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Incentives and the Governance Orientation of Distributor Networks : The Case of a Foreign-Funded  
Paint and Coating Materials Enterprise

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Economic sociology studies of market processes pay close attention to a great many trades, such as the advertizing business, investment business, garment manufacturing business and car manufacturing business (Baker, Faulkner and Fisher, 1998; Podolny, 1993; Uzzi, 1997; Biggart and Guillen, 1999). The market in transformation-era China is the subject of both practice and creation and allows researchers convenient access to the field and to personally witness the generative processes of various kinds of markets. (Shen Yuan, 2007). This paper is a case study on the market processes of China's paint and coating materials trade, and the venue of the study (Gao Bao, 2008) is the civilian-use paint and coatings distributor network of CP (hereinafter referred to as "CP network"), a foreign-funded enterprise of considerable influence in the trade. This article uses incentives as its narrative thread to describe and analyze the governance and shifts in the CP network's genesis, expansion, and disintegration (*wa jie*).

Study Venue: The CP Civilian-Use Paint and Coatings Distributor Network

China's paint and coatings industry has developed rapidly in the 1990s, and in 1991, annual national output of paints and coatings was one million tons.

In 2007, China became the world's second biggest producer of paint and coatings as the national yearly output of paint and coatings rose to 5,972,800 tons. Foreign-funded paint and coatings enterprises participated in the development of the paints and coatings industry, and the first to enter the Chinese market became industry leaders. By 1995, five foreign-funded enterprises had entered in the form of Chinese-foreign joint ventures. With policy permission, these eventually changed over to become exclusively foreign-owned enterprises. And by the year 2007, all well known paints and coatings manufacturers in the world had set up exclusively owned enterprises in China. The performances of these foreign-funded paint and coatings factories were among the best in the industry. Take for example the net profits growth rate. Among the eight foremost foreign-funded paints and coatings enterprises in 2006, the highest growth rate reached 332.81 percent, and the lowest was 18.66 percent, whereas the overall average growth rate of profits for the paints and coatings industry in that year was no more than 0.83 percent (China Paint and Coatings Industry Annual 1991-1995; China Paint and Coatings Industry Annual 2007)

The CP Company, which is the focus of research in this paper, was one of the first foreign-funded paint and coatings enterprises to enter China. The company came to China in the form of a Chinese-foreign joint venture in 1992, and became the first exclusively foreign-owned paint and coatings enterprise in 1994. The CP Company currently has nine member companies with independent accounts and manufacturing plants, with about four thousand employees. The transnational group to which it is affiliated also possesses other paint and coatings enterprises in China. CP consistently maintains an annual sales increase of 20 to 30 percent—which is among the steadiest and most remarkable in the industry—and its overall scale of production ranks among the highest. Its performance has even become

a key prop in its mother company's advancement and it is one of the world's foremost manufacturers of paint and coatings. The CP Company's rapid growth has been called a "miracle" of China's paint and coatings industry, and the direction in which it has led the paint and coatings trade has become a goal for other aspiring paint and coatings enterprises. "Who can beat CP" is an industry topic for which there is yet no definite answer.

China's sales volume of civilian-use paint and coatings accounts for 15 percent of the worldwide volume (China Paint and Coatings Industry Annual 2007: 15). Civilian-use paint and coatings are also the largest product category in CP's manufacturing and sales volumes. CP civilian-use paint and coatings are a famous brand in China. Correspondingly, the CP Network—the CP civilian-use paint and coatings distributor network—is CP's largest and most complete distributor network. The CP Network's structural pattern and even its every action are well known to, and subjects of imitation by, the entire paint and coatings industry. Its experiences have spread throughout the distributor networks of the industry, which is why this paper has chosen the CP network as its field of study. In economic sociology, "network" denotes the actual links among such principal market actors as the manufacturers, consumers, and suppliers (Fligstein, 2008: 9). This study uses the term "network" to summarize the links between manufacturers and distributors, and uses "CP Network" to denote the links between the CP Company and CP distributors.

## II. Study Issues, Line of Thinking, and Methods: Penetration of Incentives into the Governance of Networks

Transactions take place in the instant that product or service transfers occur through a technically separable interface (Williamson, 1985), and the goal of the CP Network is to promote transactions of CP products, so that the products are successfully transferred from the manufacturer to the distributor and then transferred out of the network by the distributor, with the manufacturer and the distributor both

making profits from the transfer, which is also called “the transaction.” The CP network is the CP Company’s important distributor network, and the company’s sales performance is closely bound to it. Yet CP distributors, CP employees, and even peripheral paint and coatings personages have accused it of being “chaotic”. For example, CP Management Director Mr. Tang who is in charge of the distributor network, after a cordial discussion with me stated sincerely: “Despite what is said, you will know when you come and take a look” [Interview No. Tang-gzh-06]. Distributors frequently express dissatisfaction and frustration, saying: This business can’t continue if things go on like they do.

