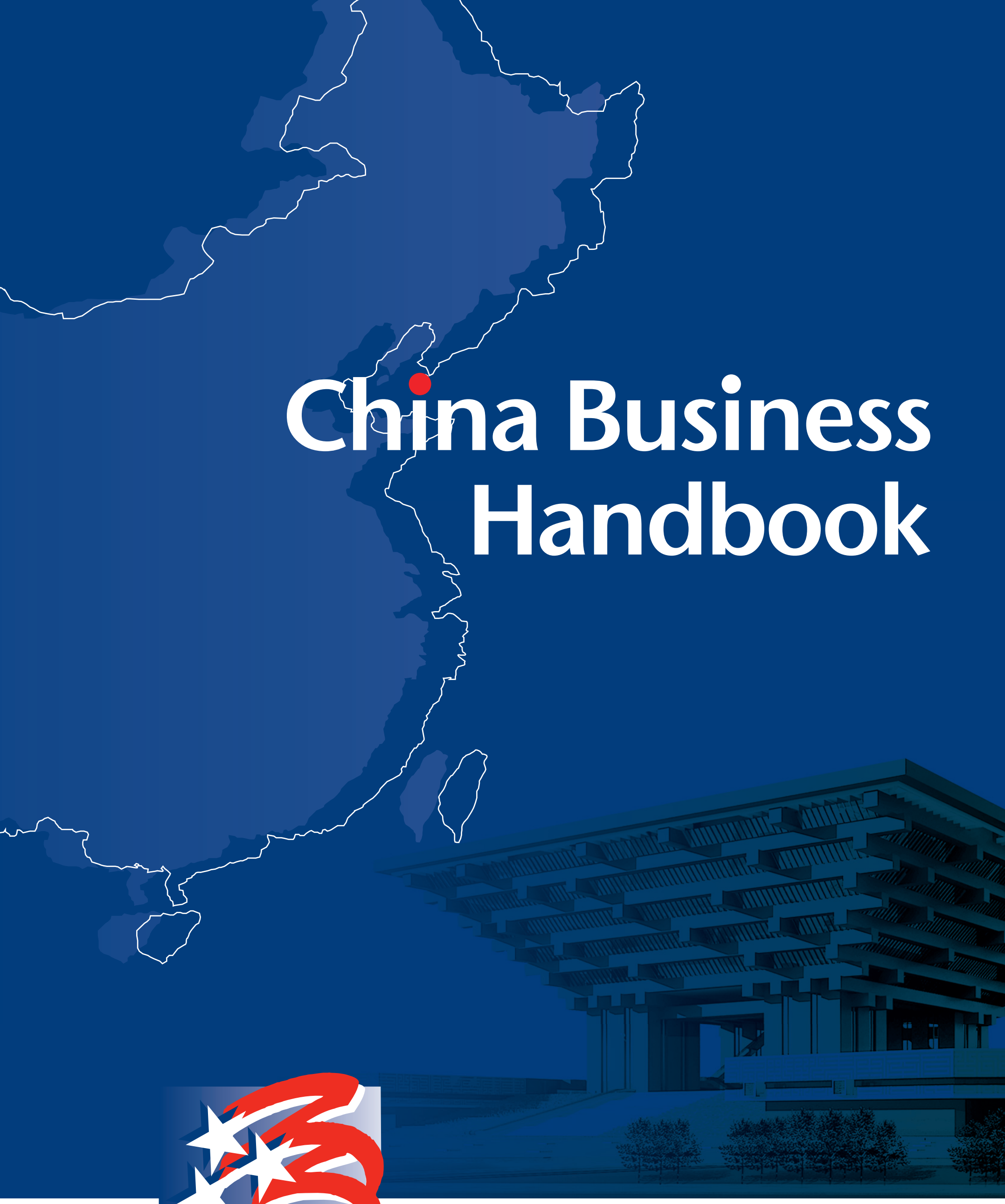


China Business Handbook

U.S. COMMERCIAL SERVICE®
United States of America
Department of Commerce

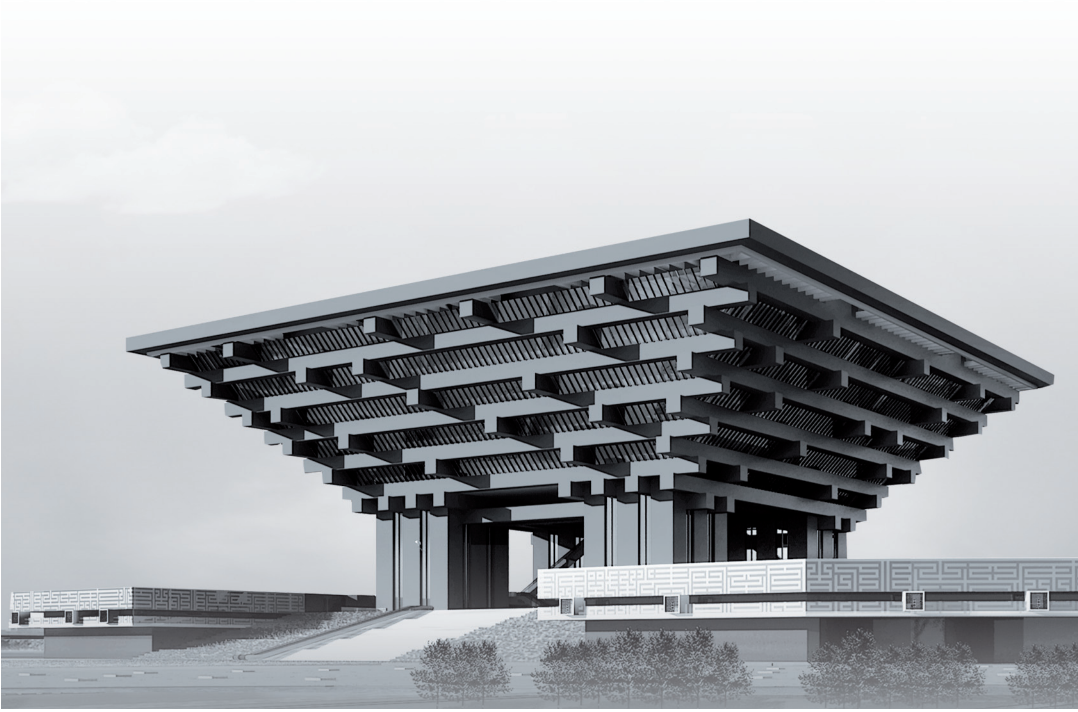
ASIA BRIEFING

Publishing assistance by **Asia Briefing Ltd.**
www.asiabriefingmedia.com

May 2011 | Volume 2

China Business Handbook

A Resource Guide for Doing Business in the People's Republic of China



Contributed by

U.S. COMMERCIAL SERVICE
United States of America
Department of Commerce

DEZAN SHIRA & ASSOCIATES
Corporate Establishment, Tax, Accounting & Payroll Throughout Asia

InterChina
英特华

Do you want to reach new customers in the China market? China's economy continues to tick along with no discernible drop in growth even as their impressive stimulus package wound down in 2010. Many economic experts predict the Chinese economy will continue to grow at or above 9 percent for the next few years – a rate higher than the targeted growth rate of 8 percent announced by Premier Wen Jiabao at the March 2011 National People's Congress. Macro economics aside, China is a relevant market for American businesses of all sizes in all industries. U.S. firms exported more than $91 billion to China in 2010 with U.S. products, services and technology playing an important role both in China's development and in U.S. economic growth.

China is buying, building and upgrading throughout the country. With rapid urban development and an exploding middle class, China's demand for consumer products reaches into more than 260 cities with over one million people. In particular, China's emerging markets in second and third-tier business centers – from Harbin in the north to Zhuhai or Kunming in the south and southwest, are growing faster than China's primary economic centers. These emerging markets account for the majority of goods imported from the U.S. and are key beneficiaries of healthcare reform activities, airport expansion projects and a host of other infrastructure development.

