

Research on the Development of China's Diversified Business Groups: Paragons or Parasites?

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Abstract: *Diversified business groups are a relatively common form of modern economy, which plays a key role in China's economic development and market process. Under the new economic situation, diversified business groups conform to the trend of economic development and play important roles in optimizing capital allocation, promoting labour employment, and enhancing brand strength. However, the development of diversified business groups is a "double-edged sword", and the positive and negative effects it brings must be fully considered. This paper discusses the formation reasons and advantages of diversified business groups in China, and also objectively analyses the tunneling behaviour, diversified discounts and rent-seeking problems that occurred during the development process.*

Keywords: *Diversified business groups, Capital allocation, Tunneling behaviour, Diversified discounts, Rent-seeking*

1. Introduction

As a form of economic organization between the market and the company, diversified business groups play an important role in economic activities. Especially in the emerging economic development areas (such as South Korea, China etc.), business groups and its influence are important factors that cannot be ignored in economic analysis. However, due to the different economic environment and institutional background of each country, the development process and role of business groups are also different. Therefore, the views of whether diversified business groups are paragons or parasites have a perpetual controversy. In the context of imperfect market mechanisms, China's diversified enterprise groups can make better use of internal capital market, coordinate resource allocation and improve comprehensive performance. These groups have economies of scale, and their business scope covers multiple regions and industries (Zhao, 2009). However, with the change of external conditions, these groups also have diversified discount, rent-seeking behaviours, and corporate governance (tunneling) etc. issues in the actual operation process. This paper will attempt to argue that China's diversified business groups play an undeniable important role, but its future development also faces pressure and potential crisis. To demonstrate this, this paper will first analyse the reasons for the formation of China's diversified business groups and its positive roles. Then, the possible negative effects and development problems of diversified enterprise groups will also be discussed.

2. The Formation and Positive Influence of Diversified Business Groups in China

2.1 Diversified Business Groups and Capital Market Imperfection

The national institutional environment and emerging market mechanisms are the main reasons for the emergence and development of China's business groups. Khanna and Yafeh (2007) pointed out that business groups can effectively fill the institutional gap in emerging economies. Compared with the economic systems of developed countries, emerging markets lack the sound legal system and stable markets for capital, labour and products (Zhao, 2009). The formation of business groups is a rational response to the information asymmetry and low efficiency of governance in the external market. In addition, diversification is a common growth mode adopted by Chinese business groups (Zhao, 2009). Diversified groups have formed internal capital market due to their involvement in multiple industries, which can realize internal financing, disperse investment risks and improve management efficiency (Gonenc et al., 2007). Theoretically, companies in emerging economies as part of a diversified business

group will be more advantageous than independent companies, because transaction costs are usually higher in unsound institutional environments (Khanna & Palepu, 2000). Under the protection of business groups, mature companies can provide capital support for growing enterprises, thereby promoting the overall performance of members within the group (Guillen, 2000). For example, the growth process of Fosun Group confirms the advantages of diversified enterprise groups in easing financing constraints and increasing corporate value. In the early stage of development, Fosun increased the efficiency of capital allocation and reduced the cost of capital by building the internal capital market. Meanwhile, mutual borrowing and equity transfer within the group have facilitated the flow of internal funds. Moreover, Fosun Group has taken the insurance business as its core to gradually improve its comprehensive financial capacity, so as to obtain more adequate sources of capital. It offset the adverse impact of the institutional environment on member companies and effectively solves the problem of insufficient financing. Therefore, in the relatively weak development stage of the institutional system, Chinese business groups through diversification to optimize capital allocation may be a more effective option than external markets.

