitumen emulsion (MICO) would be used as the road maintenance material. Micro-surfacing process consists informing a thin layer over the road with a thickness of only 10mm. Its main role is to make the surface of the road dense and to confer a good anti-sliding ability, but it cannot improve the overall strength of the highway pavement. Therefore, for the serious lack of subgrade strength network crack, pits should be grouted to reinforce the road. The construction of the entire project requires not only high technology but also some specialized equipment. So Z company rented Bokan two M210 and VSS slurry seal truck equipments, which have worth nearly 10 million yuan, from Shenzhen. In addition, the use of Shell polymer modified asphalt emulsion ensured a longer life of the road.

The feasibility of the plan needed to be supported by corresponding experimental data, such as how to choose the local basalt stones graded mineral aggregate and limestone powder, how to evaluate the physical effect with the physical and chemical properties of MICO and how to evaluate the effect of the Micro-surfacing construction program? The experimental data by Henan Institute of Transportation showed that the indicators of physical and chemical properties were better than the national standards, and also better than all the other highway road construction projects in Henan.

After the experts from the Communications Department had a comprehensive evaluation of Z company's program and test report, Mr. Y successfully won the project.

In retrospect, some important factors contributed for Z company to get the project successfully. First, the ZYRHB is not only a traffic center, but also an overloading road, so a high quality is required for the engineering work, and Z's proposal fitted this requirement. Although there were several large and powerful road construction companies at the time in the province, none of them proposed such a program, neither they had the required technical capabilities. Second, Mr. Y and his wife's overseas experience of work and study won the experts' confidence. Third, the experimental data of program were reliable. Mr. and Mrs. Y displayed self-confidence and solid engineering background in the report, which left a deep impression on the experts and government officials. Besides, this project was not given to companies of other provinces, because Henan government wanted to support their own road construction engineering companies. Finally, Z company's shareholders played an important role in making Mr. Y have the opportunity to demonstrate this innovative program to the government officials and experts.

Mr. Y 's profound knowledge of project management, the two management MBA degrees as well as his previous experience to run a business played an important role in the project. Mr. Y has a strong ability to learn. Just by observing the operation of some skilled technicians and workers, he soon mastered the technique of micro-surfacing process, and made a construction specifications and quality control system. In fact, Mr. Y's major at college is automatic control and his first job after graduation was the management of large industrial power in a hydraulic machinery company.

All the key engineers and project managers engaged in the construction had practical experience. Mr. Y tracked down the whole process of the micro-surfacing road bridge construction, and was personally involved in the management, which laid a foundation for future work and accumulated experience.

The total cost of the micro-surfacing project of the ZYRHB was about 22 million yuan. According to state regulations, constructions costing more than 4 million yuan must be through bidding. However the " ZYRHB Micro-surfacing project" was an exception because the deadline was pressing and time was limited. As for other projects, Z company must follow normal bidding procedures.

Since 2005, most of the projects Z company is engaged in are innovative, and the advanced materials and engineering technology for road construction are adopted.

Furthermore, Z company has been recommending the use of high technology and advanced materials in the industry for many years. It offers good ideas and advice to leaders and experts. This seems to have become Z company's operating model. For example, Z company followed the same mode of operation in another key project: the road work of Zhengzhou Yellow River railway bridge.

4.1.4 Cooperation with the Principal: Rapid Return of Payments

For ventures such as Z, whether the funds can be quickly recovered is a big problem. According to the rules of the construction industry, after the construction is completed, Party A (the principal) should pay B (the construction company). Take the "ZYRHB deck maintenance work" as an example. Some of the contract terms are as follows (*source:* a contract between a principal and Z company):

1. *After B* (*referring to Z company*) *enters the construction site, A* (*referring to the principal*) *pays 30% of the total cost as the advance payment*.

2. *Within 10 days after the completion of the project, Party B should submit the comprehensive information of the project to A. Party A pays 60% of the total contract price to Party B. If there is additional work, Party A should pay 90% of the actual workload*.

3. *The construction defect liability is one year. Within the year, Party B is responsible for the repair of the construction for free if there is any quality problem. After the expiry of defect liability, Party A should pay 10% of the cost to Party B within 10 working days*.

Different project contracts may vary, but the three terms are included in almost all construction contracts. Article 2 means that Party B must put money itself in the construction of the project. For those large projects with long duration of construction, the financial pressure is considerable. Article 3 means that Party B has to wait one to two years to get the 10% caution money, but whether Party B can get the money depends on its " relationship " with Party A. So, in the process of construction, Party B gets "loans" from Party A periodically to pay for the project. But the loan is not allowed to exceed the financial need of the project. State fund is not given at one time, but at different stages. So the funds cannot be obtained in time, which means that companies must figure out solutions to ease the financial pressure.

For Z company, the principal of "ZYRHB road maintenance" did not owe any money at any construction stage. Besides, Z company could get paid timely in almost all the projects. Table 4-3 shows the reason of its high receivables turnover.

4.1.5 Cooperation with Suppliers: Exclusive Contract Terms

Because Z company could get project payments timely, it never owed the suppliers any money for raw materials. Many top foreign suppliers of road surface material grant Z company the general agency status on behalf of Henan and even China. In a material contract with a famous international supplier clauses read:

1. *Party B is the exclusive distributor of Thelma pavement maintenance products and of the company's other products in Henan Province. Other agents or distributors are no longer set in this region.*

2. *After the agency agreement is signed, Party A should hand over all the customers' and projects' information in the region to Party B. Besides, the information about some relevant customers will also be timely submitted to Party B.*

3. *After Party B becomes Party A's exclusive regional agent, it can enjoy 40% discount of the market price. if the sales are cross the region, it can enjoy 50% discount of the market price, and in the mean time has the priority to be the exclusive agent in the region.*

Nearly all suppliers which cooperate with Z company grant Z exclusive agency and state preferential terms in the material contracts. Z company established a significant partnership with the following companies and organizations: the German Association of Road Detection and Technological Innovation, Shell (China) Co., Ltd., China Coriolis, CNOOC, Atom Paint Co., Ltd. of Japan, North Construction, China

Building Materials Academy of Science and other leading companies and research institutions.

Another important reason why these well-known companies and research institutes have selected Z company as a partner in Henan is that the business culture is relatively conservative in Henan Province. If the suppliers do not cooperate with local enterprises, it will be difficult for them to sell their products. Because Z company spares no efforts in spreading the high-tech of road construction, it has gradually become a well-known road material agent and construction company in this industry. Many suppliers have to choose Z as the general agent, and find it pleasant to work with Z. Therefore Z Company cooperates with some suppliers in some other ways. For example, according to the agreement of the color construction of some Zhengzhou roads between Z Company and Japan's Atom Paint Co., Ltd. :

2. *Party B* (*Atom Paint Co., Ltd.*) *authorized Party A* (*Z*) *the exclusive right to use its non-slip coating on the roads within the administrative divisions of Zhengzhou the exclusive right to use. Under the same condition, Z enjoys the priority to use this non-skid coating in Henan Province.*

3. *The mode of cooperation:* (1) *Party A is responsible for getting projects from the principal, and Party B should try its best to comply with Party A's requirements.* (2), *Party B is responsible for project construction, and Party A should try its best to comply with Party B's requirements. "*

In addition to the general exclusivity provisions, Article 3 says that Z Corporation should strive for the project for the mutual interests, because it is difficult for the material suppliers to break into the local market even if they have the construction ability. As some of the material suppliers themselves have a professional construction team, Z will invite them to carry out the construction work.

4.1.6 Efficient and Stable Workforce

When Z won the bid of a project, a construction department will be organized, including the project manager, the technicians, the financial officers, logistics and engineering team. They are responsible for the operation until the completion of the project. The project manager must organize and manage the construction, which means he should have construction background. In the meantime, he links up the project principal’s and the supervisor’s work.

The project manager, technical staff and financial staff are all Z's regular employees. Their income is divided into fixed income and variable income. The fixed income mainly includes a fixed salary plus mobile phone subsidy. The basic standard varies according to positions and years of work. The new employees’ (without communication subsidy) income is 15%~20% higher than the average salary of the new graduates in Zhengzhou. The "entry level" goes up each year. For the company's full-time staff, the fixed salary is also 20% higher than the average salary for the same positions in Zhengzhou. The salary changes twice a year, generally increasing by 5% to 10% while, in response to the current high inflation rate, the temporary workers’ fixed wages are generally increased by 15% to 20%.

The variable income includes the residence allowance, holiday expenses and year-end bonuses. The year-end bonus, which is the bulk of the variable income, comes from the profits. In general, 8-10% of the project team’s net profit is shared after the completion of the project. For those projects using high-tech materials, the proportion of sharing profits can reach 15%. Overall, Z Company's net income is 15%, or 20% -30% of the revenue of a project. The former is the profit of use of construction materials, and the latter the use of high-tech materials. Z's year-end bonuses will be given to the project manager. Then, the project manager allocates them to the technical, financial and logistical staff according to their contributions. The employees can participate in multiple projects. On average, the total average income of the project manager can reach about 150 thousand yuan per year, and the income of the ordinary staff can reach 50-60 thousand yuan per year. The income is relatively higher than for graduates in other private enterprises.

Z company attaches importance in training the staff and in cultivating employees’ comprehensive skills. The first batch of Z's staff has some work experience. Subsequently, more of the staff have been university graduates. Z's employees are trained in two ways: one is on - job training. When the company is not very busy, the employees are organized to learn skills. The director of each department and skilled staff have the responsibility and obligation to supervise the new employees. Another is to encourage the employees to participate in undergraduate, MBA and other in-service adult education learning. As long as Z Company believes that this learning is related to the job, and that the knowledge can be applied to the job, the tuition will be reimbursed upon the employee's request and his academic grades.

Z hopes to create a good professional quality and establish a good corporate culture through the training of its staff. For example, its personnel manual writes:

The teamwork spirit is Z's essence. Establish a sound career planning. Form occupational characteristics. See the future from the present work. See the ability to enhance the value, and use the value to drive yourself to make progress.

Acquire knowledge and accumulate ability from work. Gather intelligence, win respect, and finally accomplish life's task.

Respect people. On the basis of equal rights, respect the customers and the employees. Good working environment, harmonious working atmosphere and sincere relationship is Z Company's career foundation.

Healthy and work-life balance. Work is not just a means of livelihood. The work itself should bring us happiness and sense of success. Employees should love their jobs. Besides their work, all employees are encouraged to make friends, maintain family harmony, and enrich personal life in a healthy way.

The above guiding principles show the company hopes employees not only to work as a means of livelihood, but also feel a sense of achievement and fun to work. In most private enterprises, staff mobility is frequent. Z Company has maintained a relatively stable team. In the recent two years, only two employees left the company, and the reason is their own family problems, which means that Z leaders must be good at communicating the guiding principles to the employees.

4.1.7 The Conflicts of Shareholders

From table 4-2, 4-3 and 4-4, we can see that, since 2008, there has been a drastic decline in Z Company's project settlement income, engineering profit, profitability indicators and operational efficiency indicators. Eventually, the shareholders re-registered their equities in the first half of 2010 and Mr. Y took over the company. Many reasons caused this situation, mainly due to the fierce competition in the industry. Small and medium enterprises have a hard time under that condition.

In fact all enterprises engaged in road construction face huge financial pressures but large enterprises can obtain loans from banks. For example, the financial leverage ratio of the above-mentioned "Sichuan Road & Bridge," reaches 80%. Since almost no small enterprises have assets as collaterals, it is difficult for them to get bank loans. The financial pressure comes mainly from two aspects: one relates to funds used in the process of bidding; another to the rental costs of construction equipment.

Construction enterprises in the bidding process must pay bid bonds that are called "buy bids" in the industry. The bid bond for the construction of a new road is usually about 800 thousand yuan (called "construction bid") in Henan Province, and the bid bond for an old road maintenance is 300 thousand yuan (called "maintenance bid"). When the bidders are approved by the Construction Committee, the companies are eligible to participate in the bid. When an enterprise wins the bid, it must pay a bid bond again, which is usually 10% of the total cost of the contract. In practice, the bidding companies often rent some other companies' qualifications to put in a tender, so as to increase the probability of winning bids. The bid bond may reach millions or even ten million yuan. This is because of the reform of the bidding approach in Henan in 2008. A series of corruption occurred in Henan Transportation Department.

Construction is a highly sensitive industry. Therefore, the bidding system of highway construction has been modified. Before 2008, highway construction bidding took the form of a closed bid, that is, the bid of the contract price was not public. However this way was often suspected by insiders. For example, the State-owned Construction Company can make various restrictive requirements for bidders. To a certain extent, the State-owned Construction Company can better select the bidders that meet the requirements of the construction. However, the method of highway construction bidding was modified in Henan after 2008 and now the bid of the contract price is open to the public and the restrictions for the bidders have been reduced. As long as the bidders have national qualification in construction they can participate in bidding. Although the new measures to a certain extent enhance transparency, they lead to more enterprises participating in the bidding, making the competition extremely fierce. In fact, in the new tender, the companies bid a quotation that the price is known as a "reasonable low price", therefore, winning the bid is not to show a the company's technical strength, but a completely random event.

Over 20 even 30 enterprises participate in a bid. It is conceivable that if a company participates in a bid entirely in its own name, it will be difficult to win the bid. In order to improve the probability of winning, some enterprises have to hire other enterprise’s name to participate in the tender. For example, a company wants to raise the probability of winning, and rents five companies’ qualifications. If the bid bond is 800 thousand, the company must pay 4 million. Most of the bidding process lasts at least three months or over a year before the successful bidding company is announced, so the company must pay a large amount of interest for the bid bond. Furthermore, a company rarely participates in only one bid at the same time, and does not bid only once or twice a year. If a company participates in two bids, and bids in the same way (hires five companies qualifications), the needed funds will be 8 million yuan. For those SMEs established only for two or three years, 8 million is a large amount. Besides, whether the bidding is successful cannot be guaranteed. So those enterprises are faced with a huge amount of financial pressure.

For large or medium-sized enterprises, 30% of bid bond can be from their own funds and the remaining 70% is confirmed by a bank guarantee of credit. But it is difficult for most SMEs to get bank loans, because SMEs do not have corresponding fixed assets, or a third party as guarantee. Even if the company can find a third-party guarantee, the guarantee must also bear the corresponding costs. SME’s financing costs for the bidding have a very heavy interest payment: from 2008 to 2011, for Henan’s SMEs in this industry, the average financing cost was roughly between 10-12% of dividends, and in 2011, more than 20%.

In order to participate in the tender, SMEs usually use various guanxi (social capital) through shareholders to get short-term lending funds. Besides, they also have to pay higher interest for the funds than for bank loans over the same period. If the company successfully wins a bid through raising funds by its shareholders, this is a good result for the shareholders. If it fails after spending much of the shareholders’ money, many shareholders will complain and even gradually lose the trust and confidence of the industry. The conflicts between the shareholders and the company will escalate with the bidding process becoming more and more arduous and the survival environment of SMEs deteriorating.

Not only the bond bid has to be paid, but also 10% of the contract bid after the company wins the bid have also to be paid. If the latter bond bid can be paid following the former, the company can afford, but if the two bonds must be paid at the same time, the company must raise funds again. Take the previous example when the company has paid 8 million bid bonds. When the company wins the bid, the bid of the total contract cost is 100 million, which means the company has to pay another 10 million bid bonds. So the company must go to raise the 10 million funds.

Investment in fixed assets and leasing will also bring heavy financial burden to SMEs in this industry. Road construction requires a substantial amount of specialized engineering equipments, and each equipment is expensive. Road construction projects require a set of specialized equipment in almost every process such as seal coat, prime coat and asphalt paving layer. Those equipments cost millions of even ten million yuan. Take Z Company’s first business "the maintenance and repair work of ZYRHB Road and Pavement Distress at North lead": the maintenance project adopted the "U.S.

Bokan M210 slurry seal and VSS vehicle" to carry out the micro-surfacing process of road maintenance. The two equipments are worth 5 million yuan. If the construction site requires two sets of such equipment, the value would be close to 10 million. Besides, rollers, forklifts, material transport vehicles and other equipment are also needed. It is difficult for ordinary SMEs to purchase a full set of fixed assets. So they must rent equipment from large companies and such a high cost further reduces the profit.

Conflicts started to occur between the shareholders in the Z company after 2008. At the end of 2008, Z company received a sum of project money, but the money was immediately sealed by the court and was sent to pay Mr. Rj', a shareholder who borrowed the money from other companies. However, more than one shareholder had raised funds for the bid bond, not just Mr. Rj. Mr. Rj was responsible for the operation of the bid and without obtaining Mr. Y's consent beforehand, the money was withheld by the court on his behalf. Mr. Rj's action not only broke the company's order in payment (according to the loan contract, Z company's time for payment had not expired), but also directly undermined the company's reputation.

In the company's business, in addition to Mr. Rj, another shareholder, Mr. Wq, was directly involved in the company's daily operation while the remaining three shareholders were not. Mr. Wq arranged one of his relatives to be the company's cashier. Consequently, the shareholder would soon know of any expense of Mr. Y and would query Mr. Y, or even spread gossips about the cash management to other shareholders.

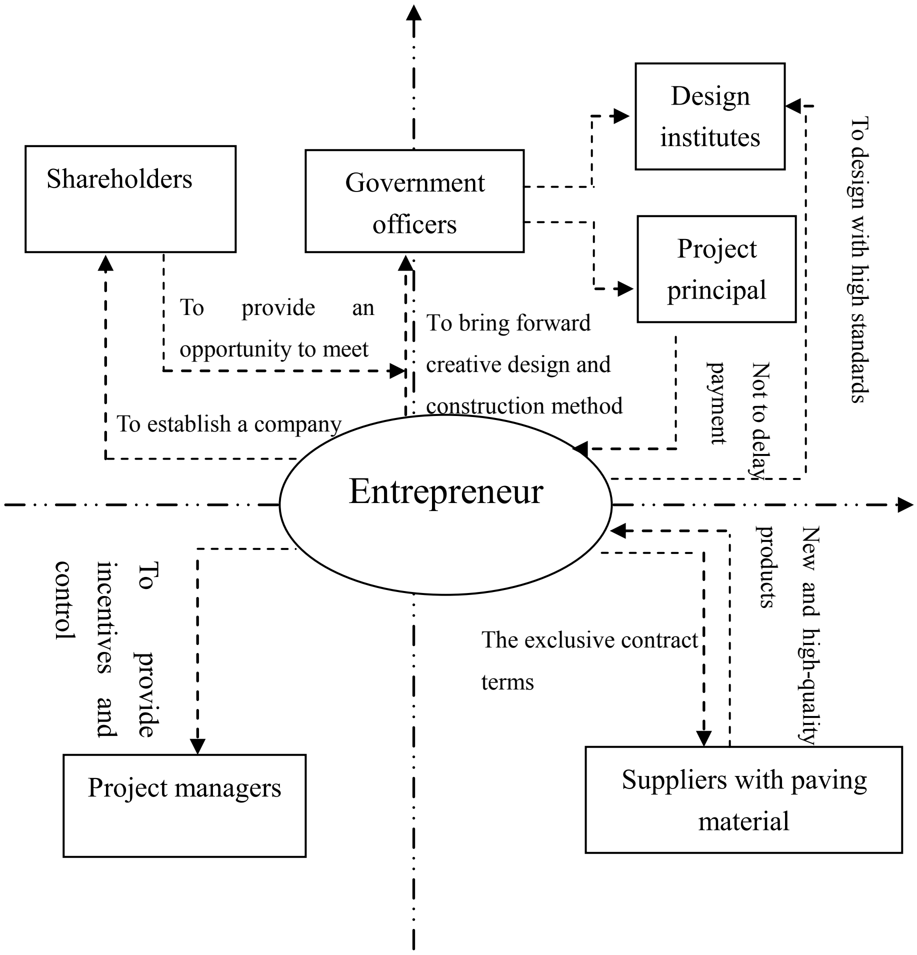
As one SME, Z Company's biggest advantage is that it can quickly respond to market opportunities, or raise some new and unique programs in the bidding process. Although under the new management of bidding, the "reasonable price" has become a common phenomenon, the tender and bid experts still hope to see programs with high-tech applications. However, if Z company proposes an innovative program to the state-owned construction company, inevitably there will be costs, such as the purchase of new materials and rental of new equipment as well as the cost of physical experiments, and others, which requires the board to quickly approve the program. However, in reality, Z Company's board of directors did not always quickly respond to Mr. Y's proposals. In fact, if one shareholder is against a certain decision, then the decision would be difficult to be implemented. The reason is that the decision rule “one share one vote” was not implemented in Z Corporation; instead all the company's decisions could not be implemented until all the shareholders agree.