However, doing business in China can be challenging. With bureaucracy, intellectual property rights, and lack of transparency among the pressing concerns, we hope this Handbook provides access to more knowledge, information and expertise needed for success in the China market. While there is no one-size-fits-all answer to doing business in China, you will find herein U.S. government assistance with initial market entry strategies and various business service providers offering approaches to due diligence and trade dispute resolution, emerging market profiles, and analysis of opportunities in various industry sectors.

Please make use of the resources in this Handbook and the knowledge and expertise that stand behind it to help you take the next step in entering or expanding your business in China.

Regards,

William Zarit
Minster Counsel for Commercial Affairs
U.S. Commercial Service, China
U.S. Embassy, Beijing

Contents

Ch 1 General Overview of Doing Business in China

By the U.S. Department of Commerce, U.S. Commercial Service

Market Overview

China responded quickly to the global economic downturn in 2008 and, as a result of a combination of monetary, fiscal, and bank-lending measures China's GDP grew 9.2 percent in 2009 and an impressive 10.3 percent in 2010. Projections are for the GDP growth to slow slightly in 2011 to between 9 and 9.5 percent.

Accompanying the rise in China's GDP, U.S. exports to China increased in 2010 by over 32 percent to almost US$92 billion. Of course, China's exports to the U.S. also increased by 23 percent, leading to a balance of trade deficit of US$273 billion. After falling in 2009, the trade imbalance with China is now on the rise again. China remains the U.S.'s second largest trading partner after Canada.

After near zero percent inflation in 2009, in 2010 consumer price index rose 3.3 percent, exceeding the authorities' target of 3.0 percent. Inflation reached 5.1 percent in December 2010, alarming authorities who undertook a multipronged effort to bring real estate prices, food prices and monetary liquidity driven by bank lending under greater control.

Inbound FDI rebounded after a dip in 2009, rising 17.4 percent in 2010 to almost US$106 billion. China is the world's second largest recipient of FDI after the United States.

China stands as the world's third largest market for luxury goods behind Japan and the United States, and some studies estimate that there are now more than 200 million Chinese citizens with a per capita income over US$8,000. Over the next several years, most economists predict a surge in the number of people achieving true middle class status.

Despite these remarkable changes, China is still a developing country with significant economic divisions between urban and rural areas, albeit one with vast potential. The number of migrant workers continues to remain high, with the number of laborers employed outside their hometowns at approximately 150 million in 2009. This number has appeared to remain static, however, with some areas, especially in the East, reporting shortages of such laborers and tightening wage situations. As of 2010, the per-capita disposable income of urban residents was RMB19,109 yuan (US$2,895), and the per-capita disposable income of rural residents stood at RMB5,919 (US$897).

Market Challenges

In addition to the large multinationals which continue to earn impressive returns on their exports to and investments in China's market, American small to medium enterprises (SMEs) are also active here. FCS counsels American companies that to be a success in China, they must thoroughly investigate the market, take heed of product standards, pre-qualify potential business partners and craft contracts that assure payment and minimize misunderstandings between the parties. Stumbling blocks foreign companies often run into while doing business in China can be grouped into these broad categories:

China often lacks predictability in its business environment. China's current legal and regulatory system can be opaque, inconsistent, and often arbitrary. Implementation of the law is inconsistent. Lack of effective Chinese government protection of intellectual property rights is a particularly damaging issue for many American companies. Both those that operate in China and those that do not have had their product IP stolen by Chinese companies.

China has a government that, in some sectors of the economy, is mercantilistic. China has made significant progress toward a market-oriented economy, but parts of its bureaucracy still seek to protect local firms, especially state-owned firms, from imports, while encouraging exports.

China retains much of the apparatus of a planned economy. A five-year plan sets economic goals, strategies, and targets. The State and the Communist Party directly manage the only legal labor union. The understanding of free enterprise and competition is incomplete in some sectors and political connections or goals at times trump commercially-based decisions.

Certain industrial sectors in China are prone to over-investment, leading to over-capacity, over-production, and declining prices in affected industries. Continued economic reform is essential for China to achieve high levels of economic growth. China's own leaders recognize a more balanced economy relying more on domestic demand and development of the service sector are essential for China to become a mature economic power. However, companies must deal with the current environment in a realistic manner. Risk must be clearly evaluated. If a company determines that the risk is too great, it should seek other markets.

Market Opportunities

The growth of imports from the United States in many key sectors, such as energy, chemicals, transportation, medical equipment, construction, machinery and a range of services, suggests that China will remain an important and viable market for a wide range of products and services. With growing numbers of Chinese traveling abroad for education and leisure purposes, China's contribution to U.S. educational institutions and the tourism industry is increasingly important as well.

More detailed information on commercial prospects in the services sector in Chapter 5, with a more extensive research available at the U.S. Commercial Service market research library at **www.export.gov**.

Market Entry

The U.S. Embassy and the U.S. Department of Commerce welcome contact with

American companies to initiate or expand exports into the China market. Two of the primary objectives of U.S. policy with regard to China are (a) creating jobs and growing the American economy by increasing exports, and (b) ensuring our companies' ability to compete on a level playing field. A company should visit China in order to gain a better perspective and understanding of its potential market and location. Especially given China's rapidly changing market and large area, a visit to China can provide a company great insight into the country, the business climate, and its people. Chinese companies respect "face-to-face" meetings, which can demonstrate a U.S. company's commitment to working in China. Prospective exporters should note that China has many different regions and that each province has unique economic and social characteristics.

Continued long-term relationships are key to finding a good partner in China. To maximize their contacts, companies should aim at forming a network of relationships with people at various levels across a broad range of organizations. U.S. companies commonly use agents in China to initially create these relationships. Localized agents possess the knowledge and contacts to better promote U.S. products and break down institutional, language, and cultural barriers. The U.S. Commercial Service China offers a wide array of services to assist U.S. exporters in finding Chinese partners through a network of five Commercial Service posts in China. They also have a partnership with the China Council for the Promotion of International Trade (CCPIT) to provide services in 14 other major cities in China. U.S. companies are strongly encouraged to carefully choose potential Chinese partners and take the time to understand their distributors, customers, suppliers, and advisors.

China is a challenging market and requires a strong understanding of a firm's capabilities and in-depth knowledge of the market. Before making a decision to enter the China market, potential exporters should consider their own resources, their past exporting experience, and their willingness to commit a significant amount of time to exploring opportunities for their products and services in China. The U.S. Commercial Service has developed a toolkit to help exporters understand some of these challenges; our "Are You China Ready" assessment is available at: **www.export.gov/china/doingbizinchina/index.asp**.

Selling U.S. Products and Services

Using Agent or Distributor

China's fast-growing economy attracts international participation, including exports from U.S. small and medium enterprises (SMEs). Unlike large international or multi-national companies that establish operations for branding, marketing and various business activities in China, SMEs with limited budgets, when expanding their business, usually start with fostering a sales network through regional agents or distributors. The discrepancies of business practices present challenges for U.S. SMEs to efficiently participate in the competition. Sales agents and distributors, however, can assist in keeping track of policy and regulation updates, both locally and nationally, collect market data, and quickly respond to changes. In addition, U.S. SMEs can take advantage of their agents' and distributors' existing networks and expand their business. Agents/distributors will also help in promoting new products and technologies.

Trading Companies

China's current regulations are designed to allow manufacturing-focused foreign invested enterprises (FIEs) to become export trading companies that may purchase and export any products or technologies free from quotas, license controls or government monopoly. FIEs are able to establish trading companies and to obtain trading rights before the phase-in of distribution rights. Chinese companies that are registered and have RMB 1 million (US$148,000) in capitalization can obtain an import/export license.

In 2005, the Ministry of Commerce (MOFCOM) issued documents outlining the application procedures for investors to establish new foreign-invested commercial enterprises (FICEs), for existing FICEs to open new distribution and trading businesses, and for existing FIEs to expand their business scope. The documents give provincial-level agencies the authority to review and approve applications. Currently, approval for new foreign enterprises occurs at the provincial level, and not the national level.

