THE WALL STREET JOURNAL.
WSJ.com

MARCH 27, 2009, 9:52 A.M. ET

China Slowdown Stunts Entrepreneurs

By JAMES T. AREDDY

SHANGHAI -- Tony Yu grew rich helping build China into the world's factory floor.

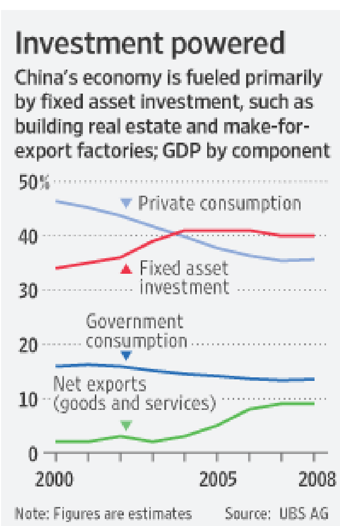
Over a decade, his small firm outfitted more than a thousand assembly lines with specialized equipment: pumps and pipes to sluice chemicals through high-tech plants. Business was so good his biggest challenge was keeping up with manufacturers impatient to cut the ribbons on their next plant. Mr. Yu poached engineers from rivals as he grew and acquired a mansion overlooking Shanghai's fanciest golf course.

Now his order book is emptying. China's February exports fell nearly 26% from a year before, the fourth in a series of worsening monthly declines. The building boom in Chinese factories is over, and Mr. Yu is casting about for business ideas. "We have ridden the wave of economic development in the last few years," he says. "We are at a loss as to what to do in the immediate future."

His fate echoes a broader challenge for China itself. The country has relied heavily for its often double-digit growth on a furious pace of investment in manufacturing. More than 40% of China's gross domestic product traces to factory construction and other kinds of fixed-asset investment.

Contributing to this have been hundreds of thousands of bootstrap entrepreneurs like Mr. Yu who appeared from nowhere, helping the Chinese economy to multiply 14-fold, adjusted for inflation, since 1980. Their bold dives into business -- dubbed *xia hai*, or "jump into the sea" -- and often unorthodox methods both thrilled and chilled the wider business community. Tiny firms shocked global goliaths with aggressive cost-cutting and sometimes corner-cutting as well.

Speed was everything. "You didn't need to be good," Mr. Yu says. "You needed to be *there*."



Over a decade these go-getters created five million businesses of at least eight employees each, according to the State Administration for Industry & Commerce. They spawned some 75 million jobs for China's university graduates, workers discarded from state companies and streams of people from the countryside. The output of China's private companies and their investment spending made up half of last year's $4.42 trillion GDP.

Now, with the global customers for Chinese factories in recession, tens of thousands of plants are closed and manufacturers have slashed expansion plans. Beijing has responded with a $585 billion economic-stimulus program, and domestic consumption is picking up some of the slack for the export decline, the head of Industrial & Commercial Bank of China said Thursday. But the stimulus is largely government spending on infrastructure that won't necessarily benefit manufacturers such as Mr. Yu's traditional customers.

"Can they build enough roads to offset the fact that they aren't building as many factories?" asks Ben Simpfendorfer, an economist in Hong Kong for Royal Bank of Scotland. He calculates that a drop of 15%, say, in spending on business equipment would cut 1.6 percentage points off China's 2009 growth rate.

Although China's economy grew a powerful 9% last year, it slowed sharply to a 6.8% pace in the fourth quarter. Industrial production, which has risen an average of 16% annually for five years, slacked off to 3.8% in the first two months of this year. For China's small businesses, it's the first slowdown they've faced, and many are struggling to reinvent themselves.

Mr. Yu, 49 years old, built a business tied to the unrelenting investment spending by his fellow entrepreneurs. His Shanghai GenTech UHP Co.

provides containers, pumps and piping that can safely carry the often dangerous gasses and other chemicals that manufacturers use in making semiconductors and other high-tech products. Operated with his wife, Joan Cui Rong, and generating $20 million in revenue last year, the business positioned itself to compete with far larger companies such as Air Products & Chemicals Inc. and Praxair Inc. of the U.S.

Mr. Yu, whose given name is Dong Lei, studied mechanical engineering in Beijing and earned a Ph.D. in agricultural engineering in 1987 at England's Newcastle University. Bored with his professors' directive to research farm equipment, Mr. Yu says, he spent much of his four years writing poetry. Back then, nearly everyone in China worked for the government, but Mr. Yu joined U.S. commodity giant Cargill Inc., which sent him to China to build an oilseed-crushing plant and then to Sioux City, Iowa, to run one.

Working in Iowa in the early 1990s, Mr. Yu sensed that more-dynamic opportunities were opening up back in China. The Chinese "need a lot of stuff from the outside world," he recalls thinking. So he quit Cargill to try his hand at exporting equipment to China from his house in Iowa.

A friend of a friend in China helped him win $1 million of orders from a new computer-chip maker for U.S.-made chemical tubing, an item so specialized that Mr. Yu wasn't entirely sure what he was promising to deliver. He also exported routine items like ambulance equipment and gas-station pumps. After a detour working in Shanghai for a U.S. pork producer that wanted to break into that market, Mr. Yu struck out on his own.

Ever since his early sale to a chip maker, Mr. Yu had kept the semiconductor industry in his sights. So when chip manufacturers began moving to the low-cost Yangtze River delta near Shanghai around 2000, he reached for a piece of the action. Casting himself as a veteran of China's nascent high-tech industry, Mr. Yu began winning contracts to outfit new factories. In 2001 he did a deal that put him at the helm of a business that refit pharmaceutical factories. Mr. Yu refocused it toward the high-tech sector.