The complaints, suspicion and constraints between the shareholders made Mr. Y frustrated. So, at the end of 2008 he suggested leaving the company hoping that other shareholders take over his equity and work. Mr. Y’s idea led to the remaining shareholders’ resonance. They wanted to dismiss the company because the business and profits rapidly declined in 2008 and 2009. However, there occurred a dramatic scene. Three shareholders who were not directly involved in the company’s management asked Mr. Y to take over the company. They and other shareholders reached a consensus and the company began capital verification. Each shareholder got cash compensation or corresponding physical assets. From 2004, when the company was established, to 2010 when the company was disbanded, each shareholder actually received more than 60% rate of return. Though may be considered not high enough, there was not a loss. In June 2010, Z company re-registered the stock transfer book, and, since then, Mr. and Mrs. Y became the sole proprietors of Z Company’s shares.

4.2 Analysis of the Case

As the first and fourth quadrants of figure 4-1 show, the entrepreneur, Mr. Y, and other stakeholders co-founded Z Company in early 2004. The company is mainly engaged in highway road construction and road-related sales of high-tech materials. One or two shareholders have inextricable "relationships" with major state-owned construction company and government officials. They also provided Mr. Y with the opportunity to get to know the leaders of the construction units and government officials. Mr. Y and his wife have an overseas learning background and rich management experience. They are able to put forward innovative road design and road construction programs, and hence have some influence on the decision-makers and leaders of the state-owned construction company. Therefore, Z Company has a higher chance of winning a bid. Moreover, through the *guanxi* with the state-owned construction company, Z Company can be paid in time.

Figure 4-1 The case process of Z company



However the great problem of Z Company is financing. It has to obtain funds from social capital network built by the shareholders, which includes bidding guarantees and liquidity. Because the social relationship plays an important role in board of directors and in the process of operating the business, Z Company forms a special governance system, where each shareholder has an equal right to vote no matter how many shares he has.

Mr. Y and his wife displayed a strong ability in governance. They established a standardized management system, a good incentive and control system, and formed an efficient and stable workforce around the main project manager. In the supply of road materials, they established a partnership with some advanced road material suppliers, and became their exclusive sales agents in Henan. Those famous suppliers provided them road material products of high quality.

After 2008, the local government modified the management rules of road construction bidding. The new rules emphasize that the price of each bid is clearly stated, allowing each construction unit to propose "reasonable price." Consequently, it is more difficult for SMEs to survive under this condition. The profits of Z Company declined and there occurred conflicts between the shareholders. The separate ownership made the sensitivity of the company's decision-making poor. Due to these problems, the company’s stake dispute erupted. Finally, in June 2010, on the basis of comprehensive review of the assets and liabilities, the ownership and control right was completely reallocated to Mr. and Mrs. Y.

This thesis will analyze the case in two aspects. One is to use the social capital theory to analyze Z Company’s investment and financing, management of bidding, and the conflicts of the shareholders. Another is to use the corporate governance theory to analyze the company's internal governance and cooperation with suppliers.

4.2.1 An Analysis Applying the Social Capital Theory

Theoretical analysis of financing and conflicts of shareholders

In this section, we will analyze the financing problem of Z Company using the social capital theory elaborated in section 3.2.2. Faced with highly uncertain business environment and high operating costs, Z Company has to establish and maintain an extensive social network for investment and financing, for having access to engineering contracts and for gaining return of funds and other activities since it is very difficult for SMEs to obtain the support of financial institutions. The case of Z Company shows that building a social network by the entrepreneurs and company shareholders is an important way to get capital.

Financing is a difficult problem for SMEs in the world, because although SMEs not only have the high growth possibility, but also have considerable uncertainty and highly asymmetric information with investors. According to the regulation of bank lending, an enterprise must have fixed assets that a bank will accept as security for a loan, but it is difficult for SMEs to satisfy this loan condition. That is to say, the micro economic characteristics of SMEs make them difficult to obtain financial supports from traditional intermediaries such as banks. In that case, it is nearly impossible for Z Company to obtain the liquidity from banks.

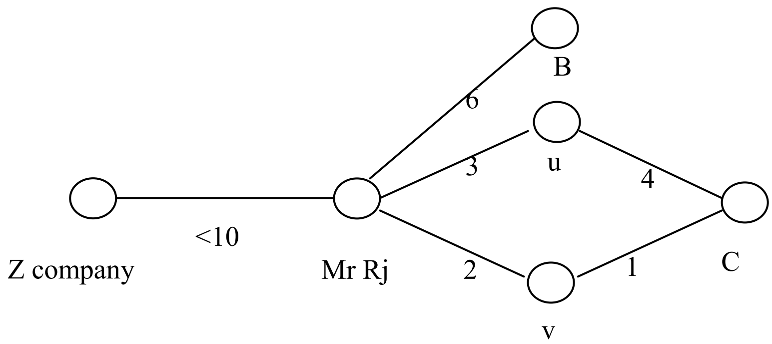
The other five shareholders in Z Company may be called angel investors. This refers to those who provide the start-ups with early period equity funding, but have no family links with the entrepreneurs. The angel investors generally do not own many equities of the enterprises, and they not only provide the funds but also the management assistance（Fenn, Liang & Prowse, 1998）. Prowse （1998）finds that angel investors provide the enterprise the financing arrangement, and the management help in employing the senior managers, solving the business problems and so on. The five initial shareholders were exactly angel investors for Mr. Y. They were in the highway construction industry, so they could help Mr. Y to enter this industry as soon as possible.

The theory of Granovetter（1985）and Uzzi（1996）is more powerful to explain Z's governance (for example the voting right rule) and conflicts among shareholders. The ownership structure shown in Table 4-1 means that, although each shareholder holds a different of shares, so should vote on a pro rata basis, actually each shareholder had the same right to refuse a proposal. The logic behind this voting right rule is, "*Althoughyou have a30% stake, and Ionly have 10%, webothare equal whatever how much you invest, because we are friends* ".

The fact that Mr. Rj uses the company's money to repay his own loans, would not have caused much psychological impact on the shareholders in a company based on market-financing since Mr. Rj would only have disobeyed the financial discipline, but would not have caused economic losses. However, in Z Company that was based on social capital financing and personal collaterals, his action undermined fairness and trust, making the six shareholders no longer trust each other. Other shareholders could reasonably speculate, "Mr. Rj is selfish and irresponsible. He did not cause any great loss to us at present, but what about the future?" So, Mr. Rj's behavior is the fuse of conflicts of shareholders.

The theory of social collateral (Karlan et al., 2009) can also be used to explain the behavior of Mr. Rj. From the view of Mr. Rj, new bidding system in Henan makes Z Company's future bleak, so that he thought that the closure of network of Z company had been worse than his own social network, as shown in figure 4-2:

Figure 4-2 The social network of Mr. Rj



Assume that Mr. Rj invested money in Z Company, which is a private loan from his own social network (such as from B and C), and the principal and interests amount to 10 units. If Mr. Rj thought the value of friendship from Z company exceeds 10 units, he would not risk losing this friendship by withdrawing the money ahead from the account of Z Company. However, Mr. Rj did not maintain the friendship with the other shareholders, which means that he thought of a value to that friendship lower than 10. In fact, according to Karlan et al (2009) individuals will continue to trade off the closure among different networks, to consider whether to establish trust or just to access a network.

This thesis argues that the closure of a network also depends on the uncertainty of the economic environment. As this case shows when the economic environment changes, the original network may also become tighter or looser.

In fact, Mr. Rj's behavior sends a signal to other shareholders, which start to worry about the company's future. So, when Mr. Y suggests withdrawing from the company, and then some of the shareholders want to dissolve the company, there is no objection.

A theoretic explanation to the bidding process of Z company

From the very beginning, Z Company used shareholders' social networks to get the projects and to improve the probability of winning bids. We wonder why Z Company does so.

Economic activities require some economic agents to work together in an environment of trust so as to complete certain actions, for people only to believe their property will not be eroded, the results of labor will be rewarded under the premise of investment and hard work pay. In the process of China's economic transformation, the protection of private property rights is insufficient, the implementation of the contract enforcement is poor and unreasonable and instable rules make the cost of economic transactions very high. Therefore, it is not difficult to understand why Z Company uses social network to reduce transaction costs.

In the field of highway construction, insufficient protection of private property rights is mainly shown in market access, as a considerable number of engineering opportunities are given to the state-owned enterprises because of political correctness (or discrimination against private enterprises). As section 4.4 describes, the construction company has to take painstaking efforts to "borrow" money for projects and besides, the payment of 10% quality margin is often delayed. This is undoubtedly a heavy burden for SMEs. In addition, in the tender guide, the project principal always proposes specific demands to bidders, such as the financial position, construction experience, past achievements, staff capability, construction equipment, management level and social reputation and other requirements. Through a number of qualifications, some enterprises that fail to meet the requirements will be eliminated. Because of the nature and needs of the project, screening is not only necessary, but also understandable. However the screening method is often not transparent. For example, it should be clearly stated why the project requires a special company and a special ability, and the qualification requirements as well as the relationship between project goals. However, many bidding documents lack this information and the project principal does not accurately check the business materials, which often leads to false and deceptive reports.

For these reasons, Z Company acknowledged the government officers introduced by the network, and then made every effort to increase the probability of winning a bidding through its innovative construction design. The network is again used to collect the project payment as quickly as possible. If the company does not relate to the network, there is no access to project opportunities. Officials in charge of tender must assess the social risk of bidding corporations, at least to evaluate corporation subjectively（Knack & Keefer, 1997）. They need to build trust and obtain the information from corporations based on informal relationships, and in order to work more effectively, these officials also need to accumulate a certain degree of social capital. More importantly, government officials and construction principal also need some achievements, and they will establish a good reputation if there is a high-quality project. It is not difficult to understand why Z's mode of operation is successful.

In fact, Z Company bears a considerable risk in the process of applying new technologies because the life-long responsibility system is implemented for constructions. Once there is any problem about the road construction, Z Company will be responsible for it. Innovative programs bring high profits but high risks as well. For Mr. and Mrs. Y, good foreign language skills enable them to get to know some foreign companies, and deal with them. Mr. and Mrs. Y’s competence in engineering makes them very cautious about the differences between laboratory products and their application in reality. Some foreign companies actively promote their innovative products to them, but some of them products may not be ripe. Mr. and Mrs. Y insist that each product be entrusted to a third party for experimental test, which is to re-examine the product, and to hand in a high-quality test report to the project principal in the process of promoting the product.

Is *guanxi* with the government officials beyond certain norm of professional ethics? Will there be rent-seeking behavior in tendering? The following two factors can respond to these questions. First, the bidding management is becoming more and more standardized and the policy more and more transparent. As many chief leaders of the Department of Transportation are arrested for corruption, highway construction has increasingly become a sensitive industry. It has been under tense supervision of the government and legal bodies, and has become a public concern. Second, even if there may be "lobbying" in some project decision-making process, it is nearly impossible for SMEs to lobby because there are too many competitors who do the same thing. According to the needs of the project, the government prefers some construction companies with great construction ability, large engineering equipment and rich construction experience. SMEs rarely have the opportunity to show their strength. Lobby means a group of people who try to influence public decision-making by means of propaganda and *guanxi*. It is a common phenomenon in Western countries where with more understanding of the politics, many restrictions are imposed on the practice making it accepted and generally not linked to bribery and corruption.

However the tender and bid rules made by Henan Transportation Department are unreasonable since they are under constant changes. The modification of the rules should improve the technical level of the tender, such as how to prevent government officials taking bribery with the project principals and the construction companies, rather than change the rules beyond recognition. To certain extent, the modification of the rules is the distorted reflection of the authorities being under social pressure. The rules also bring heavy financial burden to the construction company that has to raise many funds in order to increase the probability of winning bids. Another is that successful bid is completely accidental, just like gambling. Bidding companies lower prices in order to defeat the opponents.

When a company wins a bid at a so-called "reasonable price", the profits it can earn are already meager. It must also compensate financing cost for participating in the bidding as well as the cost for renting other business qualifications after winning the bid. So, how does the company earn profits? There are only three options. The first is to sacrifice the quality of the project. The second is to delay the construction process so as to force the project principal to add additional funds. For example, the successful bidder often claims the soaring prices make the current labor costs too high, requiring the project principal to add additional budget. Third, bidding is like drawing lottery. It is hard for the project principal to pick up an excellent construction company only from the programs. Besides, the successful bidder might not be the real construction company because of subcontracting. It is very likely that the construction quality cannot be guaranteed.

The new rules of tender and bid implemented in 2008 mean to achieve two main goals. One is to prevent possible accusation of relevant officials' corruption, which reflects the public mistrust of the government officials. Another is to echo the social demands of improving the bidding transparency and fair competition to all companies. In fact, only those with "bulging pockets" can be more likely to win bids, such as large or medium-sized state-owned enterprises, rather than those with good operating efficiency.

4.2.2 Analysis of Entrepreneurship and Management

This section will analyze Mr. Y and his wife's entrepreneurial process as well as their management ability. The previous section analyzes how the couple gets financing and improves the probability to gain project development through building social networks. In the process, Mr. Y and his wife insist on using high-tech materials for road construction. This not only demonstrates that the couple attaches great importance to technology and management as a core competency in the fierce competition, but also reflects the persistence of their entrepreneurial spirit.

An analysis of entrepreneurial process and corporate governance

Gartner (1985) thinks that the process of establishing an enterprise is mainly affected by four factors: the entrepreneur's personal characteristics, organizational characteristics, external environment and the process of business creation. Shane & Venkataraman (2000) further pointed out that the entrepreneurial phenomenon and whether it can be successful depend on many factors, including the entrepreneur's ability to identify and seize opportunities, his personal organization and management capacity, his competitive ability and knowledge, his ability to get and handle external resources.

Many studies have found that the entrepreneur’s past entrepreneurial experience and the entrepreneurial team’s cooperation have great influence on the entrepreneurial process. Empirical studies by Alsos & Kolvereid (1998) have found that the experienced entrepreneurs’ probability of success is higher than those without business experience. McGrath (1999) proposed the theory of human capital of entrepreneurs. He thought that entrepreneurs can learn experience from its previous business failures so as to avoid repeating the same mistakes in the creation of new enterprises. Kamm & Shaman (1990) summarized the relevant empirical research. They find that the entrepreneurial team plays an important role in the entrepreneurial process. Because the entrepreneurial team can form a variety of skills and competitiveness, build and maintain rich social and business networks, it helps the company to get more resources.

The innovative spirit of entrepreneurs is vital to the development of start-ups. Stevenson & Gumpert (1985) think that entrepreneurs are faced with more uncertainties than mature companies. The mature company's manager can make decisions based on the past operating conditions and industry characteristics, while the entrepreneurs do that in an entirely new environment. Successful entrepreneurs can observe the new business environment in a unique perspective, and gain insights in decision-making from the information provided by the new environment.

For Z Company, its entrepreneurial process has the following obvious characteristics:

(1) *Entrepreneurs' personal characteristics and skills:* Mr. and Mrs. Y have certain experience in management. Their earlier working experience gained from some large foreign companies play an important role in business and management. In addition, Mr. Y served some higher management positions both in China and abroad, which not only laid a foundation for building social and business networks, but also helped him to gain experience of governance.

Mr. and Mrs. Y are also capable of identifying and seizing opportunities. This is reflected in two aspects. On the one hand they are fully aware of the advantages of Henan's location with its broad market to engage in road construction and supply of new materials. In addition, opportunities for building new roads will gradually decline, but road maintenance is a long-term market. On the other hand Mr. and Mrs. Y can make good use of social network to obtain financial and investment resources.

Mr. and Mrs. Y themselves are regarded as an entrepreneurial team. In addition, as the previous section analyzes, other shareholders helped Z Company to build a strong social and business network. Mr. Y specializes in engineering, business management and in seizing business opportunities. His wife exerts her potential of human resources management. Her good communication skills in foreign languages also help establish good working relationship with foreign companies.

(2) *Continuous innovation* -Mr. and Mrs. Y obtain construction contracts by presenting innovative construction programs through the introduction of high-tech products and services to road construction in Henan Province.

Compared to other engineering companies, Z Company as a start-up does not have many advantages. First, Z Company does not have fixed assets and its capital is not abundant. For example, it has no large-scale road construction equipment, which limits the company's bidding ability and the company's financing capacity. Currently

Z Company only purchases equipments that can exert most of its technological advantage. Second, at the beginning, Z Company had no trade qualifications. The industry qualification is a key threshold for start-up companies to enter the market. Today, the company has a total of over thirty types of more than 100 professional construction equipments and a second-class (Class A) construction qualification.

Since China's economy is developing rapidly, various types of roads, especially those with heavy traffic have been in the condition of high load. Gasoline and diesel prices as well as high logistics costs lead to overloading of heavy vehicles and to many other problems, which result in short life span of roads. Additionally China's road material technology is not advanced enough. Some construction companies cut corners and use inferior materials so as to make the pavement life relatively short. According to the regulations, China's roads generally need repair for three years and overhaul five years, but most of the roads fail to meet this standard. For example, lignin fiber is a necessary mixture used for Stone Mastic Asphalt mixture (SMA). It plays an important role in reinforced mixture, dispersion, absorption and stability of bitumen. Z Company imports lignin fiber from Germany. This material uses wood as the main raw material and its price is as high as 13,000 yuan per ton, but some suppliers in Zhejiang use waste paper as raw material because the price is only 4,000 yuan per ton. Many road construction companies use such material additives and therefore the road quality cannot be guaranteed.