Order in terms of cooperation with due division of labor exists in the market (Hayek, 1988), and networks stay between the market and enterprise organizations (Williamson, 1985; 1996). Hence, within the CP Network, a cooperation-and-division-of-labor order exists that extends from the market and that is centered on transactions. This order is seen as being “chaotic.” What kind of network governance method CP, the core actor of the network, has proposed? What does the governance orientation of the foreign-funded CP signify for China’s paint and coatings industry? Those are the issues studied in this paper.

## 2. The Study’s Line of Thought

Governance theory arose after World War II and in particular in the 1970s and 1980s, and had to do with the view among academic circles that the market and the state were, to a certain extent, malfunctioning. Scientists in politics and administration put forward the governance concept and advocated replacing the “rule” concept with the governance concept. Governance may be understood as an outcome of failure to redefine targets because of disputes arising among the relevant quarters about the validity of originally set targets. (Stoker, 1999). The principle of network governance is of a selective, lasting, and structured assemblage of self-governing enterprises that engages in production and services on the basis of contracts. This is done in order to adapt to changeable environments and to

adjust and maintain transactions, and the contracts are links of a social rather than of a legal nature.  
(Sun Guoqiang, 2004)

“Principal—agent incentives” means that the principal hires another person (an agent) to perform certain services. Since the two parties’ interests do not always coincide, the principal gives the agent appropriate incentives in order to control the actions of the agent and cause the agent to serve the principal’s interests (Jensen and Meckling, 1976).

Incentives are, in themselves, important governance means for the CP Network. To sum up understandings of the network’s dynamic governance process, we used “incentive” as a theoretical tool to reduce field survey data and as the thread for descriptions of CP Network governance phenomena. By means of signing contracts, CP, as the principal, and distributors, as the agents, agreed that the distributors would pay monies to CP to order CP paint and coating products, distribute CP products to retail or wholesale markets, and form with CP a combined force to expand markets. The CP Network’s incentive mechanism was not fixed and unchangeable. It was always changing and even in a constant state of flux. For these reasons, we will return to analyses and explorations of the CP network’s governance and shifts therein.

### 3. Methods of Assembling Field Survey Data

The field surveys for this study took place from April 2006 to May 2007, after which follow-up studies were maintained at irregular intervals. The methods used for assembling data included participatory observations, interviews, and group discussions (Chen Xiangming, 2000). Apart from participation in the daily work of CP companies, participatory observations also included fixed-location observations at interviewee distributor companies. Among the subjects interviewed and the group discussion participants were high-level administrators, employees of manufacturing and sales departments, employees at agencies in various places, and legal representative or actual owners and employees of

distributor enterprises. Selection of interviewees was conducted by means of a combination of level-by-level sampling and purposive sampling. The thirty-one mainland provinces (including directly administered municipalities and autonomous regions) were divided into three groups in accordance with CP's three areas of sales jurisdiction—north, central, and south, and from each group was purposively selected three to four interviewee provinces, so that the interviewee provinces were on the whole dispersed. From each interviewee province was purposively selected the provincial capital and one to three major cities. Efforts were made to visit all of the paint and coating distributor businesses in the interviewee cities and at the same time visit local CP sales managers and employees as well as the employees of distributor businesses. During this field survey, a total of 12 provinces were visited, and successful visits were conducted on 187 interviewees, among whom ninety-three were distributor businesses and a total of ninety-four CP employees and distributor employees. At the time of the field survey, there were about nine hundred CP distributors. Interviewed distributors accounted for about 10 percent of the total.

### III. CP Networks Genesis and Expansion: From Zero Hazard Incentives to Marketing Governance

#### Orientation

#### CP Networks Genesis: Zero Hazard Incentives and Governance Explorations

The CP Network has altogether three sub-networks. In this paper, these are named Network 1, Network 2, and Network 3 respectively in accordance with the order in which they were set up. Network 1 was set up in the early 1990s. The other two, newer networks were set up in recent years and had to do with the CP Network's tentative governance reorientation. The three networks were based on Network 1 and there was overlapping among the distributors. That is, Network 1 covered the entire country and comprised the most distributors. A small number of Network 1 distributors concurrently ran Network 2 and Network 3 businesses. Some distributors concurrently operated businesses pertaining to all three

networks, and there were also distributors that cooperated with the manufacturer CP Company only within a single network.