In 2006, MOFCOM issued a notice on "Entrusting Local Authorities with the Examination and Approval of Commercial Enterprises with Foreign Investment." While this decision to delegate approval authority to provincial-level authorities for most distribution rights applications has sped up the application process, technical challenges still remain. Existing foreign-invested manufacturers that have expanded their business scope are limited to distributing goods that they produce. Uncertainty over what constitutes "similar goods" has created difficulties for some companies seeking to exercise their distribution rights. In addition, existing manufacturers that have expanded their business scope to include distribution must ensure that half of their revenue stems from their buy-sell activity.

Distributors

A U.S. exporting company that hopes to successfully enter China must gain both trading and distribution rights. Distribution covers: 1) commission agent services, 2) wholesale services, and 3) retailing. Chinese law allows foreign companies to establish wholly-owned distribution entities for chemical fertilizers, processed oil and crude oil, as well as other imported and domestically produced products. Limits exist on products including books and periodicals, pharmaceutical products and pesticides. Foreign companies may choose one of two ways to acquire trading and distribution rights: they can set up a new, stand-alone FICE or apply to expand the business scope of an existing FIE.

Given the complexities of the Chinese market, foreign companies should also consider using a domestic Chinese agent for both importing into China and marketing within China. With careful selection, training, and constant contact, a U.S. exporter can obtain good market representation from a Chinese trading company, many of which are authorized to deal in a wide range of products. Some of the larger companies have offices in the U.S. and other countries around the world, as well as a network of offices and affiliates in China.

Local agents
China is witnessing an explosion in local sales agents who handle internal distribution and marketing. Most of these firms do not have import/export authorization. They are the next layer down the distribution chain, buying foreign products and importing them through entities that have an import/export license by paying a commission. They may be representative offices of Hong Kong-based or other foreign trading companies, or domestic Chinese firms with regional or partial national networks.

Given China's size and diversity, as well as the lack of agents with wide-reaching capabilities, it may make sense to engage several agents to cover different areas, and to be cautious when granting exclusive territories. China could be viewed as five major regions: the South (Guangzhou), the East (Shanghai), the Central/North (Beijing-Tianjin), West China and the Northeast.

Trade Promotion

An important vehicle for identifying prospective agents is trade shows and trade missions. In 2010, approximately 5040 trade events were held in 76 cities in mainland China. The total number of shows, many held in smaller cities, continues to grow between 15 to 20 percent annually. Of the 5040 shows, 837 were held in Beijing, Shanghai and Guangzhou.

In general, exhibitions can be excellent venues to gauge market interest, develop leads and make sales. Most are sponsored or co-sponsored by government agencies, professional societies, or the CCPIT. Some shows are organized by American, Hong Kong or other foreign show organizers. Show participation costs are sometimes high since pricing options for available booth space for foreign companies at shows is often limited to certain areas within events. Some shows may reach only a local audience or cater primarily to Chinese exporters despite being described as Import/Export Fairs. Therefore, companies are advised to scrutinize shows carefully before confirming participation.

In 2011, the Commercial Service will recruit and organize U.S. Pavilions at 28 trade shows around China in 16 different industry sectors. The U.S. Pavilion concept is part of the U.S. Department of Commerce's initiative to promote American goods and services in key Chinese markets. Updated information about these shows can be found at **www.export.gov/china**. In addition, upcoming Department of Commerce trade missions can be found at: **www.trade.gov/trade-missions**.

Further information on doing business in China including market entry approaches specific to various sectors, advertising, e-commerce, selling techniques and selling to the government, intellectual property rights, trade regulations, project financing and more, can be viewed in the China Country Commercial Guide. Find it in the U.S. Commercial Service market research library at **www.export.gov**.

Ch 2 Regions and Sectors to Watch

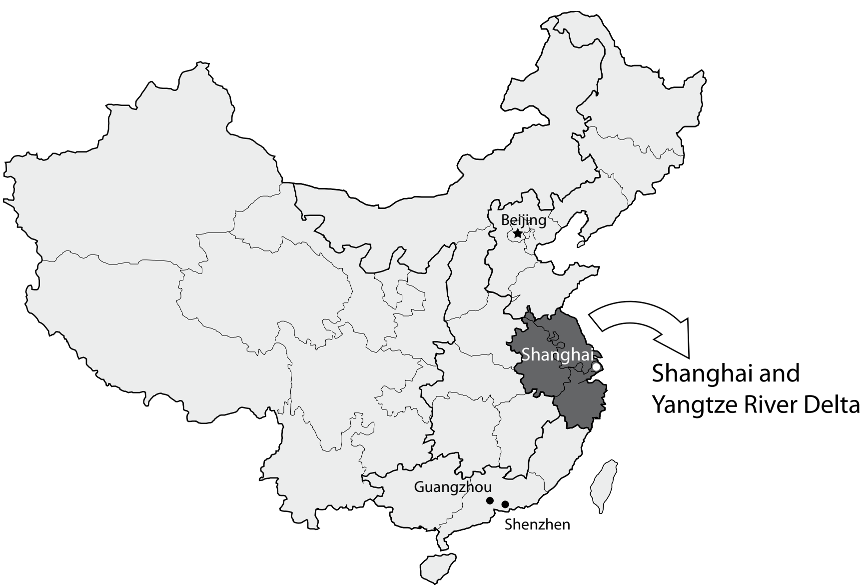
By Dezan Shira and Associates

China's first tier cities – Beijing, Shanghai, Guangzhou, Shenzhen – have been targeted by international players for many years now. While many international players enter into one of these cities to gain a feel for the Chinese business environment and Chinese market, the major potential lies outside of these household city names, in China's second and third tier cities. While the exact definition of which cities qualify in these categories varies largely by source and by geographic region, factors such as urbanization, the rising middle class, and improving infrastructure in these cities are increasingly pushing them onto the radar of foreign companies investing in China.

Below, we discuss a region of particularly heavy foreign investment and of rapid growth in second and third tier cities – the Yangtze River Delta (YRD) – and the contribution second and third tier cities are making nationally to China's rapidly rising middle class.

Yangtze River Delta Region

While Guangdong Province and the southern regions bordering Hong Kong received the lion's share of central government attention and FDI in the early stages of China's "opening-up and



reform" process, in the more recent stages of this process attention has focused on the YRD region, consisting of Shanghai municipality, Jiangsu and Zhejiang provinces. This area has historically been attractive to businesses for its easy access to China's largest sea ports and ready proximity to the inland provinces and today is considered the primary point of China establishment by most foreign companies.

Just as throughout the rest of China, business in the YRD region is focused on rapidly expanding cities and their peripheral suburban areas. While certain cities in the YRD have been China's economic powerhouses throughout a great recent history - Shanghai, for example – "second tier" cities are growing quickly and receiving increasing attention from international investors for their lower costs. In Jiangsu province, these up-and-coming second tier cities include Changshu, Changzhou, Nanjing, Suzhou, and Yangzhou, among others. In Zhejiang province, these include Hangzhou, Ningbo, and Wenzhou, among others.

Regional Economic Data, 2010

		Shanghai	Jiangsu	Zhejiang
GDP	Total	US$251.8 billion up 9.9%	US$610.49 billion Up 12.6%	406.36 billion up 11.8%
	Primary industry	US$1.7 billion down 6.6%	US$37.89 billion up 4.3%	US$20.2 billion up 3.2%
	Secondary industry	US$106.5 billion up 16.8%	US$324.67 billion up 13%	US$210.76 billion up 12.3%
	Tertiary industry	US$143.5 billion up 5%	US$247.89 billion up 13.1%	US$175.28 billion up 12.1%
Market indicators	Disposable income - urban	US$4751.9 up 7.1%	US$3424 up 11.6%	US$4083 up 11.2%
	Disposable income - rural	US$2051.6 up 11.5%	US$1360 up 13.9%	US$1687 up 12.9%
	Consumer price index	103.1	103.8	103.8
Investment indicators	Fixed asset investment	US$79.35 billion up 0.8%	US$346.06 billion up 22.4%	US$186.39 billion up 16.3%
	FDI - contractual	US$15.3 billion up 15.0%	US$56.83 billion up 11.4%	US$20.04 billion up 25.2%
	FDI - actual	US$11.12 billion up 5.9%	US$28.5 billion up 12.6%	US$11.0 billion up 11.1%
	Approved new FIEs	3906 projects up 26.4%	4661 projects up 10.5%	1944 projects up 11.9%

Shanghai

Since reform and opening, China's State Council and the Shanghai city government have begun to develop the city into an international financial and shipping center, similar in certain ways to Hong Kong. In 2010, Shanghai's GDP rose 9.9 percent, to US$251.8 billion.