If the road quality is poor, it needs constant tinkering, which not only wastes taxpayers' money, but also affects the entire transportation. In this sense, Z Company's application of new technology and new materials can be said to have set a good model for Henan road construction.

An analysis of corporate governance

In section 3.2.2, using the social capital theory, we have discussed the relation between the company and the investors in detail. In this section, we will focus on Z Company's internal governance.

Economists have systematically studied the issue of incentive problems, the classic literature including Mirrlees（1999）, Holmstrŏm（1979）, Grossman & Hart（1983）, Holmstrŏm & Milgrom（1987）and so on. The basic conclusion is that to make contract effectively, the performance signal should be able to reflect sufficiently the information of the agent'swork.The important characteristicis that both reward and punishment should be included in an incentive contract, and the distance between reward and punishment should be expanded as large as possible, that is the so-called philosophy of "carrot and stick". A widely used type of contract is a linear function of output or profit, which ratio depends on the degree of uncertainty and the risk aversion of agent. The more serious the risk of some tasks is, the more incentives to give the agent. The higher risk aversion of agent, the little the variable income should be given to the agent, but the fixed-income portion of total income should be relatively large. The agent's income may take many forms, including cash, stock and stock options, in which stock and stock options relate the agent's incomes to the future of the company.

Basically, this theory can well explain the employee incentive plan in Z Company. According to the plan, the project manager's profit-sharing ratio is relatively large because he contributes more to the enterprise and bears greater risks. Moreover, not everyone is suitable for this position as it requires certain management skills and certain risk tolerance.

Z Company not only pays the employees, but also considers long-term training of project managers. Z is a start-up company, which cannot afford to recruit experienced project managers from the market so it cultivates its own project managers and this costs much money.

Z's operation costs are high mainly reflected in two aspects. mainly reflected in two aspects. First, private enterprises intrinsically bear high-risk characteristics. They must give their most valuable employees certain compensation for risks if they want to retain them since the staff's human capital combines with the industry background as well as with the business prospect. Second, it is generally required that project managers possess comprehensive management capabilities, which means it takes much time and energy to guide the project manager's job.

Project managers who have been working in this industry for a long time usually have many opportunities to get access to the bidding and project constructions. Therefore, they tend to be seduced by external opportunities. The best solution is to have project managers' profit-sharing plans tied up in some form, which relates to granting stock and stock options. In large and medium state-owned enterprises, it is hard for the project managers to have the ownership of shares, because state's policy does not permit granting free and low-cost state assets. Many enterprises adopt the contract responsibility system to retain project managers. In this system, project managers and relevant staff form a "small company", and pay the general company a fixed management fee, or share profits with the general company based on certain percentage.

However the contract responsibility system presents many problems. On the one hand the company's contractual relationship is not stable. It depends on many factors, including the uncertainty of road construction market, the bargaining power between the company and the project manager, the company leaders' supervision of project manager and so on. In addition, although the project manager can share profits with the company, he cannot bear a series of other responsibilities of the construction, such as construction safety and legal liability for accidents. Therefore, the contract responsibility system often brings a great deal of risk to the company. Z Company does not implement the contract responsibility system of projects and equity incentive plans, mainly because the project managers neither have the ability to get projects independently nor get external opportunities.

The above analysis means that Z company must be very cautious when designing its corporate incentive plans as a stable workforce is crucial to its development mainlt because its next goal involves the independent research and production of high-tech road of materials. Moreover, with the maturing of the company's project managers, the company's stock incentive plan for the core and technical management team will be gradually incorporated.

A difficult problem in corporate governance of highway projects is how to grant the project managers' appropriate monitoring and authorization.

Aghion & Tirole(1997)studied the formal authority and real authority within an organization. The project principal of formal authority in an enterprise has residual rights of assets (Grossman & Hart, 1986; Hart & Moore, 1990) and they are the shareholders. An individual being given real authority often refers to someone who has decision right in some tasks. For example, the project manager in a construction company has the power to recruit construction workers. What real authority should be allocated to an agent depends on the asymmetric information between principal and agent, if Mr. and Mrs. Y know about the information of construction site less than the project managers, then they must distribute some decision rights to the project manager. Some private benefits of project managers will result from the control rights. When the project manager's benefit is inconsistent in some respects with the interests of company, the Mr. and Mrs. Y should weigh the costs acknowledging the information and the costs generated by authorizing the decision to the project managers.

Aghion & Tirole (1997) argues that authorizing to some extent (empowering) helps to increase the enthusiasm of agents for the work, to reduce the loads of the principal, and also to prevent the intervening excessively from the principal. He also believes that it helps to reduce the efforts of principal to monitor the agents, if the agents can be permitted to share the making of decisions.

This theory helps to explain the status of corporate governance in the field of highway construction. As it is difficult to monitor the project managers' job, many companies have to give them greater discretion, even let them be responsible for their own profits and losses (contract responsibility system). Z Company's young female project manager rather let rivals harm her own company's interests than tell Mrs. Y that she will resign. This shows the staff of Z Company does not have sense of master's responsibility.

4.3 Brief Summary

This chapter examined how a start-up engages in the highway construction and the sales of high-tech road materials. The company was founded by a couple who has overseas study experience. Like most SMEs, the company is faced with financing problems. Therefore, only through the shareholder-based social network the bid bonds and current funds needed in the bidding process can be obtained. As social relations played an important role in the company's board of directors and its management, a unique governance model is formed in the company. Each shareholder has the same right to vote in the company's voting process independently on how many shares each one owns. The company gets projects mainly through the proposed innovative road design and construction program, and has opportunities to meet the project's decision makers and leaders, through relationships thus increasing the probability of successful bids. In a sense, the company's success relies on social networks, but this also results in the company's management problems.

This chapter uses the social capital theory to analyze of Z Company's financing and governance issues. The company's condition shows that building social networks by the entrepreneurs and its shareholders is an important access to capital financing. Once the company has a promising prospect, the shareholders will use their social networks to offer financial resources and management assistance to the company. However, once the company's prospect is weak, the situation might be the opposite. In the board of directors mainly, which is mainly based on social networks, the principle of voting on the one share one vote is replaced by friends' "each has the equal voting right regardless of how much he invested". Trust and fairness are the foundation of the company's operations; once they are undermined, the company will move toward dissolution.

When the company is near the edge of dissolution, eventually Mr. and Mrs. Y repurchased it. Dissolution came into being mainly as a consequence of the reform of the bidding management system of Henan Province. This chapter analyzed the new system. Seemingly, the reform strives to improve the transparency of the bidding process, but in fact, it violates the basic rules of bidding, resulting in more serious problems such as making the cost of financing for SMEs extremely high. Besides, it becomes nearly impossible for SMEs to win bids, and consequently, the quality of the highway construction becomes worse and worse.

This chapter further used entrepreneurship theory to analyze the process of starting up Z Company, and found that Mr. and Mrs. Y display good spirit of innovation and entrepreneurship as they always promote the application of new technologies and new materials to the highway construction. They consider it not only to be the core competitiveness of enterprises, but also to reflect the entrepreneurs' risk consciousness and social responsibility. As Mr. and Mrs. Y's construction plans cater for government officials' interest to improve their political performance, they can successfully lobby them into adopting new technologies.

In corporate governance, Mr. and Mrs. Y established a stable workforce around project managers. According to the analysis, the incentive system and empowerment of project managers are in line with relevant theories. However, in start-ups where the main assets are human capital, training and managing a team of project managers is difficult and costly.

Chapter 5: Development in Difficulties: Eagle Corporation

5.1 Corporate Background and History

5.1.1 Establishment and Development History

Initial stage: 1988~2003

Mr. H, the founder of Eagle Corporation, was born into an ordinary farmer household at Xuedian, Xinzheng, a town around Zhengzhou, Henan, China. Hardworking as he was, he ended up with a failure in the national college entrance examination in 1988, when he made a dauntless decision, and managed to get 100.00 yuan and paid for a 23 days long livestock raising class at Zhengzhou College of Animal Husbandry Engineering without permission from his parents. In the winter of that very year, Mr. H, after being trained, had only 50.00 yuan to his name but felt quite motivated, and he managed to collect 200.00 yuan and opened up a household chicken farm. 200.00 yuan was not a small sum at that time. The CGWR that year wrote: “In 1988, Chinese urban residents have disposable personal income of 1,119.00 yuan per capita, an increase of 22.2% over the previous year, while farmers have an average net income of 545.00 yuan per capita, an 17.7% increase.”

He kept a dozen of hogs and hundreds of chickens; he was not a good raiser then, but he saw a favorable market and got his first barrel of gold in his life: several thousand yuan. As chicken raising features easier technology and less cost than hog raising Mr. H had his principal business in raising chicken and a subsidiary business in raising hogs.

Even though he saw some ups and downs, his chicken farm developed quite fast and made his breeding hens raising scale up to 5,000 in 1995, when he officially named his farm as Eagle Breeding Hen Farm. At that time, tens of households bought baby chicks from the farm and established cooperative relationship with it, and the raising scale leaped from thousands to tens of thousands, an impressive snowballing development. Mr. H developed his chicken farm step by step, from raising only commercial egg layer hens to raising breeding hens, hatching baby chicks, selling broilers and providing technical services, which became an integrated business model. At that time, Mr. H was quite a sensational figure, who drove more and more farmer households to play a role on his chicken raising chain.

However, one day, within no more than one week, most of his 5,000 breeding hens died off, and his hogs also had something wrong. The slump of the broiler market then added to his biggest setback as his earning over the years and the overall assets of the chicken farm came to nil overnight. Loads of not-so-big chicken farms in the market closed down one after another. Mr. H did not take the defeat, and he borrowed money from relatives, former classmates and friends; he was not overwhelmed by but eventually survived the insolvency.

After the epidemic, the chicken raising industry started a new round of expansion in 1996, when the egg price hit the historical high price of 8.60 yuan/kg. The unexpected favorable market helped Mr. H to get to his feet again, strong and robust. This roller coaster experience was so thrilling and exciting that he had profound understanding and recognition of the epidemic prevention technology.

To further expand the production scale and profit of the breeding hen farm, Mr. H began to practice the protective gain price purchase among farmer households. Chicken raising households needed to pay some sum for raw material, after which they could obtain baby chicks, piglets, fodder, veterinary medicine and the like with just accounts kept. After the chicken and/or hogs were raised up, the Eagle Breeding Hen Farm bought them off. The Eagle Breeding Hen Farm just deducted the breading cost out of the sales revenue of raising households and returned the profit back to the farmer households. If the wholesale market price was higher than the protective gain price, the Farm would buy the livestock from those households at the wholesale market price; if the market price was lower than the protective gain price, the Farm would purchase at the protective gain price. This way the raising households would never lose money, so more and more farmers felt attracted and joined his livestock raising chain.

As a matter of fact, at the very beginning of its cooperation with farmer households, the Eagle Breeding Hen Farm only meant to market its baby chicks and piglets. One day in 2000, a sales person of Chia Tai Feedstuff Company came to Xinzheng to visit Mr. H and expressed his proposal to open up a company jointly. This sales person proposed that a company based on the baby chicks business of Mr. H and the feedstuff business of Chia Tai should be established to sell foodstuff and baby chicks to raising households in a package. The salesperson said, "We make money out of our foodstuff, while you make money out of your breeding hens". Mr. H felt this proposal was theoretically rational and workable, but he rejected since he believed the profit margin mostly went to foodstuff, and he would not make much money at all. He would have to take all operational risks, while the foodstuff company had no risk but profit. It would be impossible for the foodstuff company to pay for the high transportation cost of foodstuff from Pingdingshan to Xinzheng; when the market was unfavorable and farmer households lost money, the foodstuff company was not willing to cover the loss. After the salesperson left, Mr. H pondered over the proposal. After all, his company began to purchase loads of foodstuff and veterinary medicine at lower price and sold them to the farmer households at the most reasonable price at his discretion.

In early 2003, the "SARS" epidemic broke out and swept around China. The chicken price at home plunged and no one bought Mr. H's eggs or chicken. Almost all breeding enterprises had to face such a nationwide epidemic, which was quite fatal to many of them. Livestock breeding is such a different field that no farm can power off the operation and put workers on vacation like most industrial enterprises. That will never work for chicken farms, as the chicken are alive and need to be fed on foodstuff, and the workers also have to be paid.

Mr. H had a broken funding chain and was trapped in difficulties again, when he suffered hyposomnia constantly. All day and night long he racked his brains to figure a way for money, and tried his best to borrow money from his former classmates and friends. So united was his family that they decided, “They would sell their house to support the farmer households and ensure farmers interests”. Meanwhile, the customers had great confidence in the Eagle Company, and paid it in advance in view of their previous trust and cooperation. Mr. H also put all of his family’s house property on mortgage for a loan of 1.5 million yuan. Along with the 3.5 million yuan advance payment from the customers, the Company went through the difficulties.

With his experience in 1995, Mr. H felt quite confident in handling this crisis, and he knew the victory lied just ahead right after the epidemic. He took three steps. First, Mr. H rented refrigeration houses with borrowed money and butchered the chicken he bought at the protective gain price and stored them up. Then, Mr. H called up his staff and farmers for a mobilization meeting, when he made the point that the “SARS” crisis could be made into actually a once-in-a-life-time opportunity, because many farmers might not be strong and courageous enough to go through it, while those who would survive would surely see a better chance. He was trying to encourage them, and in fact he felt great pressure deep down. Under tight financial strain, he had to tell them their salary or accounts would be paid off or settled in four months, and those who were not willing to stay with him could leave or terminate their contracts. If the farmers felt the company had a promising future, their contract would go on, and their chicken would be bought at the protective gain price. So the farmers would not lose a penny. If some farmers have financial difficulty, they would borrow 500.00 yuan from the Company in advance. Since 2001, to further motivate the farmer households, the contract signed between the Eagle Breeding Hen Farm and the chicken raising households specified that should any *force majeure* render loss to the farmer households, the company would give them bottom profit of 18,000.00 yuan for account settling at the end of each year. Finally, Mr. H persuaded the partner livestock raising households to conduct forced moulting of chicken so as to change their hormone cycle and enhance egg-laying rate. During the forced moulting period, the chicken would not feed on any foodstuff, and many farmers were afraid of the risks, Mr. H proposed a bottom profit of 23,000.000 yuan for those households who would conduct forced moulting. Mr. H was very confident, as he had done experiments, where 14 chickens out of 16 survive starving for 18 days. Mr. H made some calculation and found if the forced moulting operation succeeded the Company would make a profit of 500,000.00 yuan, and if not, the loss would be only 50,000.00 yuan.

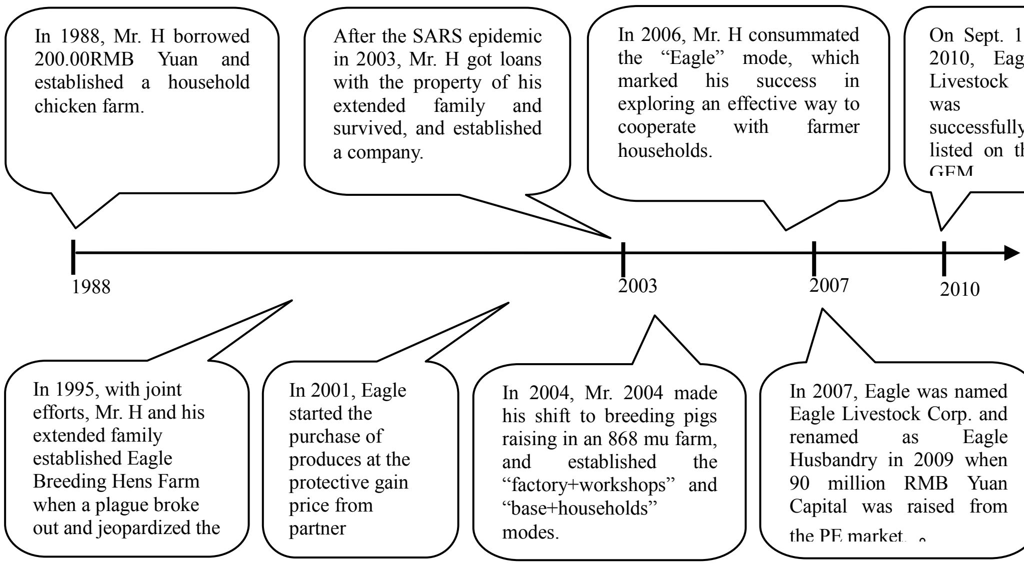
During the epidemic, many livestock raising enterprises suffered capital chain breaking and shifted their loss on farmer households; Mr. H, however, behaved the other way and signed bottom profit contracts with farmers to ease their worries for possible loss later on. He said, “Stock raising process is just a process of profit distribution; should dealers and distributors of baby chicks and piglets, foodstuff, veterinary medicine, butchering and all other links be unwilling to sustain the loss, it should not be those farmer households that would suffer?”.

After the “SARS” epidemic in May 2005, the company had apparently total direct loss around 6 million yuan; the customers however made a killing on the market later on, as fresh produce price then went up all the way because most competitors butchered their chicken in advance and froze them up. During this period, none of the partner households of Eagle left and all of them got assured payment. Thanks to its great output, Eagle had its way to indirectly cover the loss and made a profit of 1 million yuan.

Encouraged by the rebounding chicken price, Mr. H and his uncle Mr. Wuqun and auntie Madam Xidi jointly established Henan Eagle Poultry Industry Development Co., Ltd (hereinafter referred to as “Eagle Poultry”). The company had registered capital of 6 million yuan for establishment, including 4.8 million RMB Yuan of hen houses, hencoops, incubators and other fixed assets of Mr. H as evaluated, and his monetary capital of 480,000.00 yuan. Mr. Wuqun and Madam Xidi respectively added monetary capital of 360,000 yuan to the pool. This way, Mr. H and his relatives established clear-cut property relation. Fig.5-1 briefly sums up the development history and main events of Eagle.

During this period, Mr. H was awarded the honor of “Excellent Individual” by the Xinzheng Municipal CPC and by the People's Government of Xinzheng in March 2001, and "Excellent Local Talent" and "Top-notch Talent in Rural Area of Xinzheng" awards by the Xinzheng Municipal Committee of CPC and the People's Government of Zhengzhou in December 2001. In 2002, he was awarded the title of "Model Worker" of Xinzheng, and in December 2002 he was elected as member of the People's Congress of Xinzheng in December 2002. In 2004, he was awarded the title of "Model Worker" of Henan Province.

Figure 5-1 Development history and main events of Eagle



These honors show that the Chinese government pays great attention to the issues of agriculture, farmer and rural Areas[17]; except for this, Mr. H did not have actually too much direct interaction with the government and had never applied for any honors or support.

However, before 2002, private enterprises like Eagle had been discriminated in many ways; the industrial and commercial office and tax office would visit them frequently and impose fines, and other authorities also would come to request donations time and time again. Since Mr. H was elected member of the People's

[17]The so-called "Issues of Agriculture, Farmer and Rural Area" shows that the Chinese government have many polices in place to support them.