2.2 Diversified Business Groups, Labour Market and Product Market

In addition to explaining the important role of diversified business groups from the perspective of capital markets, existing researches also provide favourable views to support the positive impact of diversified groups in the labour market and product market. Emerging markets lack high-skilled and well-trained labour force, and even have the disadvantages of suppressing labour relations (Abegaz, 2005). This makes it difficult for individual companies to judge the changing economic situation and make timely labour adjustments. Business groups can increase the flexibility of the labour market by developing internal talent markets and assigning personnel to the most suitable positions (Khanna, 2000). Additionally, these groups can also effectively solve the difficulties encountered in the process of new enterprise creation. There are no powerful means to develop and protect brands in emerging markets, so that the brand image and reputation of the group will become a favourable guarantee for new companies (Maurer and Sharma, 2001). Besides, Zhu (2001) also proposed that China's business groups with high brand awareness are more likely to be recognized and accepted by consumers when they develop new products and expand business models. For instance, HNA Group, as a leading company in the aviation industry, has successfully extended its business scope to tourism, logistics, finance, real estate fields by leveraging the reputation of its main brand to seize the psychology of consumer brand loyalty. Therefore, under such institutional and market conditions, diversified business groups have become a profitable strategic choice, which is a solution for companies to seek a competitive advantage in a transitional economy.

2.3 Research on the Performance of Chinese Diversified Business Groups

Through theoretical analysis and empirical evidence, the causes of diversified business groups and their important roles have been confirmed. Meanwhile, from the data and some actual cases, the comprehensive performance and positive influence of business groups will be further verified. As a large number of companies participate in business groups, the types of companies within the group are diversified, thus promoting the simultaneous growth of the group's overall economic strength (Ning and Beatson, 2011). Su and Liu (2019) use the financial data of Haier Group (1995-2016) as an example to explore the impact of diversification strategies on performance. The results confirm that the diversification strategy of a business group is conducive to the improvement of the overall operating ability. Meanwhile, from the perspective of profitability indicators, related diversified operations enhance the profitability of the entire group. In addition, the important feature of China's business groups is that their economic strength is mainly concentrated in large state-owned business groups "national team" that are interfered and guided by the state (Ning and Beatson, 2011). Although in terms of total profit scale, state-owned business groups exceed private business groups, the strength of private-owned groups is constantly increasing, and the operating efficiency shows a good upward trend (Figure 1).

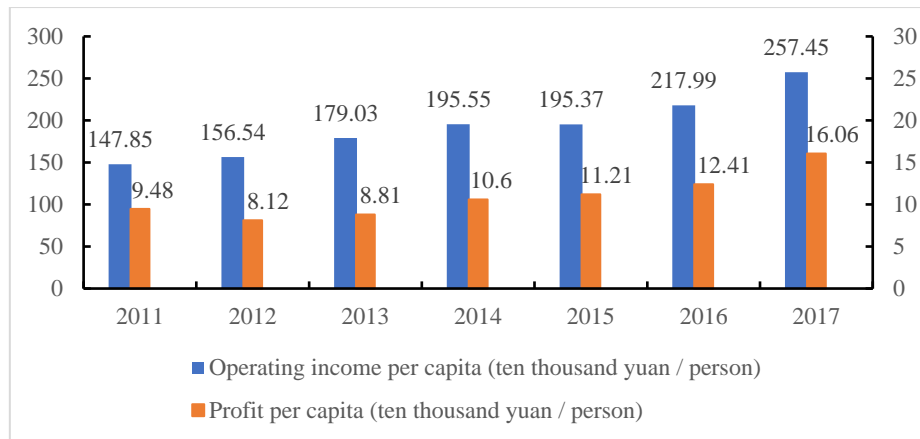


Figure 1: Operating Efficiency of the Top 500 Private Business Groups in China Source: (ACFIC, 2018)

Fosun Group mentioned before is an example. As a successful diversified private-owned business group, it has formed a pattern of diversified investment and specialized management. Besides, Guo Guangchang, chairman of Fosun Group, put forward the strategic layout of "China's power grafting global resources", and realized the integration of resources on a global scale. According to the group's revenue data from 2016 to 2018, the overall performance of Fosun Group has maintained steady growth (Figure 2). Therefore, combined with the theory, empirical evidence and case studies, China's diversified business groups have indeed played an active role to a certain extent, which can be regarded as "paragons".