Let us first discuss Network 1. Network 1 was started up at the same time as the CP Network. It has been in use right up to the present time and now serves as a solid foundation for the CP Network. The most commendable act during Network 1's genesis was the CP employees' spontaneous adoption of an apparently irrational verbal agreement to seek distributor clients by means of the "zero hazard" incentive.

Prior to the 1990s, lime was still the principal material for whitewashing walls. People whitewashed their rooms only when new residences were completed or when getting ready for weddings and celebrations. The coatings were of inferior quality and small amounts were used. Nonetheless, optimistic CP manufacturers saw a potential market here. They maintained that China's market for high-grade coatings would grow along with economic development, and they did their best to find breakthrough points in the market. The retail terminals in those days were small general stores that sold interior decorating materials. Large numbers of these were widely distributed in urban and rural streets and lanes and constituted readymade channels for opening up a market for paints and coatings in China. And so, CP salespeople, lugging containers of paint and coatings, walked from one small store to another, patiently promoting these "high-grade paints and coatings." The prices of CP paints and coatings were five times those of ordinary paints and coatings. CP salesmen themselves felt that these were unconscionably high, and it was not surprising that shop-owners balked at placing orders.

For lack of better alternatives, CP salesmen left their paints and coatings with these small stores to be sold on commission, and took the risk of being unable to recover the monies for their goods.

Distributors who were willing to sell CP products on commission could pay up after the goods were sold and thereby avoid incurring risks. This "zero hazard incentive" successfully promoted the establishment



of Network 1 and produced unexpected results: Paints and coatings were sold, shop-owners paid for the goods as agreed, CP opened doors to markets, and clients developed a desire for consuming “good paints and coatings.” Painting industry specialists have evaluated this interlude in history as having “changed the paint and coatings industry.”

The CP network’s entire governance strategy at this time was similar to the “zero hazard incentive.” It was versatile and exploratory, and it was also vague, and unsystematic. We can see this in the recollections of our interviewees.

*Mr. Xu is sales manager in charge of the southern district in China. This sales district covers one fifth of China’s territory, but its sales performance accounts for one third of CP’s total sales volume. Mr. Xu first obtained a position as CP salesman in Beijing. He was later assigned to Guangzhou to open up the southern market, so he went there on his own, and with containers of paint and coatings traveled from place to place selling these and becoming a voluntary advocate of the “zero hazard incentive.” According to Mr. Xu, the CP Network had not yet taken shape at this time, and no governance strategy existed: “No one was in charge of you, and no one told you what to do.” [Interview no. xhj-gzh-06]*

#### 1. The CP Network Expands: Fully Market-Oriented Incentives and Governance

Ten or more years of development took place from the time when the first group of distributors was assimilated by means of the “zero hazard incentive” up to the year 2006 when Network 1 had acquired approximately one thousand distributor clients. The larger among them had sales districts that covered a prefecture-level city and annual sales volumes of tens of millions of Yuan; smaller ones consisted mainly of a single store with annual sales volumes ranging from several hundred thousand to several million Yuan. Distributors also developed their own retail stores. These retailers were smaller stores with miscellaneous brands of paints and coatings. They set up business in the streets of many townships and villages and their aggregate sales volumes were not to be despised. As General Manager Li of a

certain CP district put it: “They came up like a flood, quickly filling all interstices.” [Interview no. 1.If-07] Thus CP products blanketed the markets, and whether in town or countryside, consumers would come across CP products wherever they purchased paints and coatings.

CP exerted impetus on the distributors from two aspects--the cost of the products they stocked up and their profits, urged the distributors to engage in market competition, and thereby expanded the market share of CP products. One can get an idea of the incentive and governance strategies of this period from information obtained through interviews with CP employees and CP distributor clients. Now, let us get to know the latter.

The earliest CP sales managers were promoted from among salespersons who, toting paint and coating containers, roamed alone through the markets. Today, CP employees total about 3,000. A provincial-level sales team consists of about twenty employees, including the sales manager. They constitute the main sales force of the CP offices stationed in each province, and are the “CP people” most often seen by the distributors.