The Pudong business district, the city's "growth engine" east of the historical center of the city, accounts for more than 20 percent of the city's GDP. Since Deng Xiaoping decided to develop the Pudong business district in 1990, Shanghai received a large number of central government grants and loans, allowing it to attract FDI and draw the surrounding YRD regions in its wake. The city aims to draw more foreign investment into six service sectors - modern logistics and transportation, financial services, exhibition and travel services, information services, professional services auxiliary to manufacturing, and entertainment. Shanghai's goal is to have 85 percent of the city's GDP from the service sector, primarily in the downtown areas.

The people's government of Shanghai has issued a set of regulations encouraging multinational companies (MNCs) to set up regional headquarters in the municipality. As of mid-2010, there were 281 regional headquarters of multinational companies and 311 foreign R&D centers in Shanghai. Major global companies have established businesses in the city over the last few years including Walt Disney, BASF, Munich Trade Fairs and Citigroup.

Furthermore, the government has introduced a number of initiatives in recent years including efforts to ensure a stable and adequate power supply, improvements to ADSL capacity with international internet service providers and strengthening of anti-IPR infringement measures. The government is making efforts to tackle its traffic congestion problems by improving the transportation infrastructure and introducing stricter measures to counter industrial pollution.

Jiangsu

Jiangsu is among the wealthiest provinces in China, with a GDP of US$610.49 billion in 2010, up 12.6%. Historically, Jiangsu has had a strong light industry sector, but recently heavy industry sector growth has become more prominent. The provincial and city governments have been focusing on fast-growing technology and capital-intensive industries and Jiangsu has become an increasingly important manufacturing base for the IT, petrochemical, and the pharmaceutical industries.

The southern part of Jiangsu province – Suzhou, Wuxi, Nanjing and the surrounding area – is booming, with southern cities like Suzhou and Wuxi having a GDP per capita around twice the provincial average. In Jiangsu province, Nanjing will focus on modern logistics, science and technology and cultural tourism, with the goal of becoming the modern service industry center north of the Yangtze River. The provincial government has tried to move labor-intensive industries from the south to northern cities such as Xuzhou, Huai'an, Yancheng and Suqian.

Jiangsu Province has the largest number of environmental protection-related firms in mainland China and excels particularly in the area of wind power. As a whole, Jiangsu province will establish 7000 MW inter-tidal and offshore wind farms by 2020. The primary city in this development is Nantong, which has a current wind power capacity of 992 MW and a targeted wind power and installed capacity of 3000 MW by 2015. In addition, an environmental technology based focusing on wind power development has been developed in Nanjing Economic Development Zone and the city of Huishan has a large Wind Power Science and Technology Industrial Park focused on renewable energy manufacturing and related R&D. A 1 GW offshore and inter-tidal wave project is also planned in the province.

Zhejiang

Zhejiang's economic success in recent years has been largely home grown and not built on central government investment or huge inflows of FDI. While this is starting to change as big multinationals relocate out of Shanghai and into the surrounding regions, the previous absence of outside help led to the development of an entrepreneurial spirit that some dub "the Zhejiang model." This model emphasizes small businesses that are responsive to market fluctuations, large local government investments into public infrastructure, and the bulk production of low cost goods for both domestic consumption and export. Cities in Zhejiang are known for specialization: Ningbo for suits, Shaoxing for textiles, Wenzhou for shoes, etc.

In 2010, Zhejiang province's GDP hit US$406.36 billion, up 11.8%. Zhejiang province's wealth comes from a manufacturing industry centered upon electromechanical industries, textiles, chemical industries, food and construction materials. One of the provincial government's major aims in the coming years is to develop the high-tech industries, particularly biotechnology, medicine, new materials and other related industries. This development will focus on three important economic belts: from Beilun to Ningbo and cities along the Shanghai-Hangzhou-Ningbo Expressway, including Shaoxing, Jiaxing and Huzhou; the coastal cities of Wenzhou; and along the Zhejiang—Jiangxi, Wenzhou—Taizhou railways.

The National Development and Reform Commission's Regional Plan for the Yangtze River Delta, published by the State Council in May 2010, lays out specific goals for cities in Zhejiang. These goals include:

- Hangzhou will focus on cultural creativity, travel and leisure, and e-commerce, and aim to become the center of the modern service industry in the south of the Yangtze River Delta
- Suzhou will emphasize logistics, technology services, business exhibition and travel and leisure
- Wuxi will mainly develop creative design and service outsourcing
- Ningbo will concentrate on the service industry of modern logistics and business exhibition

Summary

The economy of each geographic area of the YRD - Shanghai, Zhejiang, and Jiangsu - is developing in a fashion directly related to that area's individual circumstances: its historical industrial layout, central government attention, local government priorities, FDI incentives, etc. The second and third tier cities of Zhejiang and Jiangsu continue to grow, largely due to their close proximity to Shanghai, and the commonality among the economy of each of these areas is simple - growth and growth often at break-neck speeds.

China's Rising Middle Class

The number of middle class and affluent Chinese (those with household incomes exceeding 60,000 yuan or US$9,000) will increase to over 400 million by 2020, almost tripling the approximately 150 million in 2010. This intoxicating market potential has let to what some are terming the "in China for China" trend, in which foreign investors who once predominantly saw the country as a manufacturing center are increasingly looking for ways to sell to the country's rising middle class.

It's true that Chinese consumers – by and large young, fond of foreign brands and still formative in terms of taste and spending habits – have great potential as spenders. But attempts to sell to this group should involve much more strategy than simply setting up shop in Shanghai and hoping 1.3 billion people will bang down the door to buy what you're selling. In fact, getting Chinese customers to spend money can be tricky, as market researchers and the Chinese government alike are finding out. As in any market, successful selling to China's middle class requires an understanding of the consumer as well as the big economic picture that shapes their decisions.

Second and Third Tier Cities

A large portion of the growing middle class is currently concentrated in first tier cities – including Beijing, Shanghai, and Guangzhou – but the majority of this growth in this sector will be in second, third, and fourth tier cities. Additionally, such cities have smaller markets than first tier cities, but competition is – in the short run – less fierce. Foreign brands that have already been successful in the first tier cities have made the new consumer class emerging in the second- and third-tier cities central to their strategies. Untapped provincial cities and "country towns" of more than a million residents will be critically important in the race to reach the Chinese middle class.

Non-first tier cities are the place to find Chinese consumers for operational costs and market saturation reasons as well. In small-city markets are less consolidated than markets in larger cities and therefore offer more opportunities for market entry. In addition, studies reveal that consumers in small cities demonstrate greater consumer confidence and larger discretionary budgets, creating more growth in spending.[1] Not only are consumers in non-first tier cities hungry for more variety of foreign goods and increasingly able to pay for them, but profit margins could be much higher as real estate, labor and advertising costs (while rising) are nonetheless significantly less than Beijing or Shanghai prices. Limiting yourself to first-tier cities may mean losing out on this long-term potential.

A Culture of Frugality?

