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Huawei: A Case Study of When Profit Sharing Works

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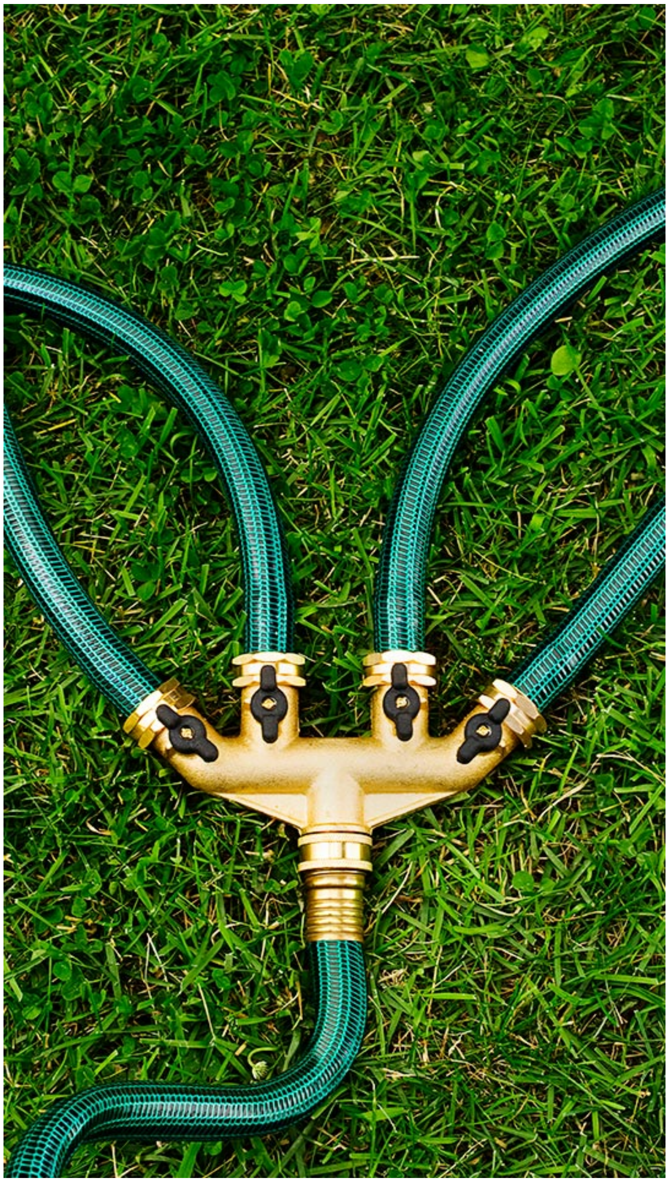
The gaps between what CEOs earn and what workers do are startlingly large around the world. Such uneven wealth distribution has long been a topic of discussion in economic and policy circles, but it's now increasingly common in the corporate world as well. A 2014 IMF study illustrates that extreme inequality is self-defeating as it slows down economic growth and insights from behavioral economics show that it damages employee morale and productivity, while large executive bonuses have presented PR nightmares for the companies that award them.

From this discussion, profit-sharing plans have emerged as a potentially viable solution to both the problem of wealth distribution and the challenge of employee engagement. But how feasible are these plans at large, global organizations?There aren't a lot of models out there aside from a few, well-known examples such as Waitrose, a British online grocer.

One example that's less well known in the West is Chinese telecom giant Huawei, a private company owned by its employees. Founded in 1987 by Ren Zhengfei, today it employs about 170,000 staff, including more than 40,000 non-Chinese (75% of employees outside China are local hires), and serves more than 3 billion customers



worldwide. It is the only Chinese company that receives more sales revenue from markets outside China (67%) than from inside it. (Editor's note: It's worth noting that the U.S. isn't one of those markets. Some U.S. lawmakers consider the company a security threat. For its part, Huawei's internal policy is to use U.S. law as the guiding law in their international business.)

At Huawei's inception, Zhengfei designed the Employee Stock Ownership Plan (ESOP). At the time, Zhengfei had no idea what a stock option system was – not being familiar at that time with the types of incentives systems developed in the West. Around that time, China was still struggling with the aftermath of the Cultural Revolution and being a private owner and thus capitalist was still perceived by many as an ugly thing. In light of that reality, Zhengfei felt that not owning the company was also the least dangerous thing for a founder to do.