*The Guangzhou member company is in charge of paint and coatings marketing in the South China area. In 2000, Mr. Zhang joined the CP Guangzhou member company as an ordinary employee. The CP paint and coatings sales market was still a blank in many provinces of South China at the time, and for this reason Mr. Zhang was assigned to Yunnan province to serve as sales manager. CP was already quite well known at the time, so it was not necessary for Mr. Zhang to promote “zero hazard commission sales,” but the consumption power of this western province was lower than that of cities in the eastern regions. Mr. Zhang made every possible effort to take over and develop markets, and even suffered personal injury when he attempted to crack down on counterfeit and shoddy knock-offs of CP products. He was later transferred to become sales manager in Guangdong Province. Guangdong’s sales volume of CP*

*products is far greater than that in Yunnan Province. As CP employees see it, his work transfer indicates that his efforts have received affirmation from CP.* [Interview No. zhsh-gzh-06]

Actors who have had an important influence on organizing input and output have relied on such influence to obtain extraordinary discursive rights in terms of the distribution of resources within the organization. [Please check with original!!] (Pferrer and Salnick, 1978; Fligstein, 2008).

*CP Human Resources Manager Ms. Du has told our reporter: "CP very much dotes on its sales managers. They can draw on a great deal of money."* [Interview No. dbzh-gzh-06].

*The sales managers also find great favor with the higher-ups. At one of the monthly meetings of a large sales district, ten or more provincial-level sales managers each persisted in their own opinion and argued without end. Mr. Tang, their former immediate superior, proudly told our reporter: "I personally trained all of these 'hooligans'!"* [Interview No. twb – shh -06]. From his way of speaking, one could see his affection for his subordinates.

Most of the private entrepreneurs who started up from scratch in the 1980s did not have a higher education (Jean Ruffier, 2006). Of the CP distributors interviewed during this field survey, and because of the small scale of the distributing businesses, most of them they "had no much of an education." Among the ninety-three distributors interviewed, only eight had obtained formal academic credentials at or above the college level. These accounted for 8.6 percent of the total. Not a few distributors had entered the trade in the 1990s to make a living. Among them, for example was Mr. Zeng:

*In 1994, Mr. Zeng had left his government job to go into business because of the changes in the systems of state-owned enterprises. "I have been in this business for twelve years (up to 2006). The former planned economy changed into a market economy, the enterprise collapsed, and so I came out by myself and tried my hand at different things." Mr. Zeng declares he was "incorporated" by CP in 1999: "We*

were “cuan huo” [“Selling brand products on other people’s turfs”] at the time, and (sales manager) Xu came and advised us to make an honest living. He spoke to us like a friend, and he was as good as his word. The day after our talk, we signed a contract.” [Interview No. zzhq – xm – 06]

Some of the distributors had been working as unskilled laborers in the interior decorations trade during their teens. They saved or borrowed ten or twenty thousand Yuan, rented a small storefront and went into the paint and coatings business. Mr. Zhao was one of these.

*Mr. Zhao left his hometown after graduating from junior middle school and became an unskilled laborer at a general store that sold interior decoration materials. He later put together ten or twenty thousand Yuan of capital, rented a small storefront and went into business selling paints and coatings. Today, his company’s annual sales volume exceeds a hundred million Yuan and he serves as distributor of several brands of paints and coatings, including CP’s.* [Interview No. zhchh-shzh-06]

When talking about distributors, the CP employees we interviewed often maintained that they [the distributors] had insufficient capital and that they lacked market sensitivity.

*Mr. Chen who is of CP managerial level says that paints and coatings are not a very profitable business among the industrial chemicals or interior decorations materials businesses, and provide little attraction for the best distributors. For this reason he held investment conferences (zhaoshang hui) during the time he served as provincial-level sales manager, but never succeeded in attracting any ideal distributors, and had to continue looking for distributors within the paint-and-coatings and related businesses.* [Interview No. ch-shh-06]

The distributors were aware of their status of “being led.”

*Distributor Mr. Wu frankly admits: “My business got big only after I joined CP.”* [Interview No. wshsh – shzh – 06]

*Mr. Zeng clearly recognizes who leads: “The CP Company has always been leading us. Whenever it proposes ways of doing things, we feel these are strange but we have no choice other than to go along with them. And by the time we realize why these things are done, they are already obsolete.” [Interview No. zzhq – xm – 06]*

After a decade of development, the CP Network’s governance had become quite different from that in “zero hazard” times, and governance had finally been linked up with contracts. CP signed contracts with distributors once a year, and the core clause in CP’s contracts with distributors was that there had to be increases in the monetary value of purchases every year. When finalizing the coming year’s contracts, distributors hoped for smaller increases in purchase volumes, but the sales managers had already calculated the distributors’ capital, sales channels, and the estimated sales volumes they might attain, and on this basis increased the amounts of the purchase volumes. The two parties signed the contracts after some bargaining, and agreed to purchase amounts ranging from a hundred thousand to several tens of millions of Yuan.