Chinese consumers have gained a reputation as savers, with one of the highest savings rates in the world, approximately 25%. Analysts attribute this rate to a combination of the cultural value placed on frugality and the lack of social benefits like free education, universal health insurance and retirement benefits. In 2010, there was a good deal of political discussion about shifting the country away from growth based on exports and infrastructure to a domestic consumer-driven economy. This was particularly the case in 2008 and 2009, with the global financial crisis and its immediate effects. Exports accounted for as much as 70% of growth before 2009 and then dropped off about 25% amidst the global economic downturn of 2008-09, making it painfully clear that stoking domestic consumer spending will be the key to maintaining strong economic growth in the future. Analysts have recently been quick to point out that while the 12th Five Year Plan (2011-2015) mentions the necessity of boosting consumer demand; it does so only briefly. However, government action to encourage consumer spending may be irrelevant; the pure size of the rising middle class is creating a Chinese consumer base with intoxicating potential.

One key illustration of this is the role of luxury goods. China is a hot spot for big international luxury brands like Tiffany, Rolls Royce, Gucci and Louis Vuitton. In 2010, sales of luxury goods in China increased by 23 percent and the overseas purchase of luxury goods of Chinese people increased by 30 percent, as announced by the Chinese Commerce Minister Chen Deming. China's luxury market is expected to hit 14.6 billion U.S. dollars by 2015, according to estimates published by Xinhua News Agency. Sales of luxury brands are proof that Chinese customers, though frugal, are willing to spend on the right products, and will sometimes pay much more for a foreign brand if they think it is better quality and therefore a better investment. Scandals involving shoddy, fake and sometimes even poisonous domestic goods that shocked American and European consumers have shaken Chinese consumers as well. Foreign retailers have cashed in on this preference, and have also found that the young generation of affluent Chinese aspires to own name brand foreign goods. This opportunity is not just for high-end luxury retailers.

[1] *The Boston Consulting Group. "Big Prizes in Small Places." 2010.*

Ch 3 Business Advisory

By Dezan Shira and Associates

Choosing Your China Structure

Foreign investors have several choices when it comes to structuring a China enterprise: the representative office, the joint venture, the wholly foreign-owned enterprise and the foreign-invested commercial enterprise.

When deciding among the various entities, you must first consider why you want to make an investment in China. You will need to address questions such as:

- What do you need to do in the country now? What about a couple of years down the line?
- Do you need to hire your people on the ground and rent an office?
- Do you need to invoice locally for services or products?
- Are you getting a feel for the market or have you decided to commit to a larger scale operation?
- Are you planning to set up a trading or production-oriented entity or do you need only a representation in the country to carry out market research or liaison activities?

Each entity has different features that can help or hinder your China venture, so using care and foresight to choose the right structure will be invaluable for long-term success.

Representative Offices

Representative offices (RO) are organizations established by foreign companies to carry out liaison activities in China. ROs are the least dynamic of the entities for establishing a foreign presence in China. The administrative regulations on ROs issued by the State Council in November 2010, which took effect in March 2011, specify that the activities that ROs are permitted to engage in include (i) market research, display and publicity activities that relate to company product or services; and (ii) contact activities that relate to company product sales or service provision, and domestic procurement and investment. ROs are forbidden from engaging in any profit-seeking activities except for those which China has agreed on in international agreements or treaties. As such, an RO may not directly invoice for sales or services in China and can only interact with Chinese businesses indirectly. In addition, a parent company must have been in existence for two years to establish an RO.

While ROs have little control over the movement and sale of goods and services, as the extended arm of overseas parent companies, they can be very helpful in facilitating market entry by coordinating sourcing activities and marketing, and establishing trade ties between the parent company overseas and the entities in China. They can also act as a liaison in matters relating to orders, shipping payments of taxes, and repatriation of money.

It is important to note, however, that while there is no capital requirement for setting up an RO, they are taxed on their business expenses. A circular issued by the State Administration of Taxation on February 20, 2010 explicitly stipulates that ROs must pay corporate income tax on their taxable income, as well as sales tax and VAT, and will be required to assess CIT liability using either the cost plus method or actual revenue method.

Because of this, it may be less expensive for foreign companies under certain circumstances to establish a Wholly Foreign-Owned Entity (WFOE) as revenues can be balanced with expenses, resulting in lower taxes.

Wholly Foreign-Owned Enterprises

A wholly foreign-owned enterprise (WFOE) is a company that is set up with funds paid only by foreign investors. The WFOE has become the investment vehicle of choice for the international investor wanting to engage in the manufacturing, service or trade sectors in China. In addition to the WFOE's expansive business scope, its unrivaled popularity arises from multiple other factors:

- 100 percent foreign ownership and control
- Security of technology and intellectual property rights
- Self-developed internal structure
- Insertion of existing company culture
- Ease of disinvestment and strategic decisions
- Possibility of hiring more foreigners (vs the 4 maximum allowed under a RO structure)

Joint Ventures

A joint venture (JV) is company formed by a foreign investor or investors, or a foreign individual, and a Chinese company. Forming a JV in China can be a successful endeavor as long as each side's goals, contributions and responsibilities are mutual and understood. It's crucial for foreign investors to understand the purposes of joint ventures and whether their Chinese partner is capable of fulfilling them.

Types of JVs

There are two types of JVs in China: the equity JV and the cooperative JV, sometimes known as the contractual JV.

An EJV is a joint venture between Chinese and foreign partners where the profits and losses are distributed between the parties in proportion to their respective equity interests in the EJV. The foreign partner should hold at least 25 percent of the equity interest in the registered capital of the EJV. The company enjoys limited liability as a "Chinese legal person."

The CJV is a very flexible FIE where Chinese and foreign investors have more contractual freedom to structure cooperation. It is a joint venture between Chinese and foreign investors where the profits and losses are distributed between the parties in accordance with the specific provisions in the CJV contract, not necessarily in proportion to their respective equity interests in the CJV. CJVs have the option to operate either as a limited liability company or as a non-legal person.

There are significant operational differences between the contracts and laws governing EJVs and CJVs, including in terms of liability status, management structure, contractual obligations, capital contributions, profit sharing and equity ratios and reclaiming capital investment.

Foreign-Invested Commercial Enterprises

A foreign-invested commercial enterprise (FICE) is a WFOE or a JV established to engage in import and export as well as domestic distribution in China. Previously, foreign companies were restricted in their abilities both to purchase domestically and then re-sell domestically in China.

In 2004, China's distribution and retail sector was liberalized, permitting foreign-invested commercial enterprises to conduct the following activities:

- Import, export, distribution and retailing
- Retailing – selling goods and related services to individual persons from a fixed location, as well as through TV, telephone, mail order, Internet and vending machines
- Wholesaling – selling goods and related services to companies and customers from industry, trade or other organizations
- Representative transactions on the basis of provisions (agent, broker)
- Franchising

A FICE brings the control needed to secure quality, service level and bring you closer to your suppliers as well as enable you to invoice your clients in Chinese currency.

There are limitations, however. A FICE cannot change the nature of the product but only sell what it has purchased. Additionally, certain products – such as books, periodicals, newspapers, automobiles, medicines, salt, agricultural chemicals, crude oil and petroleum – face some ownership barriers. Namely, if a foreign investor in China has more than 30 retail stores that distribute products such as books, magazines, processed oils from different brands or suppliers, the foreign investor's share in the retail enterprise is limited to 49 percent.

Foreign investors interested in international trade should also know that FICEs can now obtain their own import/export license.

Obtaining additional licenses for importing and exporting specific goods can become difficult though it is necessary in certain cases.

Set-up Considerations

When structuring your WFOE or JV, you need to pay attention to the following:

Business Scope

Ensure your business scope is accurate and genuine. The requisite administrative government offices may quickly pass your proposed business scope, but that does not mean you are finished. Your proposal will then make its way to the state and local tax bureaus, and they will also thoroughly check your application. Any attempts to fool the tax bureau into thinking you are producing one thing when you are actually producing another will inevitably fail in the long run. Companies in China can only operate within the business scope approved by the authorities. The business scope article within your articles of association will define exactly what your company is going to do.

Minimum Registered Capital

Registered capital requirements are used as an entry barrier to ensure foreign-invested enterprises are of sufficient quality and financial strength.