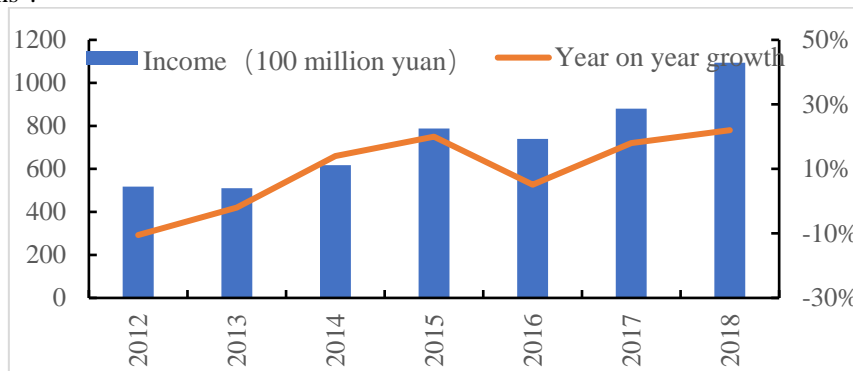


Figure 2: Operating Income and Growth Rate of Fosun Group Source: (Fosun Group Annual Report, 2012-2018)

3. Research on the Problems of China's Diversified Business Groups

Although numerous studies have confirmed the positive effects of diversified business groups, the role of groups in the new economies has gradually changed. As emerging markets develop and mature, diversified business groups may become less useful (Amsden and Hikino, 1994). The emergence of diversified groups is largely caused by the limitations of some institutional factors mentioned above. Therefore, when the external environmental conditions change, business groups will also face new problems, and even cause negative effects (Gaur and Delios, 2006). Next, this paper will discuss the prominent problems existing in China's diversified business groups from three aspects.

3.1 Pyramidal Business Groups and Tunneling Behaviour

At present, a large number of researchers from different countries and regions have confirmed the universality existence of pyramidal structures in enterprise groups (Claessens et al., 2000). Baek et al. (2006) indicated that "tunneling" is very common in developing countries, especially the complex shareholding and organizational structure of pyramidal groups make "tunneling" more covert. Therefore, it is worth considering whether China's business groups are forming pyramidal structure and also facing related issues. Most empirical studies on the pyramidal structure are based on agency theory.

The controlling shareholder strengthens their control over the internal company of the group, which leads to the agency conflict between controlling shareholders and minority shareholders (Wang et al., 2013). Johnson et al. (2000) first proposed the concept of "Tunneling", and believed that the main reason for the pyramidal structure damage to the company's value is the infringement of the interests of controlling shareholders against minority shareholders. Besides, Cheung et al. (2009) explicated that large shareholder usually have an absolute controlling position and use the mean of related-party transactions to transfer (tunneling) the assets or profits of listed companies, which damaged the interests of minority shareholders.

Ning and Beatson (2011) analysed the top 50 largest enterprise groups in China in 2007, and the results confirmed that a total of 18 groups were found to have a multi-level pyramidal structure. For instance, Sinopec Group also be proved to have a short pyramidal chain, in which Sinopec Co., Ltd. as a listed company and a first-level subsidiary, owns and controls the majority of the shares of many subsidiaries, including Yizheng Chemical Fiber (42%) and Shanghai Petrochemical (55%) etc. (Ning and Beatson, 2011). Additionally, Wang (2006) found that within the pyramidal business groups, related party transactions of listed companies are the regular channel for the implementation of "tunneling", which has a significant negative impact on the group value. Wang et al. (2013) used the data of some business groups and their listed companies (2005-2008) as samples to verify the existence of tunneling behaviour in China's pyramidal groups, and further explored the situation of asset transfer and allocation within the group. The results proved that the controlling shareholders tend to transfer resources from the bottom company (less ownership) to the top company with higher ownership (Wang et al., 2013). Moreover, Ning and Beatson (2011) also indicated that China's pyramidal groups provide opportunities for certain elites (controllers) to pursue personal interests and improve their economic influence. Therefore, the tunneling behaviour of pyramidal group in China will lead to a few people owning the control of the business group, which may have an adverse impact on the management decision-making and benefit distribution of enterprises.