The actual incentive operations that both parties were concerned about were not written into the contracts. The main incentives were two: Volume/price incentives, and yearly deduction incentives. By volume/price incentives were meant versatile variations in product prices. Prices were set according to volume, and lower prices could be obtained for large orders, and manufacturer reduced-price promotions could be launched at irregular intervals to attract orders from distributors. Yearly deduction incentives consisted of year-end redistribution of profits to distributors based on reviews of distributor’s purchase volumes. The larger the annual purchase volumes, the bigger were the deductions’ percentages in the purchase volumes. These two incentives were applied simultaneously, and the distributors very soon recognized that no matter which method they employed to make profits, they had to aggressively invest capital for placing orders and digest their inventories to the maximum extent.

CP's sales volumes increased by about 30 percent annually and consistently took a leading position in the industry. This should be attributed to these two aggressive market-oriented incentive measures.

During the ten years that CP advocated versatile management, its sales managers were given fairly substantial powers of decision. This could be seen in the marketing measures used to assist distributor sales in various localities: Virtually no two provinces could be found that had the same sales strategy. Where one province launched an 80-percent reduction sales promotion for distributors, another province might be launching a "give-umbrellas-for-buying-products" activity for its distributors. Moreover, variations in the percentages of volume/price incentives and yearly deductions incentives were to great extent controlled by CP sales managers, who made judgments in light of market conditions and trends.

*High-level Executive Mr. Tang recounts that at the end of a year when he served as sales district manager, he was inspecting the market in Zhejiang province. A nearby distributor heard about this and made an appointment to discuss matters related to yearly deductions in the hope that Mr. Tang would give him a favorable yearly deduction. It was already evening by the time the distributor arrived after a drive of nearly ten hours, but Mr. Tang refused to discuss yearly deductions and instead had a subordinate ply the distributor with drinks. The distributor eventually left empty-handed. At this point, Mr. Tang remarked: "I should have given him something, since we were already such good friends."*

[twb-shh-2007]

Devolving the power to control incentives to sales managers closest to the markets was a decision made by the governance strategy of the CP network's market orientation. CP dominated the market and turned in excellent performances because it believed in the strengths of the market.

#### IV. The CP Network's Changing Sub-Networks: Localization (*bentuhua*) and Verticalization (*zongxianghua*) of Incentives and Governance

##### 1. The Difficulties Network 1 Faced in Terms of Market Orientation

Large quantities of products left the factories for Network 1 under the effects of these incentives and this governance strategy, but when the market could not absorb these promptly, product overstocking was likely to occur. The distributors were willing to market them at low prices and even at purchase prices in order to reduce inventories and recover their capital, and merely pinned their hopes on increasing sales volumes so as to obtain more yearly deductions at year's end. In addition to diverting products through their conventional delivery channels, distributors also sold their inventories at low prices in the market areas of other distributors, and in effect "*cuan huo*" [Sold brand products on other people's turfs] This situation, where "yours and mine are all mixed together" further depressed product prices and compressed the distributors' profits margins.

CP attempted to conduct supervision by means of covert visits, evidence gathering, and monetary penalties, but the cost of supervision was too high and appropriate handling of such cases was difficult. CP also tried to suspend production of current products that brought in meager profits and frequently launched new high-profit products to replace the latter. However, the life cycle of new products continued to shrink and profit margins were increasingly difficult to maintain.

CP employees of non-manufacturing department often could not understand why distributors said they were not making any profits.

*Human Resources Manager Ms. Du said: "It is abundantly clear that we have given them fairly substantial profits, but they always complain about not being able to make money."* [Interview No. dbzh – gzh – 06]

In reality, distributors were not deliberately complaining about being hard up. Amid the acute competition, the distributors' profits were consistently lower than CP estimates. Some distributors had even reached the state where they could hardly keep going if they sold CP products only, and it became quite common for distributors to make use of CP product popularity to concurrently sell products of other brands in CP franchise stores.