According to the law, the legal minimum capital requirement is as little as RMB30,000 for multiple shareholders investments but immediately jumps to RMB100,000 for entities where only one shareholder is present. In reality, however, the minimum capital requirements vary drastically by location and industry. People are often duped into attractive but untenable minimum capital requirements proffered by local magistrates trying to meet their quotas. This will lead to complications with the central and local tax bureaus, both of whom will be intimately involved in your business life. It might be helpful to note that your registered capital is also your limited liability. It could become a deal-breaker if a potential client wants to do business but cannot determine whether or not you are sufficiently capitalized.

Choosing your China Structure

Type of Structure	Legal Status	Common Purpose(s)	Pros	Cons
Representative Office (RO)	No legal personality	• Market research • Planning longer-term ventures • Liaison with home country companies	• Inexpensive to set up • Allows exploration of the market and liaison activity	• Cannot invoice locally in RMB • Must hire staff from local agency
Joint Venture (JV)	Limited liability legal personality (in most cases)	• When restrictions require a local partner • When a local partner can offer e.g. sales and tangible benefits distributions channels	• Use of existing facilities and workforce • Use of existing sales/ distribution channels	• Management can be awkward, inheriting staff liabilities • Overinflation of assets or sales by the Chinese partner during JV setup and negotiation • Technology transfer/ IP/ • management risks, split profits
Wholly Foreign-Owned Enterprise (WFOE)	Limited liability legal personality	• Most manufacturing businesses (for China sales or export) • Service businesses	• 100% ownership and control • More flexible business scope • Security of technology/ IP, development of own infrastructure • Insertion of existing company culture • Allowed to convert RMB into foreign currency for profit repatriation	• Need to fund total investment capital requirement • Development of China sales operations on your own
Foreign-Invested Commercial Enterprise (FICE)	Limited liability legal personality	• WFOE or JV mainly used for trading, distribution, retail	• A specialized structure for trading, retailing and distribution	• High registered capital requirements for trading

Working Capital

The amount of working capital required until a business is self-sufficient is often underestimated. When the time comes, do not simply put in the minimum registered capital requirement during initial capitalization as you may later find the business is under-capitalized, unable to pay its bills and out of funds. Injecting (increasing) capital is costly in terms of time and money. Do consider what your business really needs to be self-sufficient rather than what the minimum capital is unless you are sure that you can immediately generate positive cash flow in your China entity.

Bear in mind about the taxes involved in the venture, from value-added tax (VAT) to business tax and corporate income tax. VAT may have a negative impact on your cash flow if you were in trading or manufacturing for an initial period of time so it is advisable to do a cash-flow projection to assess the real financial requirement of your entity. Many new businesses do not cater for this as initial working capital (as part of their registered capital requirements), leaving them short of cash later on. Again, factor in your working capital requirements as your registered capital amount as opposed to any "minimum" suggestions.

Total Investment

Registered capital and total investment figures are both required during the application procedure. Total investment is the amount necessary to realize the company's operations, while registered capital is the equity pledged to the local authorities. The difference between registered capital and total investment represents the debt of the investment and can be made up by loans from the investor or foreign banks. Pay attention to the relationship between registered capital and total investment in case you need to obtain further debt or other financing from your holding company or other financial institution. Keeping this window open will cost you nothing, but closing yourself off from further financing by equating registered capital and total investment may leave you handcuffed. The payment schedule of the registered capital also needs to be specified in the articles of association. The investor may choose to pay it as a lump sum or in installments.

Set-up Process

Setting up a WFOE or JV, beyond being a complicated application process, is also a lengthy one due to the requisite translations and multiple bureaucratic departments. The process can be divided into two parts: pre-business license (i.e. before the entity formally exists) and post-business license (i.e. after the entity formally exists). Pre-business license includes name registration, feasibility study report, environmental protection valuation report (for manufacturing entities), and articles of association, among other steps.

After the Certificate of Approval is issued by the local office of the Ministry of Commerce and the entity is registered with the local branch of the Administration of Industry and Commerce (large incorporations and those in restricted industries will need to register with the State Administration of Industry and Commerce), the entity legally exists. The post-business license process includes approval for making chops issued by the

Public Security Bureau, Enterprise Code registration with the Technical Supervision Bureau, RMB bank account opening, customs registration, commodity inspection registration with Entry-Exit Inspection and Quarantine Bureau, injection of capital and the capital verification report, among other steps.

Intellectual Property Rights in China

China is notorious for a counterfeit industry that creates and sells virtually any imaginable product – watches, DVDs, CDs, clothing, art, toys, and electronics – for a fraction of the price of the original brand. Tourists and frugal Chinese consumers may love these products, but they can do serious damage to businesses. The film and fashion industries aren't the only ones who should be concerned about intellectual property rights either counterfeiting affects products in all industries and is not restricted to luxury goods or famous brands.

The quality of Chinese IP laws has risen to meet international standards, but enforcement has lagged behind and remains a major problem. Western countries have reacted to poor enforcement by threatening to initiate WTO procedures against China for non- compliance. Private companies have also pursued their causes, as in early 2009 when several major fashion brands successfully pressured Beijing's Silk Street Market to shut down vendors of counterfeit goods. The Chinese government itself has launched campaigns against counterfeiters, but fake products of all kinds are still ubiquitous in China and IPR infringement is still one of the major risks for any foreign company here.

Having the right strategy to protect IPR is imperative for any foreign company that wishes to benefit from the opportunities that the huge Chinese market provides. IP registration will help give your company exclusive legal property rights in the Chinese market as well as increase your competitive and export value and even act as a mark of professionalism upon meeting with your Chinese counterparts. Companies that do not do business in China would be wise to also file for IPR rights in China as there are numerous cases of counterfeit China-made products making it to third countries.

It is alarming how many companies do nothing to protect themselves, even though they are fully aware of the IPR related risks in China. Surveys conducted by national chambers of commerce reveal that many companies from the United States and Europe currently do not use existing legal measures to defend their IPR – most have not even filed for their IP rights. In reality, there is much that can be done to proactively protect intellectual property in the China market.

Overview of China's Intellectual Property Laws

The Chinese government's stake in curbing IPR infringement goes beyond simply making good on the WTO's conditions. The government wants China to become an innovative country and sees intellectual property as an increasingly strategic resource in national development and a core element in international competitiveness. China has joined several international agreements to protect intellectual property; drafted and promulgated domestic IPR laws; and established specialized courts, registration procedures, enforcement processes, and training programs.

As an international investor, you may already be familiar with some of the major international agreements regarding IPR. China has signed onto most of the major WIPO agreements, including:

- *The Madrid System for the International Registration of Marks*
  Allows property holders to apply for trademarks from one centralized, international entity and receive a bundle of trademark rights from many member countries.

- *The Berne Convention for the Protection of Literary and Artistic Works*
  Promotes equal enforcement of international copyrights by requiring its members recognize the copyrights of other member countries just as they would in their own country.

- *The Paris Convention for the Protection of Industrial Property*
  Allows inventors to file for patents in several countries with the same priority date, thereby reducing the risk of losing novelty while waiting for other patents. It also allows the inventor to wait for the results of the first filing before spending money on further filings in other countries.

In addition to international agreements, the various types of IP rights are defined in the Copyright Law, the Trademark Law, the Chinese Patent Law (revised in 2008 to expand protection) and the Law on Unfair Competition. The 2010 Chinese Tort Law also addresses intellectual property rights, such as copyrights, patent rights, trademark rights, etc and is also the only Chinese law to address issues in relation to contributory infringement and consequential liability. Further regulations and interpretations issued by the Supreme Court aim at clarifying certain questions such as IP right infringements on the Internet.

Getting Protection

Copyrights

The following works are protected under China's Copyright Law:

- Literary works
- Oral works
- Musical, drama, dancing
- Fine art, photography
- Movie, television, and video works
- Engineering design, product design with illustrations
- Maps
- Other works protected by laws and administrative regulations

Unlike patents and trademarks, copyrights don't have to be registered with the Chinese bureau. Because China is a member of the Berne Convention, work will be automatically protected in China as long as the creator's country is also a member or the work has been first published in a member country. Registering can be helpful, however, to serve as evidence if legal enforcement actions do become necessary. Each province or municipality has a patent office with jurisdiction over registration of works of authors or other copyright owners.

