Eclipse of the Jin and Hui Merchants: Lessons for Entrepreneurs and Value Investors

By KEE Koon Boon

Pinnacle to pits. Such is the tragic and thought-provoking path of the powerful Shanxi-based "Jin Merchants" and Anhui-based "Hui Merchants" during China's Ming Dynasty till their demise in the late-Qing Dynasty as they could not cross the chasm to "Stage 2".

They were richer than the emperor and their business empires stretched as far as to Asia, Russia and Europe. The powerful Shanxi "banks" (piaohao) offered a full array of financial services, establishing the remote inland Shanxi province's Pingyao and the nearby Qixian and Taigu counties as the premier financial centers or China's Wall Street then; the first and largest of them, Sunrise Provident (Rishengchang), was the modern equivalent of JPMorgan.

They were extremely hardworking; the Hui Merchants were also called "Hui Camels" as camels symbolize their propensity to tolerate hardwork and overcome adversity in harsh conditions. They were highly educated and cultured; the Hui Merchants were also called "Confucius merchants" and one in five imperial scholars came from the Anhui province then. They worked in "teams"; family groups and clan members collaborate to dominate geographies and industries ranging from tea, timber to textile.

So why and how did these two powerful business empires went into oblivion?

Both the Jin and Hui Merchants, for all their vast accumulated wealth, did not invest for growth in building an economic moat, a unique durable business model.

Take the case of Dashengkui, one of the largest business empires established by three "Jin Merchants" then. It had 20,000 camels, dominating the logistics business in China, particularly in the transport of tea to Mongolia, Xinjiang and Russia. Its assets were said to be so vast that they can be converted into enough 50-liang tael to lay a road that stretches from Ulan Bator (the capital and largest city of Mongolia) to Beijing.

Despite the advent of steamship as a low-cost and efficient transportation means, Dashengkui failed to invest any of its profits or reserves in upgrading its logistics assets. Also, the Jin Merchants who dominated the tea trade and became very rich, used the profits and cashflow from the businesses to fund their lavish lifestyles and indulge in asset speculation, purchase land and rebuilt their houses.

In 1866, without the burden of tariffs, the Russians started to transport tea from China via the sea route and subsequently exported the tea to Europe and Middle-East. They established modern processing and manufacturing facilities in places such as Hankou, Jiujiang, Fuzhou, making use of coal-based steam turbine technology and machines rather than the manually-driven turbines and labor-intensive manufacturing methods used by the Chinese Jin Merchants.

The Russians produced high quality and low-cost tea bricks in huge quantities and had the added advantage of transporting via the cheaper sea route instead of the conventional land-based path dominated by Dashengkui. The fortunes of the Jin Merchants started to take a sharp deterioration. They were contented to rely on their core business of piaohao and pawnshops for the cashflow to speculate in property and to fund their lavish lifestyles. As a result, they missed the opportunity to convert their piaohao into banks, including declining the invitation to invest in the current HSBC.

Hu Xueyan (1823-1885), dubbed the richest-ever Chinese entrepreneur and known as the "Red-Topped Merchant" (hongding shangren) after the scarlet tasselled hat which reflected his position as a first-grade imperial official and awarded the "yellow mandarin jacket", was probably the most celebrated Hui Merchant.

Despite the realities of the Industrial Revolution exposing the weaknesses of the labor-intensive manufacturing methods employed by most of the Chinese merchants as compared with the modern machines which western companies invested heavily in, Hu, a veteran in the silk business, insisted on using labor to process raw silk. At that time, the western companies had the upper hand and deliberately depressed the price of raw silk in China.

In May 1882, Hu purchased raw silk in bulk, hoping to monopolize the supply in order to force the cartel of western companies to buy at higher prices. Hu was an accomplished opportunistic trader all his life and he was highly confident that his Fukang "Bank" was "rock-solid" in providing the financing to fight the battle with the western companies.

Unfortunately, after two consecutive years of drought in Europe prior to Hu's purchase, Italy had a good silk crop harvest. Raw silk prices plummet and Hu's unsold inventory depressed the silk market further. A French navy fleet also arrived at Shanghai, threatening to attack China.

With the prospects of a Sino-French war breaking out, cash became king and banks withdrew their short-term loans. Trade halted and there were massive property and asset disposals in Shanghai. Bank runs erupted, impacting Hu's "rock-solid" Fukang Bank. By December 1883, Hu was bankrupt. Hu died in 1885 in the same year as did General Zuo Zongtang, who provided Hu protection and patronage, enabling Hu to get and stay rich.

Their neighbors, the Ningbo Entrepreneurs, were more far-sighted, reinvesting their profits into building sustainable industrial businesses rather than making speculative asset transactions that yield transient profits, making the successful transition to Stage 2.

While investing for growth is critical, it is important for value investors to note that making capital investments without allocating them to build a team and an economic moat is likely to be an inefficient and value-destroying exercise. They will fall into the general category of firms described by finance researchers Sheridan Titman, John Wei and Xie Feixue in their 2004 *JFQA* paper. These firms that increase capital investments substantially destroy future firm value in the long-run because investors consistently fail to appreciate managerial motivations to put the best possible spin on their new "growth opportunities" when raising capital to fund their "expenditures".

In addition, value investors need to be discerning in understanding that investing to build an economic moat to build up the intangibles and core competencies for sustainable and scalable growth could depress short-term cashflow. Thus, the financial numbers may not look appealing from a historical snapshot perspective.

Established by Mr. Sze Man Bok and Mr. Hui Chit Lin in 1985, Hengan grew over 20-fold from US$480 million to US$11 billion since its HK listing in 1998 to become the largest producer of personal hygiene products such as tissue paper, sanitary napkins, pantiliners and baby diapers.

Interestingly, Hengan was below a billion market cap post listing until 2004. From 1998 to 2003, Hengan invested a total of around S$140 million in capital expenditures and conserved cash. The capex figure scaled six-folds to a total of S$830 million from 2004 to 2009 as Hengan invested heavily to move up the value chain in higher-end products and to distinguish itself from the hundreds of low-end producers. Annual profits grew six-folds from a size of S$57 million in 2003 to S$400 million in 2009, creating S$12 billion in firm value in the process.

Long-term entrepreneurs need to appreciate that generating profits via collecting transactions will not lead to sustained multibagger returns. Hu Xueyan, the consummate trader in accruing multiple profitable transactions all his life, witnessed the horror of not building a durable economic moat when he opened his warehouses that were stockpiled with unsold silkworm pupae. The silkworms had metamorphosed into moths and Hu literally watched his fortunes flutter away.

Profits need to emanate from, housed and reinvested in an economic moat to be rejuvenated, propelling the enterprise to scale new heights and generate sustained multibagger returns. Without doing so, they risk blowing up in Stage 1 like the Jin and Hui Merchants.

It is the task of value investors to dive through the rumpus and bustle of cabal in poignantly troubled times in a vigilant watch for outstanding entrepreneurs devoted in their intensive task of building an economic moat.