On the other hand, the devolution of market decision-making powers to provincial sales managers had the effect of highlighting the relative powers of CP sales managers and distributors. For example, CP managers would ask distributors to "coordinate" in creating business achievements, such as by increasing orders for products, starting up CP franchise stores in designated locations, and so forth. Good "coordination" meant versatile market operations, the purpose of which was to expand sales and market share and create a win-win situation for both the manufacturers and the distributors. Yet what caused distributors the least reassurance was the fact that such coordination was frequently based on verbal agreements, and that it required increased capital investments on the part of the operators. If the "coordination" plan were terminated because the sales manager left his job or any other reason, the operator would face a great deal of trouble simply to recover his previously invested capital, to say nothing about making any profits.

*When I visited Distributor Ms. Huang, she declared uncooperatively: "There is nothing to talk about. In any case talking is useless." Then tears welled up in her eyes, as though she had been deeply wronged. It is said she is a highly emotional person and sheds tears at any mention of her plight. The cause of the incident was a verbal agreement between her and CP salesperson Ms. Chen regarding recompense for a sales promotion activity and a promise to pay up at the end of the year. Ms. Chen subsequently annulled the recompense on the excuse that Ms. Huang had violated regulations in another respect. Ms. Huang*



*had repeatedly written appeals to CP in the hope that company higher-ups would “redress the wrong” done to her. In the end, she never got the recompense she insisted upon.* [Interview No. h-gzh-06]

Many of such “appeals” have made me suspect that they use such howls as a weapon (Scott, 2007). One effort to reduce such disputes was a letter sent by the general manager of a large CP marketing district to distributors in 2006, respectfully notifying the distributors to adhere to conventional procedures of cooperation and not believe verbal promises made by CP employees. The letter manifested the good will of CP higher-ups, but the governance and incentives stipulations of the CP market orientation determined that CP sales managers had to use market competition methods to impel distributors to increase investment, lower profits, and release CP products on the market to the maximum extent. This was done until market turmoil caused people to perform some half-hearted work to safeguard market order. Meanwhile, verbal promises and other temporary incentives were frequently used as market means, and the above-described examples were precisely the things that resulted in conflicts.

The whole of Network 1 is full of difficulties like these, but the network still advanced along the established path until such time as it came up against more direct reminders. When the new year was soon to arrive, and when managers had to consider how to formulate sales objectives for the coming year, contract- appointed product purchase volumes served as operable indexes for appraising distributors, and foreshadowed manager considerations about extending contracts with these distributors as well as overall considerations about dismissing or retaining and/or increasing or decreasing the number of distributors. Changes in distributors took place in all provinces virtually every year. Some provinces suddenly reduced the number of distributors; others might engage many distributors. When a manager cut the number of distributors, the reason could be that he wanted to

increase incentives for focal distributors, and when he increased the number of distributors the reason could be that he wanted to take over more terminal retail outlets. The reasons varied.

Most of CP's earliest group of distributors has already left due to attrition on CP's part, and no distributors who had worked with CP more than ten years were found among the interviewees of field surveys. The longest term of cooperation was slightly above eight years and reached eight years among only seven of the distributors. These accounted for 7.5 percent of the distributors interviewed. Matters developed to the point that high-level CP administrators could hardly make direct contact with distributor clients.

*General Manager Huang manages one third of the markets nationwide. She issued faxes according to the contacts on the list of distributors, but not all faxes reached their destinations. An investigation revealed that some distributors had terminated cooperation [with CP], and new partners had been found for some markets. [Interview No. lj-lf-06]*

Within an organization, the higher-ups are empowered to issue orders to their subordinates, and subordinates have the duty to obey. However, higher-ups and subordinates are interdependent. The higher-ups depend on the efforts and good faith of their subordinates for their successes, for which reason subordinates possess the means to exert pressure on their higher-ups (Crozier, 1999). In the CP Network, a loosely organized framework, the CP side was the higher authority and the distributors consciously assume a subordinate position. CP placed importance on the extent of coordination evinced by the distributors and required that the operators be "obedient."