Today, Zhengfei himself holds only 1.4% of the company's total share capital, with 82,471 employees holding the rest (as stated in Huawei's 2014 Annual report, as of December 31, 2014). Furthermore, because Huawei is not a public company and owned by its employees, employees take a large share from the companies earning. In the case of Huawei the total net profit that was earned over the last twenty years is considerably smaller than the total net profit that was paid out to its employees. To be specific, the sum of employees' salaries, bonuses and dividends is 2.8 times the company's annual net profit, and plans are to further increase the ratio to 3:1.

The structure of the ESOP is based on two important premises. The first are the Confucian values of equality and harmony, which underlie Zhengfei's desire to prevent wealth gaps between employees from becoming too big. To achieve this, Zhengfei believes that if employees own the company they will be motivated to act as entrepreneurs and initiate more projects that could help all of them to earn more and diminish differences in wealth creation considerably. This feature of providing opportunities to all employees to increase their wealth is characteristic of what an employee-owned company stands for and differs from public companies where primarily the happy few at the top are earning more by serving their external shareholders and thereby widening salary gaps within the company significantly. But although Huawei is big on creating equal access to those opportunities, they do not employ a view that also promotes equality in the distribution of outcomes.

The second premise is built on the idea of equity. The harder you work, the more you can earn — but working overtime is only rewarded extra if the work directly addresses the needs of their customers. Overtime projects that do not reveal direct positive consequences for customers are not rewarded. This plan not only controls wealth gaps and allows employees to earn more, but also allocates more influence and authority to those who show strong skills.

In Zhengfei's view, people care about belonging to and being proud of a collective but also have the desire to differentiate themselves from others. Huawei's ESOP can satisfy both human needs. The ESOP emphasizes the idea that Huawei belongs to everyone in the company and that Zhengfei expects all employees to act like owners, with dedication and committment. This entrepreneurial spirit allows the company to learn and innovate, collectively, in support of Huawei's mission: "To improve quality of life through communication."

One limitation is that, due to legal constraints, non-Chinese employees are not able to participate in the ESOP, despite many of them having expressed a desire to be included. To meet these demands, Huawei has recently adopted a long-term incentive plan called Time-based Unit Plan (TUP). First piloted in 2014, TUP is a profit-sharing and bonus plan based on employee performance for all eligible employees ("recipients"). Under TUP, time-based units ("TBUs") are granted to the recipients, which entitle the recipients to receive cash incentive calculated based on the annual profit-sharing amount and the cumulative end-of-term gain amount.

Another important limitation is that Huawei is a private company; it's not clear how the approach they use would translate to publicly traded companies, and Huawei currently has no plans to go public. Huawei believes doing so would effectively dismantle their profit-sharing plan, hurt morale by creating inequality, pressure the company to think short-term, and curtail innovation and growth – which are of high value within the telecom industry.

Huawei's example helps us understand two things about how profit-sharing schemes work at scale. First, the idea of an employee-owned company requires a culture with a long-term focus and a collective orientation, which in turn imply not being a public company. Second, the idea of an employee profit-sharing scheme is innovative in serving both individual and collective interests simultaneously because it links the motivation of an individual employee to act as an entrepreneur to the achievement of the company's vision. It is here where an employee-owned company has the potential to turn individual ambitions into a sense of intrinsic motivation and pride to serve the company's purpose on the long-term.

At the same time, the Huawei example also highlights suggestions on how global companies can handle those profit-sharing plans and what the likely challenges will be. Specifically, it is clear that companies operating in different countries will face legal challenges that may introduce an inequality between employees in the company's home country and employees elsewhere. Huawei approaches this challenge by working together with a consultant firm to arrive at new incentive plans like the TUP, but also to offer its non-Chinese employees higher salaries than Chinese employees at the same level. Usually those pay rates are also higher than to those in the local countries or regions. Another challenge that global companies will face when giving employees a stake in the company's profits is to develop tax-efficient incentive plans. Countries will differ in the extent to which and how much tax benefits they want to provide to stimulate profit-sharing schemes.

For example, in the current U.S. presidential race, candidate Hillary Clinton has suggested that companies that implement a form of profit-sharing could receive tax incentives for the first two years. The underlying idea is to nudge companies toward a mindset that sharing profits will instill a sense of ownership in employees — something that's profitable and effective in the long term.

The challenge thus primarily lies in shifting our focus from external shareholders to internal shareholders — internal shareholders who not only work at the top layer of the company, but across every layer. And it is exactly this mindset that employee-owned companies strive for: the idea that wealth and profits are common goods that are shared — and not only awarded to a few golden boys — and as a result, can boost productivity and innovation and serve as a catalyst for growth.

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