Following the semiconductor industry into China were makers of optical fibers and flat-panel television sets, all of them wanting assembly-line equipment and wanting it quickly and cheaply. For Mr. Yu, winning orders was less of a challenge than keeping his engineers from walking out the door to open a competing business.

All of his darting around China to sign deals left him little time to consider where the high-tech industry was going. Indeed, "most of the time we didn't know what the customers were making," he says.

Amid a frenzy of small businesses rushing to be cheapest to supply whatever was needed, Mr. Yu says he decided to build a company with more "professionalism." He moved into an industrial park, wrote an employee handbook and built a "clean room" of the kind chip makers use, to raise the quality of his products. He relaunched the business as GenTech, stitching the name in English on engineers' blue jackets. "Everything we did we wanted to do it professionally," he says.

The company got a chance to show that when a customer had an accidental release of a "pyrophoric" gas that can ignite on contact with air. Mr. Yu and his team worked through the Chinese New Year to prevent a catastrophe.

Battling Giants

Soon, GenTech was nipping at the heels of industry giants. By quoting low prices but maintaining standards, it won subcontracting work from majors like Air Products and Chemicals. With his ambitions growing faster than his expertise, Mr. Yu poached engineers and salesmen, including so many from Air Products that GenTech was nicknamed "Little AP."

After he grabbed one highly regarded manager from Air Products, an executive of that company called to protest, asking in frustration, "Do you really need to have this guy?" say people familiar with the conversation. The poaching ran both ways. Mr. Yu says a headhunter called one desk after another at his business trying to lure people away.

Meanwhile, he was growing wealthy. With his wife and business partner, Ms. Cui, who is also an engineer, he toured Tibet, Europe and South Africa. They bought two peacocks for the yard of their large house. After Ms. Cui won a bet with her husband by closing a difficult deal, he settled the wager by buying her a black Porsche Boxster.

One thing keeping GenTech busy was a burst of investment in the photovoltaics industry, which makes equipment to turn sunlight into electricity. Mr. Yu directed his sales and engineering teams to focus primarily on the sector. Anticipating a windfall, last year he expanded production floor space tenfold and borrowed for the first time, an $880,000 working-capital loan.

But the rise in solar spending disguised a weakening elsewhere in technology, especially semiconductors. One bellwether Shanghai chip maker, Semiconductor Manufacturing International Corp., had multiplied its capacity eightfold over five years, averaging about $1 billion in annual capital spending. But this year, it expects to spend only about $190 million.

Chip demand fell off so much last year that China's industry could sell only 80% of the semiconductors it had the capacity to make, according to Raman Chitkara, head of the technology practice at PricewaterhouseCoopers. As a result, "most of the companies are being extremely selective in [expanding] capacity," Mr. Chitkara says.

The worry for Mr. Yu: "If there's no capital expenditure, there's no business for us."

As he fired up a laptop in his tiny office each morning, he recognized the growing clouds over China's exports. But his focus on the details of his business had left him little time to consider strategic issues that might have made GenTech less vulnerable to a downturn, he acknowledges. Near the middle of 2008 he was taken by surprise when a major company in the solar industry postponed a contract signing, citing a financing snag. In the past, Mr. Yu says, "They didn't need to talk to the banks -- the banks would talk to them."

More contract delays followed. By October, cancellations from solar-equipment customers were flooding in. This year one customer, Suntech Power Holdings Co. of Wuxi, China, slashed its 2009 capital-spending budget to a third of last year's level.

The changes left GenTech more vulnerable than the big multinational suppliers of pipes and pumps that move chemicals. Those companies also supply the chemicals themselves, getting most of their revenue that way. GenTech just makes the equipment -- equivalent to selling only razors when most of the money is in razor blades.

Suddenly, GenTech found its revenue wasn't covering the expenses of its 150-strong team of engineers and salespeople. Then in January Intel Corp. said it would eliminate Shanghai as an assembly base. Though Intel wasn't a GenTech customer, Mr. Yu saw this as a sign tech companies were starting to see the Shanghai area as too expensive.

Humbling Times

Months before turning 50, Mr. Yu faces humbling times. He says GenTech "will have a tough year" but should avoid its first annual loss, thanks to unexpected orders from fiber-optics makers who want to get in on third-generation cellphone service in China. He vows to avoid layoffs or pay cuts this year.

Over coffee in his boardroom, Mr. Yu spoke of his hopes for a new "killer application" to spark a fresh round of high-tech investment in China -- even as, in the next breath, he recited reasons that is unlikely for now.

In an unused half of GenTech's expanded production facility, engineers set up two badminton courts. But Mr. Yu told them to use their idle time to try to invent new kinds of equipment that might make the company more valuable if he decides the best strategy is to sell.

His wife, Ms. Cui, is exploring a way to turn their decade's worth of contacts into a new trading business. Mr. Yu is taking a series of weeklong executive training classes at Beijing's Tsinghua University to "meet new people and hear new ideas."

Having learned the perils of dependence on an ever-growing manufacturing industry, Mr. Yu is determined to find another way. "One hundred percent of our business relies on investment, expansion," he says. "That's what's got us scared. It's not a sustainable business model."

Write to James T. Areddy at james.areddy@wsj.com

Printed in The Wall Street Journal, page A1