*For instance, when Mr. Fu, a CP regional manager, talked about the way cooperating distributors were selected, he said: "What we want is a client that works whole-heartedly with us. It makes no difference what kind of abilities he has. Smaller abilities can be given support. Bigger ones may be further strengthened." [Interview No. fu-gzh-06]*

Nevertheless, the realization of achievements depends on the efforts and good faith of distributors. To hit back at pressure from CP “higher-ups”, distributors took a negative attitude toward selling CP products, and expanding business in other brands under the CP brand became a commonly known business practice. The “order within confusion” on which Network 1 prided itself included the operators’ partial abandonment of CP. [not clear what this means—Trans.] CP eventually took note of this, despite the fact that CP annual sales volume was still quite remarkable. However, the rate of increase was gradually falling, and in contrast the increase rates registered by important CP competitors were better than CP’s despite the smaller base figures of their sales. CP saw this as a dangerous signal and tried to make adjustments at the governance level.

## 2. Localization and Verticalization: Incentive and Governance Endeavors of Two Orientations

The goal of many strategies in the commercial field is to create stable social relationships. Once stable social relationships are formed, signals about prices and product strategies are communicated among enterprises (Fligstein, 2008). With this in mind, CP set up two additional networks—Network 2 and Network 3—and implemented cautious reforms. At the governance level, Network 2 tried out Chinese-style *weihu fangzhi*, and Network 3 emphasized vertical management of distributors and terminal markets. Based on the governance lines of thinking of these two networks, in terms of incentive strategy the incentive awards by Network 2 were conducted en bloc [*cheng tuan kuai*] on platforms centered on large distributors, whereas Network 3’s incentives worked according to the vertical principle and emphasized manufacturers taking direct charge of and controlling the interests of more participants.

Prior to Network 2, there were latex paints and wood coatings among the civilian-use paints and coatings that constituted the main products circulated by Network 1. Due to the complex skills and

post-sales technology required for applying wood coatings, sales volumes of these were much smaller than those of latex paints although both were sold in the same Network 1 stores. However, the local privately operated HR Company had scored notable achievements in terms of wood coatings. CP referenced the HR Company model to set up its Network 2.

HR was in Shunde (Guangdong) where a furniture industry cluster is located. The needs of the furniture industry for wood coatings promoted HR's development, after which it advanced to markets nationwide. They helped employees they sent out to set up independent marketing companies, which become HR distributors. These distributors secured business districts in provinces and became HR's distributor networks. It was rare in the paint and coatings industry for a company to control distributors in such a relaxed manner and it was precisely for this reason that HR—distributor relationships were so close. The “HR service centers,” an important service system in the HR network, were the hub of the entire HR manufacturer—distributor network. The center's business, as for example free after-sales coatings, consisted of *shou ci yun zuo* [first-time operations] in the paint and coatings industry. The objective of other business operations was to mobilize distributors, in-store salespersons, and painters and coaters to participate in brand promotion and product sales. Distributors provided the centers with office space and personnel, while HR gave them guidance in their work and used the centers as platforms to spread the company's influence. The guidance given to these service centers was succinct and effective, one example being the sales-technique training known as “use wood coatings to promote latex paints.” This training course had found that the paint-and-coatings process consisted of attending to wooden furniture before painting and coating walls, and thereupon developed targeted training in guided paint-and-coating purchases. This was the first time systematic training in sales skills was conducted in the paint and coatings industry. Trained store employees could use sales skills to recommend wood coatings to consumers, and then recommend latex paints that would be used next. Consumers often responded at once with purchases.

The CP Company hired former high-level HR managers to set up a wood coating distributor network, i.e. Network 2. Network 2 consisted of about sixty distributors. A minority of these was selected from Network 1. More were attracted by the network's management level from the lumber industry and related fields. The "turfs" that Network 2 distributors could make use of were somewhat larger than those of Network 1. Network 2's operating methods were like those of the afore-mentioned HR distributor network. It required that distributors set up "CP service centers," the business methods of which were similar to those of the HR service centers. CP also launched a batch of wood coatings that comprised new business concepts and that were sold only within Network 2, as a concentrated form of recompense for Network 2's distributors. Network 2 brought about substantial increases in CP's sales performance in terms of wood coatings.

The factors considered for Network 3's verticalized governance were three-dimensional. Consideration was given to the influences of the CP network's external environment in addition to the network's existing governance problems. One of these influences was adjustment in the manufacturing structure within the paint-and-coatings industry and the frequent enterprise mergers and capital restructurings. CP, for example, bought up many small paint-and-coatings enterprises, while the afore-mentioned HR Company was purchased by an American paint-and-coatings manufacturer. Another influence was the overall deployments in China's market by large foreign retailers—partners in the marketing domain. For example, B&Q, the British construction materials supermarket chain, started to set up stores in Mainland China in 1999, and by 2008 had opened up more than sixty large building materials supermarkets in twenty-six cities. Super-sized dimensions gave more powers of initiative to large retailers during commercial negotiations and put a great deal more pressure on new manufacturers.