Trademarks

A trademark is any word, phrase, symbol, design, combination of colors, product configuration, group of letters or numbers, or combination of these used by a company to identify its products or services and distinguish them from the products and services of others. China maintains one of the world's largest trademark registries with a total of about 4.48 million valid trademark registrations as of the end of 2010. China is a first to file country in trademarks, which means that you should file as soon as possible. Four kinds of trademarks are recognized by the Trademark Law in China:

- General trademarks, in which "trademarks for goods" and "trademarks for services" are included
- Collective marks, signs which are registered in the name of bodies, associations or other organizations to be used by the members thereof in their commercial activities to indicate their membership of the organizations
- Certification marks, signs which are controlled by organizations capable of supervising some goods or services and used by entities or individual persons outside the organization for their goods or services to certify the origin, material, mode of manufacture quality or other characteristics of the goods or services
- Well-known trademarks, marks that have a strong reputation among the relevant public in China—where a dispute arises in the procedures of trademark registration and the party concerned believes that its trademark constitutes a well-known trademark, it may request the Trademark Office or the Trademark Review and Adjudication Board to determine whether its trademark fulfills the criteria for a well-known trademark

Even though China is party to the major international agreements like the Madrid system, trademarks and patents are only protected in China if they are registered with the Trademark Office of the State Administration for Industry and Commerce in Beijing. An authorized trademark agency must file on behalf of a foreign company. China uses the International Classification of Goods and Services, which sets out 45 classes of goods and services, meaning owners must apply separately for each category in which protection is sought. It's also wise to register a trademark in both the original and in the Chinese language, as another company might register the Chinese version if the trademark is only registered in the original language.

Usually, the TMO makes its decision whether or not to accept an application for registration within 24-30 months of the date of application. After acceptance, the TMO publishes the mark in its journal, beginning a three month "opposition period" during which the public can challenge the application. Assuming no objections are raised, the TMO will issue a registration certificate. An applicant with a rejected trademark application may apply for review to the Trademark Review and Adjudication Board within 15 days of the date on which they receive notification, or may institute proceedings in the People's Court within 30 days.

Once registered, a trademark is protected in China for ten years from the date the registration is granted. The registration can be renewed indefinitely for additional ten year periods, but renewal procedures must be started no later than six months after the expiration date. Under Chinese law, use of the trademark is mandatory. Three consecutive years of non-use from the day of grant puts the trademark registration at risk for cancellation. The cost of filing a trademark application per mark per class for any language is approximately US$480, including the agent fees, official fees, and disbursements.

Patents

Hoping to increase China's competitiveness in science and technology innovation, authorities revamped the national Patent Law in December 2008. The new law sets out a stricter patent application and strengthens patent protection by raising fines for counterfeiters, clarifying the legal process and strengthening administrative powers to investigate patent violations. It also incorporates infringement determination standards, extends the scope of infringement exemptions and clarifies stipulations on compulsory licenses.

Patents can be obtained for inventions (or "patents" in the strict sense or according to the international terminology), designs, and utility models.

- Inventions are new technical solutions relating to a product, a process or an improvement thereof. This means that any innovation in the field of technology is patentable. However it is important that the result of the innovation is something materially perceivable. That is the meaning of the word "technical."

- Design patents protect ornamental or aesthetic aspects such as shape, surface, patterns, lines or color. Industrial designs are applied to a wide variety of products: technical and medical instruments, luxury items like watches and jewelry, housewares and electrical appliances, vehicles and architectural structures, textile designs and leisure goods.

- Utility models, which are like patents but shorter-term and easier to get, can help protect inventions in China. Utility models and designs are only subject to a preliminary and often superficial examination, and the Patent Office will only look deeper if an invalidation procedure is filed, usually parallel to court infringement lawsuits.

In order to be granted a patent right, the invention or design must possess novelty, inventiveness and practical applicability.

- Novelty means that before the date of filing the same invention or utility model has not been publicly used or made known to the public.
- Inventiveness means that compared with the technology existing before the date of filing, the invention has prominent substantive features and represents a notable progress and that the utility model has substantive features and represents progress.
- Practical applicability means that the subject matter of a patent application for invention or utility model must be one that can be made or used industrially and produce positive effective results.

An application form, detailed description of the product and an abstract should be directly submitted in Chinese to the filing office of the State Intellectual Property Office (SIPO) in Beijing, or to a government patent agency established in cities like Shanghai, Shenyang and Chengdu. Foreign companies cannot apply directly for a patent and must go through an ad hoc appointed Chinese patent agent. If the application materials are in place and other formalities met, SIPO will publish a preliminary approval of the application within 18 months or earlier if a request is made. Next begins a "substantive examination" that can take as long as two to four years. For utility models and design patents, the application will be carried out much faster - designs can take 10-12 months, utility models about 12-18 months - because these are merely checked for formalities and published in SIPO's journal, not examined for substance.

Patent applications with up to 10 claims cost about US$1,650, including official fees and fees for a Chinese patent agent but excluding translation fees. After approval, a registration fee of approximately US$150 and the first annual fee of US$110 must be paid. Patents for invention are granted for a period of 20 years from the date of filing, while utility model and design rights get 10 years. Patent holders pay annual maintenance fees and can lose rights if they fail to comply with the fees. Applicants who are rejected can request a reexamination from the Patent Reexamination Board within three months from the date of receipt of notification. The PRB's decision can be appealed to the People's Court within three months from notification.

Foreign investors operating R&D centers or other forms of invention development contracts in China should note that national applications are mandatory when inventions are made in China by Chinese citizens or a Chinese entity. Inventions developed by a Chinese sister company or R&D center of a foreign company might belong to the Chinese entity and as such must be filed for patent in China before being filed abroad. In many instances foreign companies comply with this provision by letting the Chinese sister company file for a Chinese patent and subsequently filing a PCT application. However, contracts might also be construed to create direct ownership of the invention and therefore allow the foreign mother company the right to apply for patent directly.

Additional steps to protect IPR

There's no substitute for legal protection, but avoiding legal battles with basic preventive strategies should be your first line of defense. While filing for patents or trademarks does entitle you to defend yourself legally, these rights will not completely protect the content of your intellectual assets. It is highly recommended, therefore, to combine IP rights with other protection mechanisms.

Carefully monitor intellectual property

It's not easy in a huge market like China, but detecting counterfeiters early on will help contain the damage. Watch the internet and relevant publications, visit trade fairs and exhibitions and do on the-spot market research. The longer an infringer has to establish counterfeit products, the higher the cost of fighting them and the more damage is done to name recognition, trust in the brand and market share. If need be, specialized investigation agencies can monitor your IPR and secure evidence that will be accepted in court.

Adopt a strict confidentiality policy

Preempting any legal battles with a careful policy of strict confidentiality is one of the best protection methods, particularly for long-lasting products or technologies. Think of how Coca-Cola has managed to keep secret its famous recipe much longer than the lifetime of a patent would have allowed. Keeping access to IP confidential is a simple and effective way to protect recipes or production procedures for any product that can't be simulated easily.

Prepare a company procedure for handling IPR theft

Outlining a company procedure on how to handle potential IPR infringement problems is an integral part of IPR planning. Developing a plan will help create awareness inside the company towards the threat of infringement and will prevent a hasty and perhaps imprudent response should any IPR threats surface.