Congress, this kind of fines and charges substantially decreased. Mr. H believed it would be hard to get money from the government and, when after the “SARS” epidemic in 2003, the local government promised supporting funds, the Company did not get a penny. The local government also ceremonially rewarded “model workers” with cars, which turned out to be only keys for show on the prize presentation and no cars whatsoever after the meeting. Mr. H, however, felt grateful all the time to the favorable national polices to “Agriculture, Farmers and Rural Area”, as they exempted related entrepreneurs from income tax, only having to pay a small business tax, allowing these enterprises to gather up their capital which plays an important role in their development.

Development stage: 2003~2007

The “SARS” epidemic in 2003 shocked Mr. H, and he became aware that raising chickens would be very risky. He decided then to shift his priority, and gradually expanded his hog raising scale. In addition to the epidemic, his judgment on the market development also added to his decision to make a change. First, people in the north particularly in Henan did not have much chicken for meal regularly, and the consumption of chicken in the north was much less than in the south, and pork still enjoyed much larger consumption in the market in the north. Secondly, compared to the south, raising chicken in Henan had no cost advantage. Henan as a major grain production province used to enjoy great superiority in feedstuff price. Since the second half of 2003, however, the feedstuff price in the north has been growing up which made the feedstuff price grow from the original 0.10 yuan to 0.05 -- 0.06 yuan. Mr. H also found that there were not too many hog raising competitor enterprises especially in the north where there are not sufficiently large-scale pig raising enterprises.

It took capital to expand the livestock raising scale, so Eagle established a cooperative relation with local RCC (Rural Credit Cooperatives), which is briefly introduced here. By 2003, Eagle mainly had conducted its primitive accumulation based on the capacity of his extended family, and had seldom contacted with financial institutes. The company had difficulty in obtaining loans from banks and local credit cooperatives, as its operational land, chicken houses, pig houses, hencoops, incubators and other fixed assets as well as his sows were not recognized to that end. Before 1994, the so-called RCC had been affiliated to the ABC (Agriculture Bank of China), and both of them had shared the same approval procedures for loans. In 1994, the RCC began to separate themselves from the ABC and became officially independent in 1996; they have been under the direct supervision of the PBC (People's Bank of China) ever since. After that, the authorities then envisaged the RCC would be built up as an organization "shared by the commune members, democratically managed by the commune members and serving commune members financially". The RCC have never actually become a real cooperative organization for farmers. As a matter of fact, after that separation, the cooperative became a bigger mess, and their credit operation was completely decided by the directors of the cooperatives at all levels. Chances were that someone might borrow 100,000.00 yuan from a cooperative but bribe the directors with 20,000.00 yuan as commission, and would never return the remainder 80,000.00 yuan, and the cooperatives would take these cases as bad debts.

Mr. H remarked that he had no strong or wealthy family background, and would never do anything out of line like that; he knew the authorities would review and censor these cases sooner or later, and there was no way to get away with it. During the 10 years from 1994 to 2004, the credit cooperatives in Henan lost money in a row. As anticipated by Mr. H, a pilot reform on RCC was carried out in full swing in Henan, and the first step for the reform was to investigate the personnel, capital and bad loans of all 145 cooperative unions at county level, 2,054 legal-person cooperatives, 6,662 networked offices in Henan, and the bad-loans of 9.5 billion yuan would be retrieved by 2006. The main objective of the pilot reform was to consummate the corporate governance structure of the RCC and remake some qualified credit cooperatives into RCC.

The rural credit cooperative in the place where Eagle was located pioneered and began the reform in 2003. In 2003, the cooperative chose Eagle as a demo unit for cooperation supported by the favorable policies for "Agriculture, Farmers and Rural Area", and with contact established, the cooperative has become a good partner of Eagle ever since. Mr. H attached great importance to faithfulness and integrity, and always refunded as scheduled, which helped establish a virtuous cycle; the company did not request for big loans, though, as its first loan only amounted to 100,000.000 yuan.

Since the company had credit interaction with the cooperative, it has gradually built up its credit rating. At the end of 2004, the rural credit cooperative, based on their greater attention to the favorable policies for agriculture, farmers and rural area, to the enterprise scale building and the promising development prospects, offered the company the credit of 40 million yuan for three years. In early 2004, Eagle and Shineway Group signed an agreement for supplying 200,000 hogs, based on which the company requested a loan of 15 million yuan from the Rural Credit cooperative to build up a hog raising base.

Covering an area of 868 mu (1 mu=666.66 square meters), the base was divided into 4 zones and 8 fields. Between two zones, there was an area of 200 mu protective forest as an isolation belt, by which different zones could be managed in an enclosed manner. This base was built up in October 2005, and was home to 14,000 purebred sows, which gave birth to 50,000 cross swine and 250,000 commercial piglets. It became the biggest pig breeding and piglets supply base around Central China. At the same time, Mr. H did not give up the breeding of hens business, which he depended on to build up his new business. The hens' output was kept around 800,000.00 sets. With the increase of pig raising capacity, the revenue from hens had less and less proportion out of Mr. H's main business revenue and went down to only 10% by the first half of 2011.

At that time, Mr. H had applied the proven "Company + Workshop" mode for Eagle Poultry to the breeding pig raising zone.[18] It consists of the following links: ①

[18]The "Company + Workshop" mode consists in the following: The livestock raising farmer households themselves collect 50% of a fund, while Eagle provides guarantee so that the household could

The farmer households do not need to invest in fixed assets and all buildings including pig houses and other first-rate facilities shall be used by the farmers for free; ②For each pig house, the farmers can just pay some sum of raw material payment before conducting raising work in the zone, and the raw material payment mainly includes that for feedstuff and veterinary medicine; ③Eagle provides all-around technical services for free and shall bear 80% of loss in case of livestock death due to illness; ④To address the long raising period and slow capital turnover, Eagle takes a four-phase raising mode, and the profit is paid every two months; ⑤For different farmer households, different modes might be established: A. Most farmer households can just pay raw material payment and come to the zone for raising work; B. Some farmers in financial difficulties can pay half of the raw material payment first and the remainder can be covered by Eagle in advance which will be deduct from their profit for refunding and a little late fee; C. Those households short of labor can even recruit workers with the support of Eagle. Under exceptional circumstances, the breeding households might drop out, when part of their bottom profit margin shall be paid.

For those households who are willing to raise broilers and pork pigs, Eagle takes another mode of "Base + Household" according to which retail raising households can pay some sum of raw material payment (7.5 yuan per baby chick, and 550.00 yuan per piglet) and keep the livestock in the field they prepare, while Eagle provides the same "Five Unifications" services mechanism. The so-called "Five Unifications" refers to "unified piglets and baby-chicks supply, unified feedstuff supply, unified epidemic prevention, unified treatment and unified sales" services package.

For both breeding pigs and commercial broilers raising operations, Eagle will

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borrow the same amount from the bank (livestock raising households submitted 25,000.00 yuan and Eagle provided guarantee so that the household could borrow 25,000.00 yuan from the bank) and Eagle provided livestock raising households with standardized henhouses, equipment and other facilities. Farmers directly made use of the hen houses to raise chicken, while Eagle provides all-the-way services and management. Each hen house is home to 2,800 breeding hens annually, while 8 to 10 batches of broilers could be produced annually, with each batch amounting to 3,000 broilers.

sign bottom protective gain price agreement with the livestock raising households. When the market is below the protective gain price, Eagle will buy the produces at the protective gain price, and the price difference will be covered by Eagle; if the market price is higher, the purchase shall be made at the market price.

To attract more households, and extend its influence, Eagle later put forward the operational slogan "Eagle liable for the loss of livestock raising households". When Mr. H put forward this concept, his staff and senior management disagreed, and believed that the responsibility for loss should be pinned down to individuals and the company should never be liable for others' faults. Mr. H however hold that the Company made money with the farmer households: if the households quit, the Company will not survive, and least alone make profits. Here comes an excerpt from a newspaper in Henan during December 2007:

"*In 2001, when Mr. Guanqin heard that Eagle began to take nearby villagers in for livestock raising operation, he immediately invested 15,000.00 yuan to buy 3,000 baby chicks. This time Mr. Zai Guangqing stepped on the track for prosperity by raising livestock.*

Upon his union with Eagle for livestock raising business he tasted the benefit, and he has been seeking further and bigger development ever since. Such an opportunity really came unexpectedly the other day. In 2004, Eagle started its hog raising program and invited villagers nearby to join in, when Mr. Guangqin took 8,000.00 yuan off which he prepared for his son to build a new house, and invested in building a hog house. During his livestock raising efforts, however, he made some mistakes due to his lack of experience, which caused some loss, and luckily Eagle covered all of his loss. That year, he sold two batches of pigs and earned more than 10,000.00 yuan.

Mr. Guangqin learned a lesson and saw his way for prosperity by raising hogs, and in the winter of that year he extended his hog raising scale up to 100 pigs and his pig houses had transformed from an open-ended one to the current enclosed one. Little did he think he would earn net income of 10,000.00 yuan by selling the first *batch of 100 pigs in that year.. Mr. Guangqin and his wife felt more than happy looking at such a big sum of money they made over the past 3 months. Mr. Guangqin made 20,000.00 RMB Yuan in that very year and felt even more motivated and tried harder in raising hogs. In 2006, he earned up to 30,000.00 yuan by raising pigs, 17,000.00 yuan out which was from one batch. So happy were the couple that they flew to Hangzhou and did sightseeing around Xihu Lake and other places of interest.*"

In 2002, most livestock raising households with Eagle were scattering around all villages in Xuedian Town. In 2003, the operation spread around Longwang, Mengzhuang and other nearby towns and townships. By the end of 2004, Eagle had successively established four demo farm zones, and five network zones linking livestock raising households, which involved and drove more than 1,120 households in Xuedian Town and more than 10 towns and townships around as well as four counties (cities) bordering Xinzheng City. Over the three years, the demo zone farmer households had an average net profit of 30,000.00 yuan and the highest even reached 50,000.00 yuan; the partner farmer households had annual sales of more than 100 million every year: 103 million in 2002, 107 million in 2003 and 160 million yuan in 2004. Their net profit of livestock raising reached 2,210.00 yuan, and the average annual net profit for each household exceeded 8,000 yuan. In 2003, the per capita net income of livestock raising households was 5,585 yuan, 2,285.00 yuan or 69.2% higher than 3,300.00 yuan the average per capita net income of farmers in Xinzheng City; in 2004, their per capita net income was 6,067 yuan, an 8.6% growth from that of the previous year, and 2,428.00 yuan or 66.7% higher than that of per capita net income of farmers in Xinzheng City.

Meanwhile, to help farmer households with financial trouble, Eagle established "Fuming Bonding Company" -a bonding company working with local credit cooperatives to take the form of "a guarantee by enterprises, so that the credit can be given to farmer households who can refund the loan with eggs and piglets". In this way, farmer households could have access to the livestock raising zone as supported by the loan. In addition, this bonding company also offered financing support for some well-off farmer households cooperating with Eagle.

Around 2004, many well-off farmer households visited the company and expressed their wishes to join Mr. H and step on the track for fast development; however, they were not willing to raise pigs personally. With step-by-step exploration, Eagle along with some farmer business owners began to try and explore how to build up standardized livestock raising zones since 2005. These farmers signed land-rental agreement for livestock raising with Eagle, by which their own and/or their relatives' and friends' idle land or other barren land and/or slope were made good use of, and they invest part of the funds to build up some pig raising farm zones, and then they would rent out these facilities to Eagle at the rent rate agreed in advance. Of course, the whole pig farm zone shall be built up as designed and standardized by Eagle, and the ecological environmental criteria of "retreating from villages and entering the raising zones, with separate facilities for human and livestock", and the detailed cooperative livestock facilities construction is mentioned in before of this thesis. In this way, some farmers became business owners or little "capitalists", as they began to make money by investment.

Since 2003, Eagle has developed very rapidly; with various investments, the company felt stained capital chain, which constituted a series of problems to its production and operation. First, in 2004, 2005 and 2006, Eagle could offer breeding pigs and breeding hens facilities, but the farmers had to build most pig and broiler raising facilities themselves. As retailed raising farmer households were around all places, many technicians needed to be recruited to serve farmer households, which presented some difficulty for management so as to be completely up to the requirements for "five unifications" management set by Eagle. Then, some livestock was raised without supervision of Eagle, so some households falsely informed the company of fowl plague and/or pig fever, and some of them even sold pigs to some dealers who offered exceptionally higher price. Eagle conducted careful screening on livestock purchased from retailed raising households, but the company was still worried about possible harmful feedstuff. Finally, if Eagle would build up a lot of livestock raising facilities, it would have to address the issue of Land Circulation; for one thing, a lot of local land was left unused, and for another, the local authorities were afraid that Eagle might put the land it requested at a large scale for livestock raising purpose into other use[19].

Working with well-off farmer households to build up livestock raising zones helped ease the troubles of capital problem and land shortage faced by Eagle to some extent. What is more, many livestock raising facilities newly built helped Eagle to admit more farmer households into its livestock raising zones, which made easier monitoring and guidance of livestock raising from sow fertilization to baby delivery and from raising piglets to butchering pork pigs.

Over the six years from 2002 to 2006, Mr. H gradually consummated his “Eagle Mode”, which has been popularized step by step year by year thereafter. This mode has evolved from the “factory + workshop” and “base + household” livestock raising mode, and been based on the cooperative livestock raising agreement of protective gain price and the “five unification” corporate operation and management, with new design and more new features.

The new mode actually involves: Eagle offers production materials including hog houses, feedstuff, veterinary medicine, piglets and so on while farmer households submit cash deposit (around 20,000.00 yuan or so, according to each phase) before having access to the modern livestock raising bases. The farmer households might decide on the livestock raising approaches themselves, but they will have to take responsibility for their profits or losses, and the company will settle profit accounts with farmer households upon the completion of each raising phase.

There are five phases involved in raising up pigs: hybridization, pregnancy, delivery, baby care and fattening, and different farmer households may choose to take different pigs to work on different phases. Meanwhile, the Company assigns one technician to four farmer households to provide guidance for epidemic prevention all

[19]With a large population and not too much arable land, the Chinese government has issued all kinds of arable land protection laws and regulations since 1986.

the way. Under this mode, the pig houses do not have to be very big, and a 200 m^2 or so pig house will be sufficient for raising 100 pigs, and usually one farmer household can take care of two pig houses. For detailed elaboration of the Eagle mode, please refer to Section 5.1.3

A great many professional talents are needed to further expand the company; by 2003, the company had been managed by Mr. H and his family, while thereafter many professional management personnel have played a bigger role. In April 2005 Mr. H hired Miss Yidi as deputy GM in charge of Eagle Poultry, who is now director and secretary of the board of directors. As Mr. Yidi specializes in accounting, other professionals hired are listed in the following table.

Table 5-1 Survey of professionals hired by Mr. H and their positions

Name	Date of hiring and previous positions	Current position	Specialty
Mr. Yidi	Hired as deputy GM responsible for Eagle Poultry in April 2005	Director and secretary of the board of directors	Accounting
Mr. Hua	Hired as deputy GM of Eagle in October 2008	Director and executive deputy GM	Risk management
Mr. Hai	Hired as deputy GM and farm head responsible for Eagle Poultry in June 2004	Deputy GM	Veterinarian
Mrs. Dong	Hired for Eagle Poultry in October 2005	Technical director	Livestock raising
Mr.Guo	Hired in April 2009 and responsible for Eagle Husbandry ever since	Senior executive of production department I	Livestock raising

Source: 2010 Report of Eagle Company

On November 8, 2007, Eagle Poultry was renamed as “Henan Eagle Livestock Industry Development Co., Ltd” (hereinafter referred to as “Eagle Livestock” or “Eagle”), with a registered capital of 30 million yuan. Its capital increase and share expansion mainly came from Mr. H and his family. the year of 2007 also marked the time when the Company had successfully sifted its business priority to hog production, when the Company had 26 demo breeding pig farms (zones) and 10 demo breeding poultry farms (zones).One of them was home to 17,000 purebred sows, which gave birth to 60,000 breeding pigs and 600,000 commercial piglets, and was reputed as the biggest breeding pigs and piglets supply base around North China. At the same time, Eagle had produced 850,000 sets of breeding hens, 2 million broilers, 13 million quality commercial broilers and 30 million baby chicks, known as the biggest black-footed chicken and speed-growth yellow chicken production base around Central China.

Rapid corporate development and stock listing: 2007～2010

Table 5-2 shows the earning capacity of all main businesses of Eagle from 2007 to 2009.

Table 5-2 Gross profit margin of Eagle's hog production over the recent years (%)

Produces	2009	2008	2007
Commercial piglets	26.77	34.70	16.92
Dual breeding pigs	48.54	53.57	38.44
Commercial pork pigs	6.13	12.49	18.08
Gross profit margin of pigs	**23.42**	**31.47**	**24.15**
Gross profit margin of poultry	**19.32**	**13.04**	**23.33**
Overall gross profit margin	**22.51**	**26.15**	**23.66**

Source: 2010 Report of Eagle Company

The gross profit margin listed in the table above is calculated in an integrated way according to the proportion of each business. For the sake of brevity, the gross profit margin of hatching eggs, baby chicks and broilers are not respectively listed. It shows that, the average overall gross profit margin of Eagle was 24.11% during this period, among which, the gross profit margin of hogs was 26.35% and the gross profit margin of poultry was 18.56%. The sales of hogs from 2007 to 2009 were respectively 133,700, 249,100 and 483,800, with an average annual growth rate of 90.27%. The hog production from 2007 to 2009 respectively accounted for 51.73%, 71.10% and 77.70% of Eagle's business, which even reached 85% in 2010. But in the meantime, the company still maintained the breeding hens raising scale of 800,000. The average annual growth of Eagle's sales revenue over the past three years was 61.66%, and the net profit increased by 114.96% as shown in the following table.