Under the dual pressures of industry restructuring and the market, CP tried out various changes. In 2005, Network 3 consisting of *zhuan xiang bumen* (special departments) emerged. CP hoped that it

would do away with simplistic and slipshod business patterns and recapture CP's gradually vanishing status as a commercial center.

Network 3 has approximately a hundred distributors, most of whom were selected from Network 1. If Network 2 used "service centers" to optimize the management and services of marketing terminals, Network 3 used CP franchise stores as platform to further strengthen top-down vertical management of manufacturers. Its train of thought found concentrated expression in its franchise stores: Funds for these were provided by distributors, and CP took part in planning the franchise stores' image, displays, marketing, and management. This was the first time that CP became involved in retail operations that were formerly given over to distributors, and it vigorously urged both parties to go from supply and marketing relations over to vertical cooperation. The actions of CP, as an influential industry leader, were, as previously, the subject of concern and conjecture, and colleagues in the paint and coatings industry went there as customers to visit and observe. They maintained that Network 3 is the most leading-edge marketing system in the paint and coatings industry. Other manufacturers were almost simultaneously working on similar plans.

The two new networks made adjustments to incentive rules and increased the number of new incentive recipients. First of all, CP decided to reduce the versatile market tendency [*linghuo shicang qingxiang*] of its incentive strategy, take back the distributors' power to decide the price of purchases and have these decided by the company's high-level departments, and changed manufacturer sales promotions into foreseeable manufacturer discounts to distributors and consumers. Secondly, yearly deductions, as *yanhou manzu de* [delayed] sharing of benefits, offered too much room for maneuver and were therefore canceled. CP took this opportunity to pass on to distributors the profit-making method of earning stable profits through stable retail prices. Also, Network 2 and Network 3 respectively have made use of service centers and new franchise stores. Newly added subjects of

incentives were the retail sales guides engaged by distributors, and sales guides who produced good performances were given rewards in the form of bonuses or wages. The measure brought the distributors' retail sales guides within the foreign-funded manufacturers' management systems and constituted a kind of encouragement for the sales guides.

#### V. The Stagnant CP Networks: The Difficulties in Governance of Foreign Paint and Coatings Enterprises

Markets always evolve through three stages—from emergence to stability and crisis (Fligstein, 2008). Network 2 and Network 3 were endeavors by the manufacturer to break out of this cycle when it realized the inadequacy of Network 1. If the interactive pattern of economic organizations is defined as markets, hierarchies (*keceng*), and networks (Powell, 1990), CP's Network 1 put its faith in the market and handed its markets over to distributors; Network 2 tended to differ from the market and hierarchy structure/network and adopted a localized way of networking; whereas Network 3 leaned toward hierarchy and endeavors to internalize, verticalize, and formally institutionalize market management, and partially retrieved domains originally given over to market competition. A paint and coatings distributor network comprising three sub-networks was unique in the paint and coatings industry, and Network 1, Network 2, and Network 3 respectively represented three different considerations about the governance orientation of a transnational organization in China. The fact that CP still maintains three sub-networks indicates that CP has difficulty in deciding which network is the best. The difficult choice of the CP Network in terms of governance orientations epitomizes the developmental strategy adjustments by foreign paint and coatings manufacturers in China, and testifies to the endeavors made by foreign manufacturers as well as their choices among marketization, localization, and institutionalization. Due to the significant influence of CP and other foreign manufacturers on China's

paint and coatings industry, the entire industry is undecided about what to do in this governance quandary.

As the matter of the CP Network's three sub-networks remains unresolved, a decision from the conglomerate has once again triggered tremors about the CP Network. The CP Network was created by high-level management personnel in accordance with the China experience and their understanding of academic trends regarding the market, localization, and the vertical integration of organizations. These high-level management personnel enjoyed substantial powers of self-determination within the networks they created, but a major personnel adjustment at the conglomeration transferred away the former CEO, and a large number of medium- and high-level managers plus basic employees have left the CP company and network. Among these people were most of the CP employees interviewed during this study. Developments at the CP Network have been temporarily suspended along with these changes. However, CP has been seen as a "training school" of the paint and coatings industry, much importance is placed on its experience, and the employees that have left it were recruited by industry colleagues. This change will take the CP network's governance thinking to other enterprises in the paint and coatings industry. This deserves further follow-up research on the paint and coatings industry.

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