3.2 Diversification Discount

In recent years, diversified groups in China have begun to appear diversification discount. There are serious problems such as resource dispersion affecting the development of the main business in the group (Wang and Xie, 2010). David and Jeremy (2000) pointed out that some enterprise groups blindly invest in expansion in pursuit of scale and benefits, resulting in excessive diversification. In this situation, the complexity of cross-industry channels makes the speed of information transmission slower, thereby reducing the efficiency of resource allocation in the internal capital market (David and Jeremy, 2000). Besides, influenced by defensive investment behaviour and human relations, groups may overinvest in the part with poor investment opportunities, while business with good investment opportunities may under investment (Matsusaka and Nanda, 2002). In fact, from a theoretical point of view, there is an inverted U-shaped relationship between the degree of diversification of groups and the internal capital market (Ellouze and Mnasri, 2020). In other words, moderate diversification will increase the value of the group. If beyond the effective range that enterprise groups can control ("optimal diversification" level), it will lead to an erosion of value and decline in performance (Zhao, 2009). For example, Lenovo Group's business involves more than 20 fields such as IT, real estate, medical, and agriculture etc. Although all kinds of businesses are managed professionally by related subsidiaries, from the overall perspective, the large business differences within the group lead to difficulties in business integration and synergies. Moreover, the improvement of market institutions will reduce the overall transaction costs of emerging economies, leading to a decline in the optimal level of diversification of enterprise groups (Hoskisson et al, 2005). According to the data of 16 state-owned enterprise groups in China from 2005 to 2006, it can be seen that its diversification index has increased from 0.53 to 1.38, but the competitiveness index has dropped from 64.10 to 62.49 (SSB, 2008). Therefore, moderate diversification of diversified business groups will be crucial.

3.3 Business Groups and the Government (Rent-seeking)

China's business groups were originally created under the guidance and intervention of the government. This special institutional background determines that most groups are state-owned and have a very close relationship with government agencies. Khanna and Yafeh (2007) explicated that these groups are called the "parasite" that relies on the government to obtain rent-seeking opportunities. In fact, there are serious monopoly problems and power rent-seeking in the Chinese market, which lead to unequal opportunities and unbalanced resource distribution (Wang and Jin, 2010). Chinese government tends to protect state-owned enterprise groups, while private enterprise groups are

generally suppressed (Keister, 2004). State-owned groups enjoy various support policies and special treatment such as interest concessions, bank loans, and debt relief (Wang and Jin, 2010). However, private business groups are difficult to obtain opportunities to enter high-profit industries due to discriminatory restrictions on industry access (Wang and Jin, 2010). Meanwhile, a large number of industrial monopolies have caused private enterprise groups to bear the pressure of rising economic costs and weakened their competitiveness. Therefore, the development process of Chinese business groups faces the threat of institutional defects such as excessive government intervention. Besides, "relationship" plays a critical role in market competition, stimulating the rent-seeking activities of enterprise groups and causing a negative impact on the overall economic interests.

4. Conclusion

In conclusion, this paper attempts to prove that China's diversified business groups cannot be unilaterally regarded as paragons or parasites. The emergence of diversified groups has made up for the imperfections of capital, labour and product markets in China's emerging economic system. In general, diversified business groups can be regarded as "paragons" to some extent, which is of great significance to the development of China. However, some problems of diversified business groups have also been exposed in the process of growth, which may have negative impacts on the entire economy. In fact, there are still different opinions and divergences on the issue of China's diversified business groups, and further research is needed to judge its impact. Future research can be analysed in detail through comparison of wider data (financial performance indicators, etc.) and real cases.

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