Table 5-3 Eagle's operation revenue and profit over the past three years before being listed

Items	Jan.~Jun. 2010	2009	2008	2007
Operation revenue	270,043	541,082	364,157	208,398
Operating profit	29,362	76,566	59,766	30,982
Net profit	31 , 736	88,316	62,495	21,655

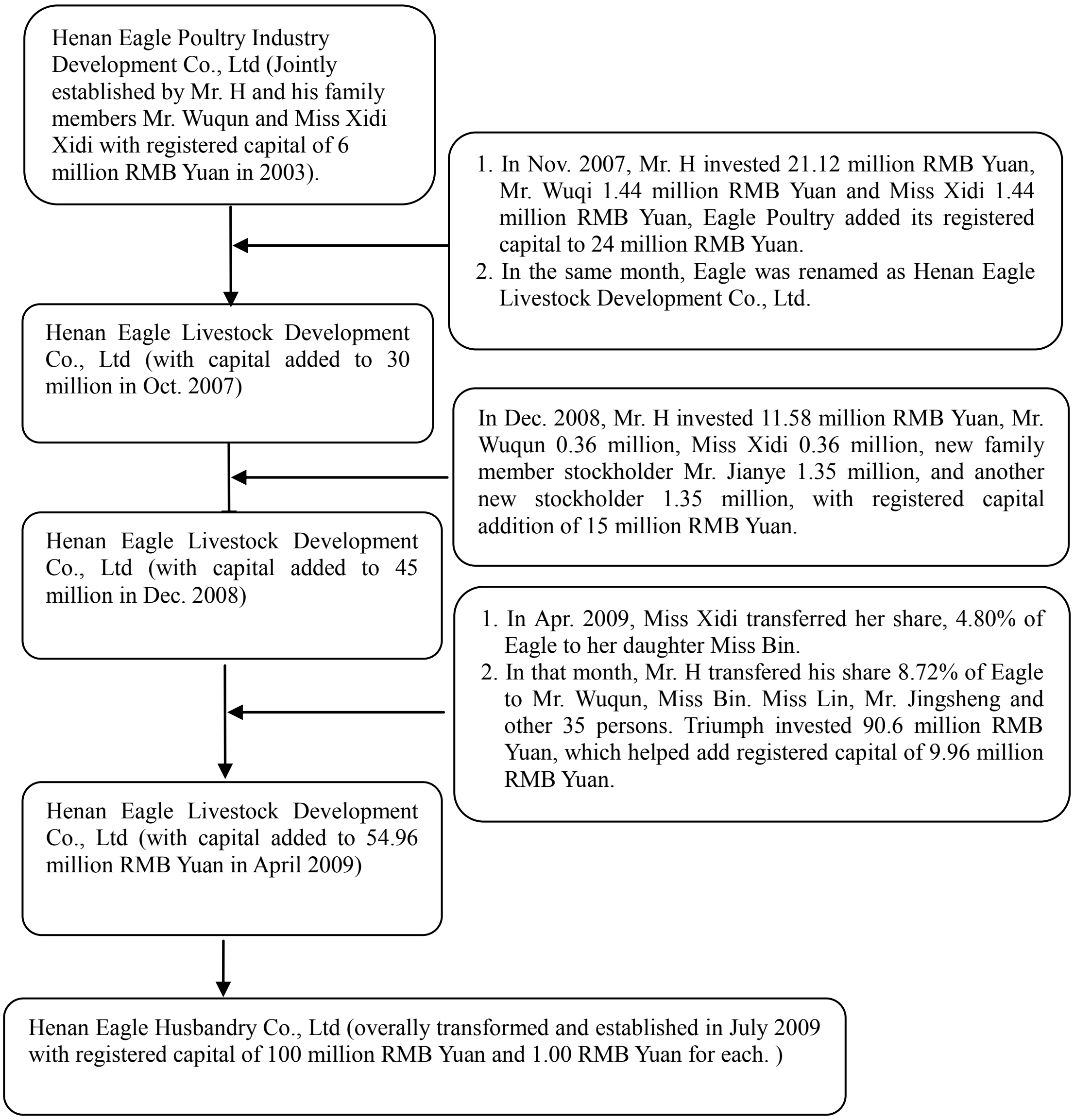
Source: 2010 *Report* of Eagle Company

We may now examine the social contributions the company made to driving the farmer households to get rich. The amount of the partner livestock raising households involved in account settlement in 2007, 2008, 2009 and Jan.~Jun. 2010 were respectively 514, 1,065, 1,579, and 1,229. In 2009, the income of the partner livestock raising households was 58,300 yuan on average and the highest was over 100,000 yuan, as was relatively high, because the average annual income of local farmers was only 7,000.00 yuan then. By the end of June 2010, there had been 558 households registered of intention to cooperate with Eagle, so that Eagle had to strictly implement the queue-up registration system (*Date source*: The prospectus of the Eagle company in 2010).

Eagle's productions have passed the National Green Food Authentication, and the whole raising and production process passed the ISO9001 International Quality Management System Certification, the HACCP Food Safety Management System Authentication and Good Agricultural Practices Authentication, which made Eagle one of the official pork suppliers to the Beijing 2008 Olympics. Eagle was awarded the "National Key Leading Enterprise for Agricultural Industrialization" award in 2008 by the Ministry of Agriculture, the NDRC, the CSRC (China Security

Regulatory Commission) and other ministries; it was recognized as the “Base of Central Stored Frozen Livestock” by the Ministry of Commerce and a “National Key Leading Enterprise of Poultry Raising and Processing” by the Ministry of Agriculture and the Ministry of Finance. The corporate indices which have significant impact on pig raising gross profit margin were much higher than the industry average, the average mating success rate more than 92%, the farrowing rate 10.7 per sow, and the survival rate 96.2%~96.8%. (*Date source*: Interviews with the company’s director.)

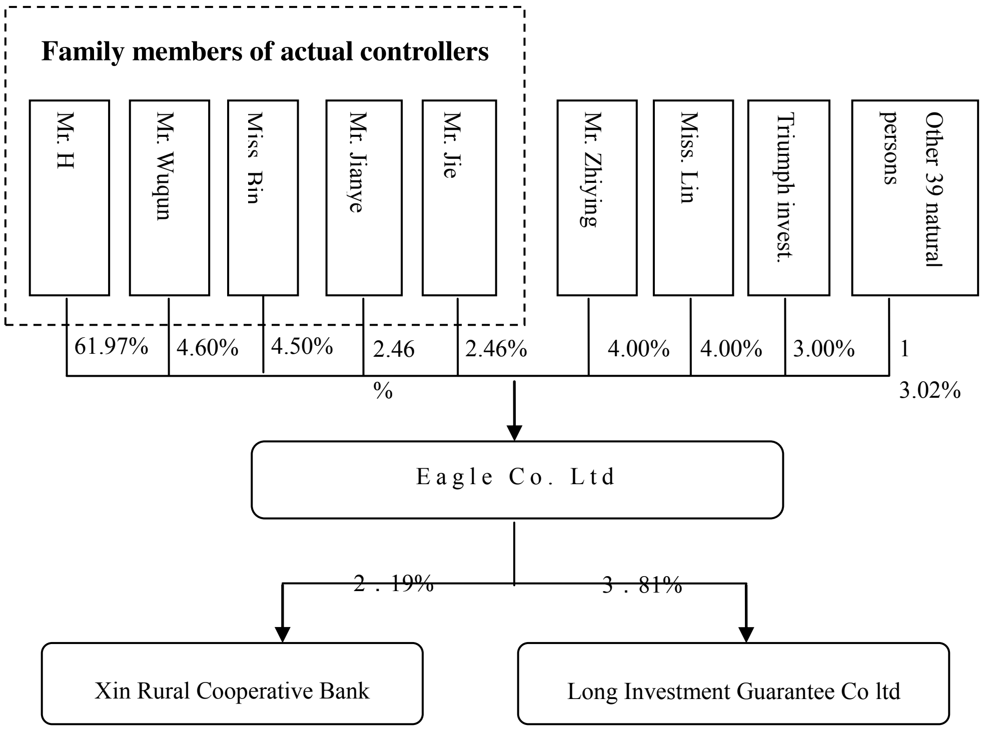
Figure 5-2 Capital increase and share expansion of Eagle from establishment to being listed



Source: The *prospectus* of the Eagle company in 2010

Since 2007, Eagle has done preparations for being listed. Fig. 5-2 shows its capital increase and share expansion from establishment in 2003 to being listed in 2010. It shows, its capital increase and share expansion for twice in Nov. 2007 and Dec. 2008 mainly came from Mr. H and his extended family. Mr. H actually shared part of his own stock equity with other members of the extended family. But the twice increase had little effect on the improvement of its balance sheets, with the asset-liability ratio at 57.36 in 2007 and 61.07 in 2008. In April, 2009, Shenzhen Triumph Investment Management Co., LTD, Mr. Zhiying and other 38 persons, invested a sum of 90, 6 million yuan to Eagle as new shareholders, which helped to add registered capital of 9.96 million yuan and add capital reserve of 80.64 million. This investment not only marked the access by outside shareholders, but also helped prepare for becoming a listed company.

Figure 5-3 Relation between the actual corporate controller and the investment



Source: The prospectus of the Eagle company in 2010

Fig. 5-3 shows the relation between the actual corporate controller and the investment. It shows that the shares of Mr. H's extended family account for 76% of the company, including his personal share of 61.97%. Both enterprises that Eagle invests in are financial ones and are closely related to it. One is the Xin Rural Credit Cooperative Bank, 2.19% shares of which is held by Eagle, and which was actually the local credit cooperative that provided Eagle with the main financial support before. The other is Long Bonding Company, which was formerly Fumin Bonding Company.

On Sept. 15, 2010, Henan Eagle Livestock Co., Ltd was listed on the GEM (Growth Enterprise Market) market of Shenzhen Stock Exchange. The IPO publically issued 33.5 million common stocks (A share) at 35.00 yuan per share with the corresponding PE ratio of 60.98. The raised capital was mainly used for building an industrial base of annually slaughtering 600,000 hogs and producing 40 tons of feedstuff, setting up a scientific research and training center and establishing a food safety trace ability management system. The actual issuing operation helped the company raise 155 million yuan of replenishment capital more than planned.

Eagle has established an operation and management mode which integrates feedstuff production, pig breeding, hog raising, hatching egg production, egg hatching, baby chick hatching, technical research, development and plague and disease prevention and cure, forming a consummating industrial chain. To control the cost and ensure the food safety, Eagle has set up a subsidiary in Jilin purchasing raw materials in local area such as prime quality corn, soybean meals and so on.

Eagle announced in October 2010 that the replenishment capital of 100 million raised before would be used to build a project in Xuedian, Xinzheng, butchering 1 million pigs annually. Eagle would also have the registered capital of 1 million RMB Yuan for establishing Eagle Food Processing Co., LTD in Weishi, Kaifeng, Henan, carrying out a project of butchering 1 million pigs annually. It shows the Company has a strategic idea of expanding its presence to the downstream industry, in order to extend and complete its green food production chain.

5.1.2 Industrial Background of Pig Raising

The business focus of Eagle has shifted to the pig raising industry, which has relatively large profit margin, so the background of the pig raising industry is specified as follows. The introduction to the Eagle mode in Section 5.1.3 of the thesis is also based on pig raising.

The main riskspigbreeding faces

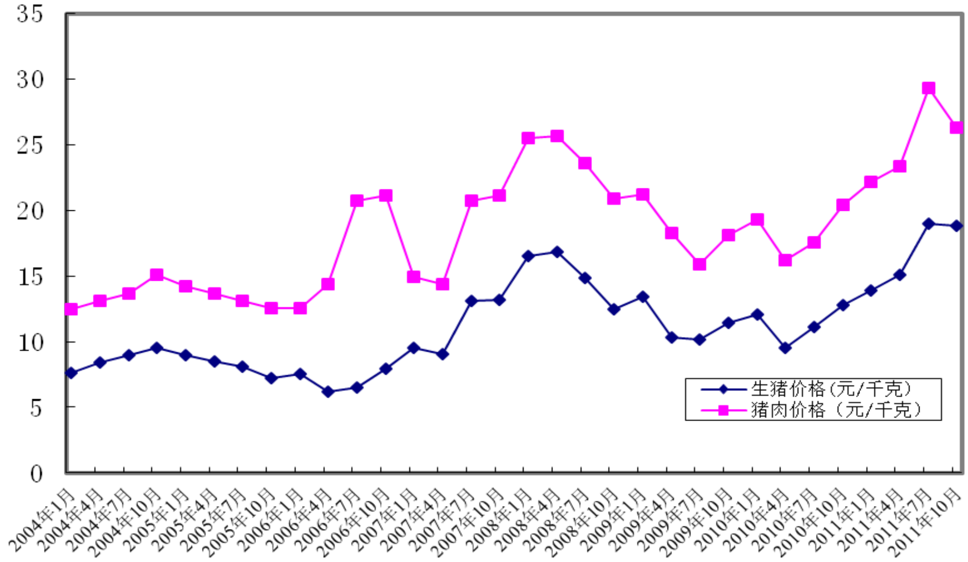
The gross profits of the live pig industry fluctuate periodically, which is determined by the agricultural product attributes. There is a considerable demand for the live pig market, but the market is relatively stable. Pork prices in the absence of the epidemic period are mainly determined by the market supply situation, and the supply situation depends on the breeders' expectations. Thus the fluctuation of pig price shows the following characteristics: the profit of raising live pigs increase =>the amount of breeding pig on hand increases =>pig price declines=>the profit of raising live pigs increases =>the amount of breeding pig on hand diminishes=> pig price rises =>the profit of raising live pigs increases.

The fluctuation of pork prices directly affects farmers' profit. Table 5-2 shows Eagle Company's gross margins influenced by the price fluctuation in recent years.

In recent 10 years, the price of live pigs in China has been relatively stable from 1999 ~ 2003. For the remaining years there are relatively great fluctuations. The main factor is not the epidemic outbreak, but the low scale of China's live pig market. Besides, the medium, small and retail farmers' ability of market prediction is poor, see Fig. 5-4.

It is difficult for small, medium and retail breeders to continuously and steadily reach 20% to 30% gross margins as Table 5-1 shows. This requires the sacling of breeding and management. In the first half of 2010, the pork price is low, which is in the periodical trough. The small and medium farmers as well as retail farmers suffer huge losses, but because the government repeatedly announces storage measures to stabilize the farmers' confidence, the amount of livestock on hand is not generally reduced. Consequently, the market prices of young pigs and breeding pigs do not decline as the pork price did in 2010.

Figure 5-4 China's pig and pork prices from 2004-2010, October
(The line above shows the price of pork, and another shows the price of hog pigs)



Source: The website of NDPC (http://www.sdpc.gov.cn/)

The risk of epidemics

Once the epidemic shit the live pigs, the result can be devastating. However, for some enterprises and breeders who can survive it, they may have unexpected profits.

Like natural disasters, which may substantially influence the yield of agricultural products, the emergencies like the pig disease can change the pork price regulation law in a short term. Previous outbreaks of swine disease show that the severity of the outbreak and the pig price in the afternoon market change in inverse relationship. During the epidemics, small and medium-sized farmers and free-range farmers tend to rapidly reduce the amount of breeding pigs on hand to avoid short-term risk. Subsequently, the market supply drops considerably. After the epidemics, pig price rises significantly because of market shortage.

In 2006, the outbreak of highly pathogenic PRRS (Porcine reproductive and respiratory syndrome) makes pig prices continue to rise in 2007. In the second half of 2009, the pig disease hits Jiangsu, Jiangxi, Hunan, Hubei, and Henan provinces and its influence is between "slight" and "serious" with pork prices in these provinces being subject to a certain degree of fluctuation. In April 2009, due to the global outbreak of influenza H1N1, live pig price glides, and reached the lowest point between April and May.

In addition to the risk of epidemics, at the end of 2007, the large-scale snow and freezing rain resulted in massive death of live pigs. Consequently, pig demand exceeded supply in the first half year of 2008. Live pig prices reached the peak from April to May during the reporting period.

State's regulatory measures of pork price

According to Chinese people's eating habits, pork plays an essential role in China's animal husbandry and food consumption. Firstly, China is the largest producer of pork. In 2010, the national meat output was 79.25 million tons and pork production reached 50.7 million tons, accounting for 64% of total meat production in China and about 50% of the world's total pork production (Source: the website of NDPC, http://www.sdpc.gov.cn/). Secondly, according to the Annual Report of China's Animal Husbandry Association, in 2010, China's annual per capita pork consumption reached 38.7 kg, accounting for 66% of total meat consumption, and is the fourth largest country in per capita consumption of pork. Besides, pig breeding is one of the main sources of farmers' income, accounting for about 10% of farmers' net income. In some traditional agricultural provinces such as Henan and Sichuan, this ratio is even higher. Just as an old saying goes: "pork stabilizes the nation".

In order to stabilize the development of pig production and prevent excessive fluctuations of pig price, the government issued the "regulatory measures to prevent excessive price fall of live pigs (Provisional)" on January 9, 2009. The measures mainly refer to the price ratio between pork and grain. Meanwhile, the price ratio between piglet and carcass meat, the quantity of live pigs and sows will also be taken into consideration. Besides, early warning indicators and specific criteria will be timely adjusted according to the way of pig production, production costs, market demand, and etc.

Under normal circumstances the price ratio of pork to grain is 9:1 ~ 6:1. This is primarily based on China's pig breeders' average profitability. The profitability of pig breeders is affected by fluctuations in both hog prices and corn prices (the main cost of pork production). Because pig breeding is mainly free-range in our country, the ratio of 6:1 is the free-range farmers' average break-even point. The main objective of the regulatory measures is to guarantee that the price ratio of pork to grain is no less than 5.5:1; the minor goals are to guarantee that the price ratio of piglets to carcass meat is no less than 0.7:1; the quantity of live pigs is no less than 410 million; and the quantity of sows is no less than 41 million (NDPC, http://www.sdpc.gov.cn/).

According to the regulatory measures, early warnings are applied to the following two cases. First, when the price ration of pork to grain is higher than 9:1, in accordance with "the State Council's notions on developing the pig production and stabilizing the market", the Government will timely provide the frozen meat reserves; if necessary, temporary subsidies will also be granted to the low-income families in both urban and rural areas.

When the price ratio of pork to grain is lower than 9:1, there are five conditions as follows: A. Green area (normal price) - the price ratio is between 9:1-6:1; B. blue area (prices slightly down) - the price ratio is between the 6:1-5.5:1; C. yellow area (price down moderately) – the price ratio is between 5.5:1-5:1; D. red zone (price drops drastically) -price ratio is less than 5:1; E. pig prices fall in other unusual circumstances. For example, when the pork prices fall in the moderate zone, the regulatory measures will trigger "secondary response." Specifically, (1) if the price ratio is less than 5.5:1, through the interest subsidy, the government will encourage some big pork processing factories to increase commercial reserves of pork and enlarge pork processing scale; (2) when the ratio is between 5.5:1-5:1 (yellow area) for four weeks in succession, the Central Government will further increase the reserve of frozen pork, and also require the big cities and coastal cities to increase local reserves of frozen pork and live pigs as well.

The regulatory measures combined with China's pork reserve system play an important role in stabilizing the pork price. According to the weekly wholesale prices of live pigs monitored by the NDPC, the pig price fluctuated considerably from 2009 to December of 2010 between a minimum price of 9.68 yuan/kg, and a maximum of 14.22 yuan/kg, the lowest being 4.54 yuan/kg. While during same period, the weekly wholesale price of corns is on steady rise. From early 2009 to December 2010, the corn price rose from 1.5 yuan/kg to 2.12 yuan/kg, an increase of 41.3%. The increase of the corn prices imposed much pressure on the cost of pig industry.

According to the price ratio of pork to grain monitored by the NDPC, the Ministry of Commerce took the following measures: on June 10, 2009, April 13 and 20, and May 20 of 2010 and in other times, certain amount of pork was purchased and reserved by the central government in an open bidding. Then, in September 2009 and early November, September, October and December of 2010 and some other times, the reserve of the frozen pork was put in the market again.

What is the result of the regulatory measures? In 2009, after the purchase and reserve of some frozen pork, the pork price stops falling and began to increase. In addition, the price ratio of pork to grain rebounds to above the breakeven point. So, the measures did work out immediately. However, in 2010, after purchasing and reserving the first batch of frozen pork, the pig price did not rise rapidly and, instead, it continued to fall. Only after the second and the third batches of frozen pork were purchased and reserved did the pig price rebound to the break-even point finally. From what is mentioned above, we can conclude that although the state's purchasing and reserving of frozen pork had a positive impact on pork prices, the main factor affecting the pork price is still supply and demand. In 2010, the Central Government's total reserve of frozen pork was 170,000 tons, accounting for about 3% (NDPC, http://www.sdpc.gov.cn/) of annual output of live pigs. Therefore, the reserve accounted for only a small percentage of the total supply. Overall, the role of purchase and reserves is more displayed in the market expectation. As a rule, it takes 2 to 3 months to have the pork price rebounded above the breakeven point after the government purchases and reserves frozen pork.

5.1.3 Eagle's Business Model

Eagle's business model is based on the long-term accumulation of farmers' trust and on closely combining scientific breeding process with farmers' experience. The concept of the model is " bear the responsibilities, complement the advantages and share the fruits". Under the unified management, farmers' enthusiasm is exerted into full play and win-win cooperation is realized. The main content and innovation of the mode are as follows:

Cooperative breeding with farmers

The company only lets the farmers raise pigs in the closed farm. The company generally cooperates with families with farming experience. Farmers can arrange 2 ~ 3 family members to participate in the cooperative breeding according to their own family labor. The farmers involved in the cooperation are often 40 ~ 50 year-old couples. The chance to be migrant workers for them is little. Further, they have certain breeding experience, a strong sense of responsibility and high enthusiasm. Henan has a large population with a high proportion of farmers. At the end of 2009, the total population of Henan province is 99,670,000, and the farmers amounted to 62,090,000. Henan is a traditional agricultural province. It is also a big province in live pig breeding. In 2009, Henan province produced 52,090,000 (Source: the website of NDPC, http://www.sdpc.gov.cn/) live pigs. The rich human resources in the rural areas and the tradition of breeding pigs lay the foundation for the development of the company.

According to the value of the livestock, the cooperating farmers must pay the corresponding deposit to the company. The deposit is generally no more than 10% of the market price of breeding livestock. After the cooperation agreement expires, the company returns the deposit to the farmers. According to the contract, all the livestock belongs to the company. If the farmer takes the livestock out without permission, the company has the right not to return the deposit. If the deposit is insufficient to cover the company's loss, the farmer should make up for the company's loss. During the agreement period, if the farmer wants to terminate the contract, the company should be notified at least ten days in advance and pay liquidated damages; the company should provide necessary livestock, otherwise the farmer should be compensated.

According to the company's breeding process, the farmers accept the feed supply, epidemic prevention, technical guidance and "closure management", but the specific ways of breeding are decided on their own. In line with the company's procedure, the farmers decide their own farming methods including reasonable arrangement of feeding frequency, the amount of feed, the number of pigs' activity and ways, warming and cooling pigs, sanitation and rest time of pigs and similar.

After the breeding cycle is completed, the company pays the farmers according to the breeding achievement, and deducts the cost. The earnings are different according to different breeding stages[20] (*Source:* The prospectus of the Eagle company in 2010).

"①For the farmer in the grow\finish house, the company pays the farmer 150 yuan for each pregnant gilt, 104 yuan for each sow and 30 yuan for each unconceived sow.

②For the farmer in the gestation barn21, the company pays the farmer 112yuan for each conceived pig. If the pig miscarries, the farmer gets 30 yuan.

③For the farmer in the farrowing house, the income is given according to the piglet's weight. The standard is 3.34 yuan per half kilo.

④If a farmer works in the nursery, the income is given according to the weight increase of the live pig. The standard is 3.40 yuan per half kilo."

The unit price is stipulated by the two sides in the contract before the start of the cooperation.

[20]Based on the system of pigbreeding and disease prevention as well as the"stageing and processing" breedingdemands._the Eagle company innovatively designs its own characteristics of the_pig breeding_process, and_designs_different_farms_with different functions. Through_collaboration and unified_ management, the company establishes a pig_breeding_chain.

[21]The breeding houses are functionally classified, which is one of the company'sfeatures. It helps pigs feeding and disease prevention atdifferent stages of growth. Meanwhile, the company's farmers are responsible for different pig houses with different functions, and take the corresponding management responsibilities. In this way, the farmers can gain more professional experience, and the breeding efficiency gets improved.

The cost mainly includes the consumption of feed, 20% ~ 90% of veterinary drug, charges for excessive water and electricity, farm interior repair, death of livestock and so on. Among them, the main cost is the feed, which is calculated according to the company's internal prices. Eagle company can get the feed at a price that is lower than the market price. This is also stipulated in the contract.

In the event of a serious epidemic and other extreme conditions, the company will ensure that the cooperating farmers get 1.3 to 20,000 yuan per year guaranteed minimum profit. In 2007, 2008, 2009, 2010 January to June, to guaranteethe farmers' minimum profit, the company paid a total of 25,500 yuan, 20,100 yuan, 20,300 yuan, 17,000 yuan respectively as compensation, accounting for 0.08%, 0.03%, 0.02%, 0.05% of the year's total profit.

In 2009, the number of the cooperating farmerswas1,579. Generally, a farmer can be responsible for each batch of 120 live pigs breeding, and each farmer can breed 2 to3 batches of live pigs per year.

The following is taken from "Henan Daily," of January 28, 2010:

"*The first farmer who joined Eagle Company is an old man named Guangqin. He and his wife are now responsible for a batch of 180 pigs each time. Every morning, he cleans the pig house, while his wife feeds the pigs. Before nights fall, they feed the pigs three times. They have to stay in the enclosed breeding area for three months until the whole feeding process is successfully completed. Besides looking after the 180 starving pigs, they also need to observe carefully the health condition of each pig.*

The old couple can raise three batches of pigs per year. Their net income reaches 50,000-60,000 yuan, and even over 100,000 yuan. More and more farmers become rich like this in the Eagle's breeding base. Guangqin and his wife have been poor and frugal during most of their life. Now they can enjoy the improvement of their living quality. They begin to travel to Hangzhou, Hainan, and other places."

In 2007, 2008, 2009, 2010 (January to June), the households involved in the cooperative breeding were 514, 1065, 1579, and 1229 respectively. In 2009, the average income for each breeding household was 58,300 Yuan, and the highest income already exceeded 100,000 yuan, far higher than their own backyard profits. The farmers are enthusiastic to participate in the company's cooperative. By June 30, 2010, the company had registered 558 new households who had the desire for cooperative breeding.

Sub-field breeding with unified management

In order to enhance the professional management, the company divides the whole pig breeding process into different stages, known as the" staging breeding". There are two main stages: breeding pigs and fattening pigs. Breeding pigs is further divided into five stages: breeding; conceiving; farrowing; nursing; growing\finishing. Each stage is equipped with different pig houses. The pig house in each stage is correspondingly equipped with professional facilities and epidemic prevention staff. At different stages, there are different farmers so as to cultivate professionals for every stage.

Sub-field farms refer to the company’s various farms or its internal breeding areas, which on average occupy small lands and keep a reasonable distance between each other. The company’s large farm, including the first pig farm and the first export base of live pigs, is also divided into different breeding sections according to the specific circumstances. The green belt must be set up between various breeding sections. The trees in the green belt usually cover 100 ~ 150 meters; in addition, in the same farm, the pig houses are separated from each other by the green belts according to the wind direction and the features of the farm.

Meanwhile each farm implements "closure management", the rules of which are strict. According to it, the technicians and the cooperating farmers in one stage cannot leave the breeding area until the pigs for which they are responsible are handed over to the next stage. At the same time, for the epidemic prevention staff and cargos of feeding need to be sterilized before entering the farm in accordance with the procedures. For example, in a 30-acre farm, there are generally 2 to 3 fixed technical management personnel to offer the farmers technical guidance and daily management, and guide the farmers to do some work such as the vaccination, epidemic prevention and disinfection.

Through the unified management, the company can achieve large-scale operation, including unified purchases, unified supplies, disease prevention, business process management and sales. Take unified purchases for example, the company uniformly purchases raw materials of feed, vaccines, veterinary drugs, breeding sows, which not only lower the prices, but also reduces the transportation cost. Take unified supplies for example, the company supplies special feed for pigs in different stages to guarantee the feed's quality and the pigs' normal growth. In view of unified sales, the marketing department makes sales strategies according to the market price fluctuations and the company's strategic plan, and meanwhile, decides breeding programs including the proportion of breeding sows for their own use and for sales, the ratio of piglets for breeding and for sales. In this way, the management of the company is scaling costs.

The company and the farmers cooperate to build the farms

In recent years the company expanded rapidly. To relieve capital pressure, the company requires some farmers to build the farms by themselves. The construction must comply with the company's requirements and then the company rents the farms. The company build sits own farms and also rents the farmers' farms. In this way, the expansion of the breeding scale is accelerated.

The company not only needs the farmers to offer financial support for the farm construction, but also requires them to manage external relations. Therefore, the cooperating farmers need to fulfill a certain number of tasks including the lease, construction, coordination of external relations, farm maintenance, management and so on. So, the capable farmers' potential is exerted into full play, and the company's management cost is saved.

Usually the funds for building a farm are about 1-1.5 million. The funding sources include three aspects. The first is the cooperating farmer's own funds, accounting for about 30 to 50% of the total funds; the second is the subsidy funds offered by the company, which accounts for about 10 to 15% of the total funds - the company will apportion the subsidy over the lease term; the third is loans the farmers get from the rural financial institutions through the company's guarantee.

If a farmer has the intention to cooperate with the company, he chooses the farming location by himself, and then the company's marketing department evaluates whether it is feasible to build farms there. Once the company confirms the feasibility, the contract with the farmer will be signed and the leasing procedures will be accomplished. The company will provide construction scheme, floor plan and pigpen construction drawings, and help the farmer with the construction as well. After the construction of the farm is completed, it will be put to use under the company's "unified management". Therefore, there is no difference between the company's own farm and the co-built farm.

After the farm is built and checked by the company, it will be leased to the company and then the farmer begins to gain rental income from it. The company leases for 15 years and, after the expiration of the contract, under the same condition, it will have the priority of tenancy. During the term of the contract, the farmer is responsible for the repair of the farm and the corresponding costs as well.

The company is responsible for the internal management of the farms. The farmers should ensure that the lease contract of the lands used as breeding places is legally valid. They should fulfill the legal requirements of the relevant procedures, and meet the requirements of the state's laws and regulations as well as related policies on land management of livestock and poultry breeding.

Because the farmers are personally involved in construction and supervision of the farms as owners, the farms are of high quality, cheap, economical and practical. The rent the company pays for the farms is lower than its self-built farms' total fees of depreciation, maintenance and management. Therefore, the farmers can obtain stable rents and the company reduced operating costs. Both sides reach a "win-win".

The social benefits were reported by "Henan Daily" on January 28, 2010:

"*Standing on the breeding farm which is being under expansion, you will find that most of the feeding 'community' is built on barren hills. Outside the 'community'* *is full of weeds and sand. One step can even make a footprint.*

Of course, saving costs is an important factor to use the wastelands. But it is indeed a good deed because it not only saves farmlands, but also develops wastelands. It is imaginable that the soil structure will slowly change after years of cultivation as the breeding base. Green belts are set up to isolate the pig houses, which not only protects the pig health, but also beautifies the environment.

Hard-working breeders grow vegetables in their leisure time; the soil will become fertile as the environment changes; the browns and will be replaced by the green plants. In order to develop recycled economy, Eagle company processes the pigs' dejects and makes them into organic manure so as to produce biogas. The preventative measure is implemented. The pollution of the source is reduced at the beginning, and thus the focus is shifted from pollution harness to pollution prevention.

After anaerobic fermentation, the pigs' dejects become the finest organic fertilizer as they are nutritious with less bacteria .As biogas has the advantage of saving energy, the farmers can save a lot of fuel. "

5.2 Analysis of the Case

The case is analyzed from two perspectives: First, the corporate governance of Eagle is analyzed. This analysis consists of three sections: Section A makes use of relevant financing theory to analyze the funding difficulty for Eagle during its initial stage, and its coping strategies; Section B. makes use of social capital theory to investigate how Eagle builds up trust and long-term partnership with farmer households; finally Section C makes use of some property rights theory to study the Eagle mode, and finds out its features of separate operations and overall control which are part of the property rights theory, and the two features compensate each other somehow.

Secondly, Eagle Company mode of operation is analyzed. Section A researches into the behavior characteristics of livestock raising households; Section B makes use of the above-reviewed theory to analyze the Eagle mode.

5.2.1 Analysis of Corporate Governance of Eagle

A. Eagle's Financing

The case shows that it took Mr. H nearly 15 years from starting his pioneering business in the winter of 1988 to establishing a company in May 2003. We all know that only those fast growing enterprises stand a chance to be listed on the GEM market; where from did the robust growth of Eagle came? Table 5-2 shows that from 2007 to 2009 this company did not have a very high overall gross profit margin (24.11%); its average gross profit margin for hog raising was 26.35%, and that for poultry raising 18.56%. From 1988 to 2003, Mr. H had his business focused on poultry; since both poultry raising and pig raising were rather competitive, and he did not have the advantage of intensive production, apparently he did not have profit margins higher than 18.56%. Eagle, however, showed its high growth rate in its expansion of scale.

Scale expansion demands financing capacity, without which Eagle will see difficulties in making it. This is the key factor that Mr. H had to spend 15 years in his original capital accumulation. As a private enterprise owner he would have to depend on his extended family for financing.

First, in China, private enterprises are faced with institutional financing constraints. Private enterprises have come into being and developed very rapidly since 1990; for example, Lan & Hu (2004) reported that the number of private enterprises increased by 33.1% on average from 139,000 in 1992 to 2.435 million in 2002. During this period, the number of SOEs, collective enterprises and foreign-funded enterprises grew respectively -27.3%, -7.6% and 9.45%. Apparently, the private sector has a more and more important role in the national economy of China, but without proper property ownership protection policies for private enterprises in place, private enterprises have been discriminated here and there. Without property ownership policies in place, private enterprises have been passively faced with ostracized by local authorities; "unjustified request for donation and arbitrary charge" to private enterprises are more than common, and some local officials made life difficult for them like asking for catering, entertainment, financial resources and the like and/or posing some other barriers to baffle them. Eagle was no exception. Bai et al (2005) based on the data of the fourth private enterprises sampling survey jointly made by the United Front Work Department of CCCPC, All-China Federation of Industry and Commerce and Private Economy Academy of China in 2000, conducted empirical research and found out that those private enterprises without their private property rights protected would see more difficulties in obtaining loans from financing institutions (as is elaborated in Chapter 2).

Second, private enterprises have some sort of uncertainty in their future development and investors are asymmetrically informed most often than not, as is another factor for them to win support from banks. Arrow (1962) named the discordance between the funding demand of fast growing enterprises and the financial supply of the market as "Funding Gap", which is mainly caused by that the financial institutions see difficulties in evaluating the risks of those enterprises and are hesitant in reaching an agreement with them. The private enterprises on their early stages always have trouble in producing guarantee by fixed assets and/or marketable securities, which makes it harder for them to obtain loan from banks and other financing institutions.

Over more than 15 years of development, Eagle in its efforts to get funds has been no exception to most other private enterprises, and the constraints it faced include those of an institutional nature and those inherent to its own business risk. Thus, it is not hard to understand why Eagle had to rely on its extended family to survive the two epidemics in 1995 and 2003. Without proper protection of property rights, private business owners will be more conservative in reinvestment. In addition, when Eagle was established in 2003, Mr. H contributed with his henhouses, hencoops and incubators as fixed assets evaluated as 4.8 million yuan, but these assets are too proprietary and special, which no banks will take as pledge of assets for lending. This basically explains why Eagle has spent 15 years in completing its original capital accumulation.

From 1998 to 2003, Mr. H had no way to obtain loans from local RCC, or in other words Mr. H would not really feel like being involved in the post-1994 disorder of RCC. Since the birth of the RCC in China, no real villager-participated cooperative mechanism has been established, and the once affiliation of the RCC to state bank ABC actually made the cooperatives grass roots offices of ABC (Xie, 2001). In 1996, the rural credit operatives separated from the state-owned commercial bank—ABC, and began to be managed by the PBC, which marked the beginning of their operation based on the cooperative principle. In 1997, the PBC formulated new administrative regulations for RCC[22], and defined them as financial institutions "shared by, supervised by and serving cooperative members". Nevertheless, Xie (2001) found that most RCC provide the same loan procedures to those of commercial banks for cooperative members, and also conduct merchant banking services and operate on borrowings. Xu & Cheng (2004) conducted further research and concluded that the reform on rural financial institutions in 1990 was basically a failure. Since 2003, however, Eagle has established very close relationship with RCC. Those credit cooperatives took the initiative to offer the Company loans, thanks to its solid business foundation as well as the status of Mr. H as member of the local People's Congress and for having been awarded several honors.

Zhang (2001) concluded that there are three ways for private business owners to protect themselves: First, "Wearing a Red Hat", that is, in the name of SOEs or collective enterprises they actually work as private ones[23], so as to seek protection from the government. Second, "political involvement", like they can find their way to be member of the people's congress or the people's political consultative. Third, bribery, that is, they can directly buy off some officials to protect themselves.

In terms of political involvement, for example, the data of Chinese private

[22]In 1997, the People's Bank of China formulated new administrative regulations for RCC, and defined them as financial institutions "shared by, supervised by and serving cooperative members".

23 This protection form was mainly employed in 1980's when most robust won and township enterprises were private in actuality.

enterprises survey in 2002(Source: data of the All-China Federation of Industry & Commerce) shows that private business owners assume the positions of members of the People's Congress and the People's Political Consultative Board respectively up to 17.4% and 35.1%. In addition, some private enterprises make efforts to build up their social status by donations, through which they can guarantee connections to protect their private property. Many scholars have conducted research on this kind of political involvement of private enterprises and their funding constraints from outside; for example, Bai et al (2005) conducted empirical study and found that those private business owners who enjoy high political status or contribute more to social and public goods stand a better chance in obtaining loans. Yu and Pan (2008) took the private enterprises listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange from 1993 to 2005 as a sample and concluded that those enterprises with political involvement actually have obtained more and longer-term loans from banks. Huang and Wang (2011) made use of the data of private enterprises listed from 2004 to 2008 and found that compared with those enterprises of better performance, those enterprises with favorable political involvement can obtain or renew more loans, even based on poorer performance.

Mr. H was awarded many honors and titles from 1988 to 2003, like having been elected member of the People's Congress of Xinzheng in December 2002 and awarded a Model Worker of Henan Province in 2004. These honors, mainly attributed to his leading role in helping farmer households to prosper, undeniably help him to obtain financial support in actuality. Moreover, Mr. H also made several donations, which is surely beneficial to the development of his enterprise.

Since 2004, Eagle has been engaged in the financial industry, with the so-called "Fuming (Enriching Civilian)" bonding company established to provide credit guarantee for common farmer households to have access to the live-stock raising zones and well-off households in order to work together and build up live-stock raising zones. Thereafter, Eagle has become a trustworthy customer of the rural credit cooperative, and a major stockholder of Xinzheng Rural Credit Cooperative Bank converted from the local RCC in September 2008. Undoubtedly, Mr. H has a favorable status for him to play a role in the financing industry. The corporate case of Eagle also confirms the perspective of Tian (1996, 2001) and Trigo (2003) that, against the background of structural transition of economy in China, in addition to the traditional entrepreneurship, private business owners shall have strong interaction with the government for the sake of the development of their enterprises. This case further confirms the point made by Allen et al (2005). From the perspective of corporate governance, the more complete the protective laws and/or provisions for investors, the more rapidly the financial sector develops, which will contribute more to economic growth. In China, the financial sector and economy growth have developed rapidly before the protective laws for investors. Therefore, Allen et al (2005) believe that. in China, there is some sort of alternative mechanism to corresponding protective laws for investors. As a matter of fact, this mechanism is the ability of private business owners to interact with local authorities.

Eagle had two corporate capital increases respectively in 2007 and 2008, all of which came from the owner's extended family members and show their more open attitude towards investment. In 2009, the Company attracted some human stockholders and private investment outside; in 2010, the Company was listed when outside equity investment came even faster.

B - Trust and corporate governance

The classic hypothesis of economic theory is based on the hypothesis of rational man, under which economic decision of individuals is embodied by the optimization behaviors of individual preference under the resource and information constraint. From a shareholder value perspective, corporate governance is even more neutral, emphasizing profitability over responsibility and seeing organizations as instruments of their owners. The hypothesis of the rational man is criticized by sociologists who point out that the so-called hypothesis of rational man takes individuals and enterprises as detached and indifferent units like atoms who do all things for maximum benefits of individuals or entities. Some sociologists hold that when individuals or enterprises make decisions, they will be aware of the decision of the society and other individuals, and follow conventional social norms and values; therefore, the research on individual and enterprise behaviors shall give consideration to their social network.

Fei (1998) (a famous Chinese sociologist) held that rural areas in China feature a special social form different from the developed market network, which can be called “acquaintance society network”. It means that in Chinese rural area, the family relation and geo-relation are centered on individuals, and extend like “a pebble thrown into a lake, with folds of ripples around the center” an orderly hierarchy so to speak. This acquaintance network and the “embeddedness” of Granovetter (1985) are quite similar to some extent.

Now, from the perspective of “embeddedness”, how did Mr. H build up trust relation with farmer households as mentioned in Section 5.1.1? Shortly after Mr. H started up his business, he sold his baby chicks and feedstuff to local farmer households, and began to buy off broiler at protective gain price from his partner farmer households. Only since 2009 has the government practiced market intervention in hog price with the protective gain price approach (refer to Section 5.1.2). This means that Mr. H would have to bear the impact of market price risk and be faced with the opportunism of some farmer households, that is, whenever the market went up and incoming buyers raise up the price, those farmer households might sell the chicken to them, whereas, when the market comes down, the farmers might buy chicken from other sources and sell it to Mr. H. Why was Mr. H courageous enough to practice purchases at protective gain price in spite of some possible opportunism from farmer households? It is because he knew all partner farmers very well then, as they were in the same village or town, and they trusted each other somehow. If some farmers did such bad deals, they might have to risk the blame and gossips of the people around since in the countryside of Henan Province many farmers still keep the habit of dropping around and having some small talks, which helps information spread around. Therefore, it is a big test whether major livestock raising households like Mr. H are courageous enough to really practice purchases at protective gain price or not.

The farmers' preliminary trust in Mr. H was established with the purchases at protective gain price and laid a solid foundation for Mr. H to survive the "SARS" epidemic in 2003. Apparently, the effect was rather striking; should the farmer shave demanded that Mr. H honor his promises and purchase off their chickens, it would be devastating to Mr. H just like those crazy bank runs.

Mr. H in 2004 again put forward "Eagle liable for the loss of livestock raising households", which actually means that Eagle had to bear the risk of plague and the risk of farmers' mistakes. When interviewed by a reporter in March 2011, Mr. H remarked, "Should a farmer household working in the livestock raising zones of the company lose money, they would not admit their fault if any, but blame the company. If a farmer household earns money with Eagle, or gets compensation from the company even if he fails, he would tell people around that Eagle is really good; he still earns some money in the end even when he fails in raising pig. This story comes from one source and spreads to ten people and to hundreds and to thousands of people; only in this way, the operation mode of the company could be duplicated ceaselessly, with more and more farmer households joining in his pool. It is quite different from other modes: 1,000 farmer households are involved this year, but only 800 next year; with favorable market 1,200 the year after, but only 800 households after that with poorer market."

The above case can find incisive expounding in the words of Granovetter (1985):

"*For example, the best way for Tom to be trusted is the information of a trusting insider, who has interacted with Tom and finds that he is really trustworthy. Even better information comes from that you have personally interacted with Tom. Why being informed this way is better? There are four reasons:* (1) *It is cheap;* (2) *It comes from the person you trust most—yourself, which is more adequate, specific and precise; (3) Sustained relation with someone helps to be willing to be trusted and this bond will avoid any future business opportunity elapsing;* (4) *In addition to sole* *economic motive, sustained economic interaction will carry trust and stay off opportunism, as is rather crucial*."

This means that the cooperative mode established by Eagle with farmer households appears to be easily imitated, but it is hard to make the imitation a success, because it takes a long-term to establish a relationship of trust.

With the expansion of scale and more farmer households joining in, however, it would be hard for Eagle to maintain the trust and prevent opportunism by the acquaintance relation or the acquaintance of acquaintance relation. Therefore, Eagle had to work out more formal rules and contracts to prevent the moral hazard and opportunism (refer to Section B section for in-depth analysis).

Tirole (2001) made it clear that for corporate governance, the stakeholders' value should not be disregarded Stakeholders refer to the employees, suppliers, customers and other individuals with close economic ties to the enterprise, and even more widely the community where the enterprise is located. It is because corporate management decisions not only affect the benefits of shareholders, but also have an external economic effect on stakeholders; for example, the shutdown of a factory in a declining community may seriously impact local workers and the economy. Likewise, the shut down of Eagle would have a disastrous effect on thousands of farmer households. The perspective of the stakeholder value is therefore the same as the perspective that applies the "embeddedness decision-making theory" to corporate governance.

Tirole (2001) held that the perspective of stakeholder value is often overlooked, because people always take it for granted that the benefits of stakeholders can be well protected through contracts or other means, like employment contracts that have been legally standardized in western countries. However it would be hard to devise the contract between the company and its management, so the shareholder value perspective pays more attention to the incentive and control of the management. In China, however, the benefits of employees have not been properly and effectively protected by the law, but how to motivate employees is actually key not only to the employees themselves but also to the development of the enterprises, which is not contradictory at all. Furthermore, in the livestock raising industry, the farmers with whom Eagle is interacting are rather different from common industrial workers, who may become independent economic entities after leaving any company. Here comes one more excerpt from an interview of Mr. H with a reporter "Economic View Daily " on July 27, 2010:

"*First, it really matters to help farmer households to earn money. That is to say, you shall not deliver lectures to farmers: if they do not see any profit there, they will not buy it. Second, Eagle assumes liability for the loss of farmer households. The farmer households are with the company for profit and a living. The outcome has to be win-win. Only when both parties win can the corporate machine operate: The company does not make too much money, and neither the farmer households; put both together and keep it going on and on, a big difference will be made*."

C. Eagle mode: from the perspective of property rights

This section makes use of the property rights theory developed by Grossman & Hart (1986) and Hart & Moore (1990) to analyze the Eagle mode, which helps to find that it is just right between two extremes, i.e., completely market-oriented deal mode of "company + farmer households" and the completely corporate-controlled mode of "company + workshops".

The "company + farmer households" mode could never be an effective cooperative mechanism from neither theoretical perspective nor practice, as it does not bring the corporate advantage into full play or work to prevent the moral risk of livestock raising households and ex post facto opportunism.

The corporate advantages lie in its stronger funding capacity, its breeding hens and breeding pigs cultivation, research and development capacity, its professional plague prevention technology, and its bargain capacity with feedstuff factories, veterinary medicine factories and butchering businesses. Farmers can provide places for scatter livestock raising, and are hard-working enough to raise pigs properly.

Ideally, the "company + households" mode can be a very good cooperative mechanism: the company can offer fine pig breeds to farmer households, and offer dine feedstuff and plague prevention, based on which the farmer households can bring their labor and self-prepared facilities into full play. On the last step the company will buy off pigs based on the price determined in advance. Nevertheless, it would be very hard for two completely detached economic entities to practice a contract like this. Grossman & Hart (1986) explained that both contracted parties have difficulties in precisely making clear all uncertainties involving the future of the contracted relation; even if they can, it would be hard to be justified and confirmed by the third party. For example, suppose a company and a farmer household agree that in the given future time, the farmer household shall supply pigs of certain quantity and weight to the company. In this changing world, however, the quantity, weight and price of hogs all depend on all kinds of changing factors like demand for pigs, cost of raising, plague impact, feedstuff and veterinary medicine prices, and the like. This means that the deal cost based on regulations on quantity, quality and price of the above-mentioned external factors would be tremendous and the contract is not so complete.

Furthermore, the incomplete contract makes the company hesitant in investing more into the cooperation with farmer households. For example, if the company can be assured that they can actually buy pigs at the price determined in advance the company would be in the position to hire more and better technicians to provide livestock raising farmer households with professional plague prevention services so that the risk and impact of plagues can be reduced to the minimum. If the company has invested a lot in research and development but cannot sell piglets of fine breeds at favorable price, they would not invest much later. Therefore, the “company + farmer households” mode will evolve and probably end up with the most common and simple mode, i.e. the company sells baby chicks or piglets, feedstuff and veterinary medicine to the farmers, who raise them and sell the produces at pre-determined prices. Even in this way, it would be hard for the fixed price contract to be properly carried out, because the ex post opportunism is almost inevitable (Williamson 1975). If the pig market develops favorably, the farmers might not honor their contract and sell their pigs to other buyers at higher prices. As a matter of fact, Chinese farmers do not really have strong contract commitment; no matter how detailed the contract is, it may not work out. When the market slumps, the company may not honor its commitment and not buy pigs at pre-determined prices.

The “company + farmer households” cooperative mode for Eagle to work with farmer households on the long term and make deals at protective gain price is the best example, because it helps Eagle to assure farmer households and maintain long-term partnership with each other. With this kind of contract Eagle can only make money by selling piglets, baby chicks, feedstuff and veterinary medicine. Once the market declines, the deals at protective gain price would lead to profit loss of Eagle. Furthermore, the livestock raising work is done in the premises of farmer households, which makes it hard to conduct unified management and supervision on livestock raising, and prevent the moral risk of farmers from mis-using antibiotics, clenbuterol and harmful feedstuff. The “Sanlu Milk Powder Scandal” and “Shuanghui Clenbuterol Scandal” fully publicized in the press were food safety accidents caused by this.

On the other hand, thanks to being separated economic entities, even if the pigs are purchased from farmer households at protective price and the farmers will not lose much under changing market, they may still have to take the risk of plague impact. Once a serious plague breaks out, the farmer households might suffer heavy losses. Thus, Eagle put forward the so-called “Eagle being liable for the loss of farmer households” which is mainly to compensate the loss of some farmer households who suffer from livestock plague.

According to Grossman & Hart (1986), the complementary assets shall be of the same ownership, i.e. the stronger party (e.g. company) shall merge off the other owner (a farmer household as an economic entity for example). In this way the company can make use of the remainder control, i.e. the decision making right, once anything not anticipated by the contract happens. The “company + workshop” mode shall be established. i.e. intensive raising and unified management can be conducted in the premises of a factory. The livestock raising farms within the premises are relatively centralized, with industrialized and automatic livestock raising facilities, where farmer workers can be employed and the industrial, automatic and integrated management mode can be practiced for large-scale livestock raising activities. The “company + workshop” mode however cannot avoid some obvious drawbacks: first, according to Grossman & Hart (1986), the merged farmers will not take themselves as masters and be hard to be motivated and managed; second, to realize speed scale expansion, the company will have to obtain a large area of land constantly, and have one-off fixed assets investment, which can be a bottleneck for development.

Thus, we believe Eagle has managed to keep the company and farmer households as independent economic entities for strong motives and at the same time obtain the intensive advantage of merging and the supervisory advantage of output, which are properly balanced. Just as Mr. H properly concluded and remarked about Eagle[24], farmers enjoy the advantages of “two haves and three not-fears i.e. they have land and labor, and do not fear hard-work, pain and dirtiness. The farmers however have the disadvantages of “one fear and three shortages” i.e. they fear risks, and are short of capital, technology and market information. Under the unprecedented opportunity of favorable policy to enrich people, Eagle with its strong technical capacity and proven management mode, can help ease their worries. For individuals to fight single-handed against market risks would be a big threat; all these justify the cooperation between Eagle and the farmers, who both can make good use of the advantages of each other to realize win-win.

The following table briefly sums up and compares the difference between the Eagle mode and the other two modes. It is worth noting that if Eagle and those farmer property owners had not worked together to jointly build up livestock raising zones in the first place, the Eagle mode would be harder to be carried out. As a matter of fact, thanks to strained capital chain and demand for large amount of land, Eagle had been cooperating with many scatter raising households for broiler raising and pig raising by

[24]The remarks of Mr. H come from the website of Eagle, while the contents in Table 6 come from the sock prospectus of the Company.

2009, decreasing year by year, though. The following table sums up all main points mentioned above.

Table 5-4 Comparison between Eagle mode and other operation modes

Items	Eagle mode	Company + households	Company + workshops
Main points	① Phase-wise, process flow livestock raising; ② Scatter raising and unified management; most livestock raising farms have small land occupancy and stay off at a rational distance; large-area farms have effective greening belts for separation; greening belts are used to effectively separate individual farms; ③ A "win-win" cooperative mode: The company works with farmer households to build up raising facilities and raise chicken and/or hogs.	① Conventional all-the-way livestock raising mode; ② Scatter raising, which is hard to be managed in an unified manner; ③ The company sells feedstuff, baby chicks or piglets to farmer households who raise them up and sell them to the company at pre-determined price for centralized processing and unified sales.	① Phase-wise, process flow livestock raising; ② Intensive raising and unified management; the raising farms are relatively centralized, with industrial and automatic livestock raising facilities; ③ With farmer workers, the industrial, automatic, and integrated management can be practiced for large scale livestock raising.
Motivation of livestock raising households	With win-win accounting mechanism established, farmers see clearly the way to make more money and are willing to work initiatively and productively with strong sense of responsibility.	Farmer households are relatively highly motivated, but they own living chicken and pigs and may break the contract under favorable market.	Raising living chicken and pigs is more dependent on the consciousness of farmers who do not take themselves as masters and are harder to be motivated or managed.
Plague prevention	The "physical separation" and "technical plague prevention" are combined to prevent plague. The plague risk can be reduced to the minimum; once a plague takes place, it will not jeopardize the whole pool, which helps solve the expansion bottleneck of "plague risk accumulation caused by scale expansion".	Farmers are willing to receive technical guidance of plague prevention, but with poor separation, it would be hard to effectively prevent the plague; once a plague breaks out, there will be no overall damage risk, but still very significant loss.	The technical plague prevention approaches are mainly used to conduct plague prevention; once anything like management goes wrong and a plague breaks out, the whole raising pool will be at risk, which features the expansion bottle of "risk accumulation with scale expansion".

Product quality	The livestock raising is conducted on the livestock premises of the company, where the company supply feedstuff and breeds in a unified manner, so mis-use of antibiotics, clenbuterol and harmful feedstuff can be avoided, and the quality can be easily controlled and assured, which breaks out the bottleneck of difficult food safety assurance for scatter raising.	Livestock raising is conducted within the premises of farmer households, which makes it hard to conduct unified management or prevent mis-use of antibiotics, clenbuterol and harmful feedstuff; this was actually one of the reasons for the well-known “Sanlu Milk Powder Scandal”.	Livestock raising is done under the supervision of the company, which can be easily supplied with feedstuff and breeds and managed in a unified manner, and the quality can be easily controlled and assured.
Scale expansion	Partner farmer households have rich experiences and high consciousness and can work productively; scatter raising does not demand for too much automation facilities and high construction investment; the cost can be controlled to the maximum, which helps solve the bottleneck of harder cost management for expanded scale.	It is easy to realize scale expansion: With little constraint on land use, the capital investment is less.	To realize speed scale expansion, the company will have to obtain a large area of land constantly, and have one-off fixed assets investment, which can be a bottleneck for development.

5.3 Eagle mode: Analysis from the Perspective of the Principal-agent Theory

As elaborated in Section3.3, we will use the principal-agent theory to explain the Eagle’s business model.

5.3.1 An Analysis of Raising Households

A. Strong risk aversion of Chinese farmer households

Traditional Chinese farmer households are so poor in assuming market risk that they have a strong consciousness of risk aversion. China has a large rural population with little arable land per capita. The scale of agricultural production and livestock raising is small in general and an efficient production cannot be achieved without large scale economy. Furthermore, small-scale peasant economy makes farmer households stranded when confronted with the product price risk. The price risk of feedstuff, pesticides and other inputs also hits farmer households. Lacking the ability to bargain, they usually bear higher prices than large-scale companies.

Deficiency of information, dull purchase and sales, and other factors bring down the initiatives of farmers to conduct various agricultural production activities. The recent years also have seen many local governments popularizing a great many projects to encourage farmer households to plant and raise. Many projects seem like profitable, but hard to put into effect. For example, some local governments encourage farmer households to plant certain commercial crops in large scale, or to raise particular livestock. Previous experience shows that when market, disease or plague risks hit the areas where favorable solutions are not in place to solve sale problems or to settle plant and livestock disease in large scale, the local governments will be stranded and the farmer households will have to suffer possible direct economic losses.

This directly appeals to certain “company+ farmer household” agricultural produce production cooperation mode. Most farmer households cooperating with Eagle do have livestock raising experience and have a deep knowledge that fluctuations in market price would constitute a big risk for independent household livestock raising. Cooperative farmer households do not want to undertake the market risk, but want to gain the profits matching their hard work.

B. Moral hazard problem and opportunism of farmer households

There are two specific widely practiced “company+ farmer household” modes, but they are confronted with the moral hazard problem of the farmer households and better solutions cannot be found.

One of the important cooperative modes is to “combine the corporate large-scale operation with the scatter raising of individual farmer households”. The company sells foodstuff, baby chicks and/or piglets, and veterinary medicine to farmer households and purchases the commercial-worthy livestock to process and sell in a unified manner. The advantage of the mode is the high motivation of individual farmer households but the living livestock belongs to the household. When the market develops well, the household may break the contract, for example, selling the pigs at higher price to others and making the enterprise suffer a loss. When the market goes down, however, another kind of opportunistic behavior may arise. For example, some farmers may purchase livestock at lower price from other households who have not signed a contract and sell it to the enterprise at the contracted price.

In addition, the raising operation is conducted at the household farm, so the enterprise cannot conduct unified raising management, and it is also hard to prevent the misuse of antibiotic, clenbuterol and/or harmful feedstuff. The typical examples could be the “Sanlu Milk Powder Scandal”, the “Mengniu Milk Scandal”, and the “Shuanghui Clenbuterol Scandal” which has almost turned down the listed company of “Henan Shuanghui ”25, all of them amply publicized in the media.

On that account, many companies set up its own agricultural production base, which leads to another kind of “company+ farmer household” mode, that is, “large-scale industrial automatic mode”, under which farmer workers are hired to practice industrialized, automatic and integrated management and are supervised to raise livestock in a large scale. This system has, however, three obvious disadvantages: first, raising living livestock more heavily depends on each one’s sense of responsibility; without ownership, they do not consider themselves as masters, which makes it harder to motivate and manage. Second, the scale expansion sees the bottleneck problem of how to obtain a large scale of land and a large sum of one-off capital input.

C. Risk of multi-task production activities

Live pigs are living creatures whose raising expertise can hardly be one of clear-cut procedures, and that is, in itself, a complicated production activity. When farmer households raise livestock independently, they have to spend a considerable time and effort on plague prevention, feedstuff purchase and hog sales, which means that they have to be faced with many tasks. Many farmers may have more than one

[25]“Sanlu Milk Powder”, “Mengniu Milk” and “Shuanghui Clenbuterol” were all serious food safety scandals that happened in recent years.

operation, i.e. they may raise breeding pigs and pork pigs simultaneously. In such two cases, it would be hard for farmer households to conduct specialized operations.

Multi-task operation also easily renders some moral hazard problems, as raising pigs does not only demand attention to the output, but also the health and quality of live pigs. If farmer households pay attention only to the output, and do not care about pork quality, and the hog purchaser enterprises have poor supervision, the farmers may use harmful feedstuff.

During the production of “large-scale industrialized automatic mode”, farmer workers have to make efforts to increase hog output and ensure its quality, with less feedstuff input, care and careful maintenance of production facilities. Facing so many tasks, how could a reward scheme be easily devised for farmer workers?

D. The impact of state market regulation and control on pig raising by farmer households

Mentioned above is the state’s intervention in the pork price with the national stored frozen pork measure. The state regulation and control measures are based on the pig-grain price rate, which is usually between 9:1 and 6:1. In accordance with the productivity of common household scattered livestock raising, 6:1 would be the break-even point. To regulate and control pork price helps to sustain the motivation of pig raising farmer households, but the regulation and control over the recent two or three years also shows that the national stored frozen pork is of limited effect. Usually, only two or three months after the storage, can the pork price be restored back to the break-even point. Only those livestock raising households and companies of large scale are in a position to cope with the adverse price change.

5.3.2 Analysis of the Eagle Mode from the Perspective of the Principal-agent Theory

The cooperative livestock raising contract between Eagle and farmer households simplifies the cooperation into one agreement issue, i.e. how to motivate farmer households to work harder and create higher social value.

This contract is exactly in line with the prediction made by Holmström & Milgrom (1987) where the contract is described as follows:

A. The household income is a linear function of the output.

$R = a + by$, where $b = 1/1 + \eta c \sigma^2$

The income of the live pig raising households shall be accounted in accordance with the weight growth of live pigs by the company, and the rate is 1.70 RMB Yuan/kg. For mating sow raising households, the company will pay 150.00 RMB Yuan per prepared mating sow (see section 5.1.3 for details).

Given that the farmer households know exactly the criteria of livestock raising profit accounting, they would make their own efforts to increase the farrowing rate and their weight to maximize their benefits. Since all data have been devised based on how to motivate farmer households, during the whole production process, Eagle has no need to supervise farmer households. As a matter of fact, it also happens that when sows are farrowing, some farmers are even sleeping around the sow house all night long to observe and ensure that the sow farrowing goes on smoothly and safely.

In practice, of course, some farmers have to pay for feedstuff, veterinary medicine and the like, which will cost some money and reduce their income to some extent. The capacity and efforts of farmer households are the bases for them to realize their own benefits. To this end, farmers may make efforts to maximize the output-feedstuff input rate and minimize the consumption of veterinary medicine, which demands their higher initiative and responsibility.

B. Tackling risk aversion

Since the pig price has been contracted before cooperation, the farmer households in actuality do not need to bear the price risk. The company's bottom profit assurance of 13,000~20,000 yuan/year to cooperative farmer households, so that the farmers do not have to bear the overwhelming risks loss caused by serious plague and other extreme force majeure. This part of household income is not a in the formula, but this works to insure the farmer households.

The higher the risk aversion of farmer households η (in the above formula), the smaller the profit share b will be. As a matter of fact, Eagle offers a series of contracts from breeding pigs raising to live pig raising, which helps people with different risk aversion profiles choose different risk categories.

Farmers can reduce their risks to the minimum or even nil, which helps them to invest all of their efforts into production. With focus and concentration, they stand a better chance to raise the livestock raising efficiency and productivity.

C. Tackling moral hazard and discriminating personal capacity

Holmström & Milgrom (1987) and Lazear (1986) pointed out that the profit sharing contract can help tackle the moral hazard and induce optimal efforts. According to these two literature sources, the means of production like pigs and feed stuff are owned by the principal, while the agent is monitored and supervised by the principal, and the output of the agent is measurable.

In the case of Eagle, however, the company owns or rents the farm, and offers pigs, feedstuff and veterinary medicine. During the livestock raising process, Eagle practices the "enclosed management", i.e. once the farmer household enters into the premises, they would not leave there before the whole period is over, while a designated technician will manage and supervise them. This "in and out together" practice mainly means to prevent possible plague risk, and at the same time prevents the misuse of harmful feedstuff, veterinary medicine and the other types of moral hazard.

Eagle requires that each cooperative livestock raising farmer household submit 20,000.000 yuan as cash deposit so as to prevent their moral hazard problems and restrain their possible contract breaking risks to some extent.

Usually, Eagle cooperates with 40~50 years old farmers, who have to raise up their children and support their elderly, and do not stand a good chance to work out of town, which makes them more responsible than younger labor and follow the corporate discipline more consciously.

Lezear (1986) believes that when the output measurement cost is lower and the output can be precisely measured, the profit sharing can make a difference between agents of different capacity. The output like pig net weight and piglet quantity can be easily and precisely measured, so a wide range of profit-sharing contracts covering from breeding pigs raising to hog raising, in addition to being devised for farmers of different preferences for risk aversion, can be also explained devised for framers of different discriminable capacity. For example, raising pigs demand rich experiences, and the profit-sharing rate is higher, so those professional farmers can be attracted.

D. Job designing for farmers

The "phase-wise and procedure flow livestock raising" mode does not only free farmers from multitasks, but also takes in other precise work assignment design ideas. Eagle divides the whole sow farrowing process into the four sub-processes of "preparation, pregnancy, delivery and piglet care" according to different functions and assignments, which is useful to specialized livestock raising and to help farmers concentrate on one assignment.

Holmström & Milgrom (1991) pointed out that another purpose for classifying work is to better measure the performance of the agent. Their paper shows the point very clearly in this case: for example, the income of farmer households of pregnant sows is accounted according to the sow quantity, while that of hog raising households is based on the weight output.

E. Long-term relational contract

The income account settlement with farmer households shall be done upon the completion of each phase, and the profit-sharing rate (see section 5.1.3 for details) for households will stay over many raising periods, subject to the rate of inflation. According to the theory of Levin (2003), once this kind of incentive structure is tampered, the farmers would have different anticipation and become less motivated. As a matter of fact, stable incentive structure helps establish the reputation of Eagle26, and helps maintain long-term cooperation between the Company and farmers.

[26] Moreover, Eagle also provides insurance to livestock raising farmer households, which also helps to build up its reputation and image, The slogan "Eagle liable for the loss of farmer households" is known by everyone around.

F. Eagle's risk neutral

Beyond doubt, the most outstanding feature of the Eagle mode is that Eagle takes almost all risks except for the production process. Eagle extends its presence around the whole industrial chain, which on the one hand helps reduce the cobweb effect of price impact to the minimum, and on the other hand makes good of the stronger bargain capacity of the company to maximize the profits during all links.

One example could be that Eagle makes use of replenishment capital from being listed to start a butchering project. Generally speaking, the hog price sees low ebb and slump market every 2~3 years: when the market develops well, the butchering enterprises do not earn very huge margin rate, while when the market turns down, the butchering enterprise enjoys higher profit margin. It would not only be an effective way to avoid risks but it would also help increase economic benefits to store up frozen pork during slump market and sell it off when the market turns up.

5.4 Brief Summary

After the reform and opening up to the outside world policy started, the Chinese lift the control over the prices of most agricultural and sideline produces, which marked an almost complete competitive market in the sector. With the impact of price risk, and bird flu, SARS epidemic, blue ear pig disease and other plagues breaking out one by one, farmer households of small-scale peasant economy have to struggle hard. In such a "sunset industry" this study provides deep insights in the case of a livestock raising company that is listed on the stock exchange. Its founder Mr. H, the bearer of a prudent commercial insight, has created an effective approach to address the troublesome "Agricultural, Farmer and Rural Area" issues. His success has the flowing significances:

First, it shows that in some fields where the governmental regulation and control are not rigid and the governmental capital seldom comes, the private businesses can innovate, which is the key driving force for industrial development and upgrading, and confirms the economic rule that free competition can contribute to innovation.

Second, under the status quo of a structural shift on Chinese economy, the private economy continues to be in want of effective property ownership protection, and has difficulty in obtaining financial support; private companies have to make use of some sort of self-protection for survival, which means that the Chinese government shall deepener form in these fields in the future. Only when private businesses are treated equally without discrimination in terms of property right protection, market access, financial support and the like, a par with SOEs, can innovations be really effectively triggered off.

Moreover, to the Chinese society, the social capital theory can be applied to analyzing and comprehending the behaviors of some decision makers. At the same time, this case further illustrates that the maximizations of stockholder benefits and stakeholder benefits are not contradictory; as shown, the company and its stakeholders can realize win-win situation and this has been a fundamental pillar of success.

Finally, when the social capital network of the decision maker becomes open-ended, necessary contract protection becomes an important backbone of the corporate operation and management, which means that China can make efforts and play well in consummating the market laws and rules. At the same time, when some family businesses expand from their acquaintance networks to much wider capital markets, the less the institutional constraint is, the higher the investment initiative will be.

Chapter 6: Conclusions

6.1 Conclusion

The healthy development of small and medium-sized private enterprises plays an important role in promoting social and economic growth and job opportunities as well. However, small and medium-sized private enterprises in China face systematic market access barriers, and structural financing problem and this has already been the main bottleneck of growth for these enterprises. Although the state took these issues seriously and made policies to solve the problems in many government documents, the actual effect does not go as well. These issues have attracted extensive attention of scholars and although there are some valuable and insightful research it is still limited in depth and scope.

This thesis first cites relevant figures to illustrate the vital role of small and medium-sized private enterprises in national economy. According to data of the All-China Federation of Industry & Commerce (see footnote 1) in 2005, the output value of private enterprises accounted for 60% of Chinese national economy and the contribution of private economy to economic growth, tax, innovation and new job opportunities made up far more than 60%.

Chinese private economy has roamed in the market economic sea since its birth but many enterprises are hard to move forward because of the financial crisis since 2008 combined with its own endogenous systemic difficulties. Statistical data indicates that even though private enterprises maintained rapid growth, the speed of growth has decreased dramatically year by year. There exists a phenomenon known as “Guojinmintui”, meaning that the state advances as the private sector recedes in investment domains. The state issued the “non-public economy 36”document in 2005, promising to treat private enterprises equally in every industry. However government institutions at various levels set up many recessive obstacles while executing policies and thus market access barriers remain a threat for the private sector. “Guojinmintui” implies that state-owned enterprises spend low-cost money at the expense of the financing difficulties and hard survival hurdles of private enterprises.

This thesis mainly reviewed the measures taken by private enterprises to deal with marker shock, access barriers and financing difficulty, how these problems affect corporate governance of small and medium-sized enterprises and the internal reason why private enterprises have become the main drivers of economic growth. Due to unavailability of massive information, complex measures to deal with intricate survival environment and complicated changes of corporate governance system, this thesis adopted the case study method as this method allows the researcher to describe and offer insights of a specific context. Case studies have been used here not only to illustrate a problem but also to show ways of solving it or to clarify issued in need.

To understand the surviving environment of private enterprises, we must first learn their development history in China. Therefore, the second chapter of this thesis first reviews the development history of Chinese private enterprises for the last 30 years that can be divided into three stages, namely 1978 to 1992, 1993 to 2002, and 2003 until now. Through the complete exploration of the development process of private enterprises in China it is possible to reach two important results, which also provide the research angle for this study. One is that, with the reform process in China, the private economy and the public sector of the economy are together along the way and the economic and social effects of private enterprises are processes to be gradually recognized by the state and the society. The second is that the private enterprises have faced the public economic discrimination from its birth and the property rights are not yet effective enough in what concerns protection. For long private enterprises have been wearing red hats and using other kinds of ways to protect their own properties and therefore it is understandable why private entrepreneurs are keen to set up political relevance.

The second chapter summarizes the research literature on the two main aspects of private economy. One deals with Chinese private enterprises encountering market barriers, and how do they break through these barriers. Related research reveals that private enterprises establish political association with the government to realize the purpose to enter some industries. The second concerns the financing problem. This thesis mainly summarizes the literature about how the structural barriers of credit market lead to financing difficulty: if private enterprises have appropriate relationships this obstacle to some extent can be avoided. Political association is the most important and key class of these relationships and this thesis reviews relevant research on the topic.

The third chapter of this thesis summarizes three aspects of the theoretical literatures that can provide necessary theoretical basis for the case analysis in chapter 4 and chapter 5. First of all, we reviewed the theory of company management, and pointed out the argument that corporate governance includes maximizing shareholders' as well as and stakeholders' value. In addition, it also briefly summarizes the research literature on small and medium-sized enterprises and family enterprises. Then, it reviews the social capital theory, including the explanation of social trust according to social capital theory, and the theoretical explanation of social networks financing based on social capital theory. Finally, it summarizes the principal-agent theory and how it can relate to the cases.

Chapter 4 and chapter 5 are the main research contents of this thesis: two case studies are described and analyzed in the two chapters.

Chapter 4 analyzes the case of a start-up company engaged in the highway pavement construction and sale of related high-tech materials for road surface. The company was established by a couple of Chinese overseas students: Mr. and Mrs. Y couple. By analyzing this case, the main conclusions are:

(1) Social networks built by entrepreneurs and shareholders are the most important financing tools of private enterprises. Once the company has prospects for development, shareholders will use the close relationships provided by their social networks to convey financial resources to the enterprise and provide various management assistance to the enterprise. Once the development prospect of the company is uncertain, the situation of reverse output may take place. In the

boardroom, the vote principle of "one share one vote" was instead replaced by a consensus agreement among friends. Trust and fairness are the basis to sustain the company operation; therefore once they are damaged, this will lead the enterprise to be dissolved.

(2) Besides financing, the company eventually also has to face the so-called "Swing Door" problem, which constitutes another recessive barrier for private enterprises to enter. In this case it concerned the change in the bidding management system within industry. The new system makes the financing cost for middle and small enterprises to double and in fact cancels the possibility for most of them to participate in..

(3) All along the company has benefited from a high performance management level. This thesis analyzes the entrepreneurial process of the company according to business theory and concludes that most has been due to Mr. and Mrs. Y's performance, good spirits of innovation and entrepreneurship. The management innovation of Z Company is mainly shown in two aspects. On the one hand the couple advocates using new technology and new materials in highway construction field, reflecting that the entrepreneurs are willing to bear risks and to assume their social responsibilities. Also, in the aspect of governance, the Y couple set up a stable worker team by taking the project manager as the keystone, which is worth analyzing and is summarized by setting in place an appropriate incentive system and by empowering project managers. These practice activities comply with related theories.

Chapter 5 studies the case of a poultry and pig breeding enterprise. The market of agricultural and sideline products is almost a market of perfect competition. Enterprises and farmers are facing the impacts of price risk, bird flu, SARS and ear disease of live pigs; they also meet the problems of arbitrary charges and levies and difficult financing at their early development stages. This is also the important reason for the enterprise to use 15 years of time to go through its establishment till maturity. The successful experience of this company can be summed up in the following conclusions:

(1) In those industrial fields where controls are relaxed and state-owned capitals are rare, the innovation brought about by private economy is the key driving force to promote the development and upgrade of enterprises, reflecting the economic law that free competition can make innovation.

(2) In the transformation conditions of China's economy, private economy lacks the effective protection of property rights and finds it difficult to obtain financial support. They are then forced to use some self protection mechanisms, implying that these areas are candidates for reform goals in China in the future.

(3) The application of social capital theory makes us further understand the reason for win-win cooperation between the company and the farmers and understand the behavior for the enterprise to implement the related benefit maximization. There is the same idea between the social capital net theory and the related benefit maximization.

(4) The success in the enterprise establishing cooperation relationships with local farmers is that, this not only keeps strong incentive factors in the market transactions as enterprise and farmers are independent, but also it contains effective supervision factors.

(5) When the social relationship networks of companies and farmers are open, necessary contract protection becomes the important support of the enterprise operation and management. This means that there is room for development for China to improve market regulations in the future. At the same time we saw how this family business jumped from its circle of acquaintances to a wider capital market: the smaller the institutional constraints, the bigger the mobility of investment.

In sum, the main conclusion of this thesis is:

Private enterprises use social capital and social networks to deal with market barriers, to face risks caused by policy volatility and to overcome financing difficulties. In state capital monopolized sectors, the fluidity of the policy leads to the difficult survival of private enterprises, exposing the limitations of social capital in the environment. In those sectors where state-owned capital is less prevailing – agriculture and animal breeding for instance–private enterprises do have a larger room for development. The key motivation for private enterprises to develop is their innovation spirit and management innovation and these are the main innovation modes of the above-mentioned two enterprises.

6.2 Limitations and Recommendations for Future Research

The main limitation of this study stems from the fact that it is a research based on two case studies: regardless on how representative they are, the conclusions cannot be generalized.

This thesis has tried to provide further insights into our understanding on the process of China's introduction of market principles, which has been a product of persistent pushes from the bottom and gradual authorization from the top. Further studies are needed to continue to hone our understanding of China's amazing economic development along the last decades and on the contribution of the private sector to such endeavor. Examples include multiple replications of this study in different sectors as well as longitudinal studies.

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