Use security measures

It can be difficult to keep technology confidential when products are in the market as many technological traits can be re-engineered. In these cases, a variety of protection measures can be applied for all kinds of products. Security experts recommend using three to ten security features and changing them on a regular basis in order to stay one step ahead of potential copiers. Some of the most common safety measures according to the level of sophistication are (low to high):

- Holography, watermarks, temperature sensible colors, color-shifting ink, mechanisms to prevent unauthorized opening
- Invisible, UV/IR reflecting color, micro writing, colors that are only visible with filters, radio-frequency identification (RFID) tag
- Bar code, matrix code, encrypted matrix code
- Digital watermarks, taggants (either a radio frequency microchip used in automated identification and data capture or chemical or physical marker added to materials to allow various forms of testing), cryptographic data protection

Security measures can serve two purposes: preventative protection against counterfeiting, or a means of generating evidence in case of a lawsuit or administrative action against illegal copies. Preventive measures include all features that can be recognized by non-experts, such as safety features on money bills. Measures that provide evidence are usually hidden and demand a complex procedure. Continuous tracking of each product guarantees the highest standard of protection against counterfeiting. However, the implementation of such a complex tracking system is expensive and may not be justified, even when the positive secondary effects such as quality control and logistics are considered.

Responding to IPR infringement

IPR infringement cases should be handled with care – a hasty reaction or vague accusations could trigger a lengthy legal battle with bad results for the rights holder. Most importantly, think through each step and identify which of the available options will be most strategically advantageous to your case. Preparing for such events will make handling them much easier when the time comes.

Consult legal experts when appropriate and remember the following rules of thumb:

- Gather as much information about the counterfeiter as possible
- Define the strategic issues that demand immediate action
- Decide at the management level whether to fight the infringer immediately or monitor development further
- Discuss thoroughly the available channels for fighting the counterfeiting activities
- Compare the costs and consequences of different scenarios for responding to the infringer

The IPR environment is certainly less than ideal in China, but the situation is improving and many methods of defense, both legal and practical, are already available to foreign companies. Governments and major international brands are likely to keep up the fight in pressuring the Chinese government to enforce its existing laws, and China itself is discovering its own vested interest in protecting IPR as well. Being informed on China's laws and the international standards as well as keeping up with changing laws and enforcement trends will be invaluable to any foreign investor in China.

Addresses and links

U.S. Department of Commerce
Information and resources to help American companies protect their IP.
Website: www.stopfakes.gov

World Intellectual Property Organization (WIPO)
Website: www.wipo.int

State Intellectual Property Office
No. 6, West Tucheng Road, Haidian District, Beijing 100088, China
Phone: +86 10 62085588
Website: www.sipo.gov.cn
(English version available)

Trademark Office of the State Administration for Industry and Commerce
No. 8, Sanlihe East Road, Xicheng District, Beijing 100820, China
Phone: +86 10 68052266
Website: www.ctmo.gov.cn
(English version available)

National Copyright Administration
No. 85, East Fourth South Ave, Beijing 100703, China
Phone: +86 10 65127869
Website: www.ncac.gov.cn
(Chinese only)

Copyright Protection Center
Wuhua Building, Chegongzhuang Ave, Beijing 100044, China
Phone: +86 10 68003887
Website: www.ccopyright.com.cn
(English version available)

Music Copyright Society of China
Jingfang Building, 5/F, No. 33, Dongdansantiao, Beijing 100005, China
Phone: +86 10 65232656
Website: www.mcsc.com.cn
(English version available)

China Audio and Video Association
No.51 NanXiaoJie ChaoYangMen, DongCheng, Beijing 100001, China
Phone: +86 10 6512 2882
Website: www.chinaav.org
(English version available)

Ch 4 Looking Beyond the Initial Investment

By Dezan Shira and Associates

Labor

New Recruitment

Cross-cultural differences in the hiring process, compensation, and employer-employee relationship expectations can make recruiting and retaining staff in China a tricky affair. It is therefore advisable to develop a comprehensive recruitment system for your company before embarking on the process to prevent unnecessary problems or high staff turnover.

A few things to keep in mind:

- *Oral and written language skills matter for all staff*
  Language is one of those aspects of a CV that can be, and often is, easily overstated, but appropriate English language skills are critical for ensuring daily operations; it is much easier to train personnel on the in's and out's of a particular business than to teach them communication skills in a particular language. Do what you can to check language skills, as many Chinese staff have their friends write their English CVs and many foreign staff may overstate their Chinese proficiency. Note also that regional dialects can enhance or limit the ability of your staff to operate locally – for example, if you really want to get something done in Shanghai, hire someone who speaks Shanghainese.

- *Local knowledge, experience, and language skills matter for international staff*
  It's not a good idea to hire only international staff have little to no local experience. Make sure to also look for expats who have had extensive experience working in the local environment, as they can bring both professional expertise and a working knowledge of China and the numbers of such available people in China are greater than ever before.

- *Don't neglect background checks and references*
  This aspect of the recruitment process is often neglected but is extremely important, as candidates can "hide" behind vague information, falsified medical records, or unexpired employment contracts and/or non-competition agreements with former employers. Taking a closer look now can help avoid future costs.

- *Maintain checks and balances in your corporate control*
  Having one person in control of all corporate documents and/or banking presents obvious risks. Pay particular attention to who holds the position of legal representative (and can therefore sign on behalf of the company) and who handles the chop (official stamp to authenticate documents on behalf of the company).

- *Be aware of the role of personal family business relations*
  Personal family business relations continue to be a significant and common aspect of the business environment in China; it is not unusual for Chinese

staff to give preference for supply or contract agreements to businesses owned by family members, which leaves your company susceptible to higher-than-market costs and possible noncompliance with regulations. Audit purchasing and sales department regularly to ensure that employees are not placing orders with companies owned by friends or relatives that are then charging the business at above market rates.

For representative offices, it is required that local staff be employed through a local agency. Foreign Enterprise Service Corporation (FESCO) is the most commonly referenced term here, but note that this is not one agency but rather is used in the names of many different agencies across the country. But even for other types of offices, it may be both time-efficient and economical to enlist the services of a well known HR employment agency in China. In brief, this method will allow you to "outsource" the initial candidate selection process to the agency, as well as any government-related employment, welfare, and retirement policies that apply.

Finding skilled and English-speaking professionals in China can often be a difficult exercise without the help of reliable local knowledge and expertise of the candidate market. Letting a service provider refer candidates to you will also allow you to focus more of your efforts on business development rather than human resources issues. As a "contract for service" is signed between the foreign entity and service provider, any particular requirements you have in terms of company culture, job description, incentives, and termination policies will be supplemental to the base work contracts signed between the agency and candidates.

Staff Recruitment in Joint Ventures

When entering into a JV or acquiring a Chinese business, you may find yourself taking on significantly more than you bargained for in terms of staff liabilities. Here we outline how to avoid these staffing situations, which are particularly prevalent in China's state-owned enterprises.

- *Employee contracts and terms*
  Review all employee contracts and personnel records when inheriting staff, checking that the employees actually exist, scrutinizing contracts and identifying all costs of employing them. Details of any recorded misdemeanors should also be scrutinized as well as time-keeping/productivity records.

- *"Ghost" employees*
  It is not uncommon for someone within the company to be claiming and receiving salaries for employees who have long left the company, retired, or even died. Check that all contracts and the payroll are matched with specific, individual identification of each employee.

- *Qualifications and longevity of staff employment*
  Sometimes the staff members that get transferred to joint ventures are incompetent or come with significant pension/termination liabilities, which the JV will pick up backdated to when the employee joined the Chinese party, not the JV. Termination is a minimum of one month's salary for every year of service. Do you really want to be inheriting staff

with 12 years of service? Consequently, you could inherit huge headaches if these are not fully identified and assessed.

- *Hidden employees*
  Some Chinese operations hide their true staff overheads by making off-the-record payments. However, staff still have legal claim as employees of the business. Ensure that the headcount and payroll match, and request a written statement from the Chinese side taking on liabilities for any staff not individually identified in any transfer of assets.

- *Labor unions*
  Make sure you have identified their charter, and payments that have been made to the union. The business has a liability here of 2% of all staff salaries to be paid to union funds so ensure you know what this is, and again, that it matches up against payroll.

- *Pension fund*
  Has this been properly administered and are the assets that should be in the fund all accounted for? You need to check with the relevant government departments that all is in order and get a statement accepting that retrospective liability is signed off by the Chinese side.

Labor Law

In June 2007, China's top legislature, China's top legislature, the National People's Congress, adopted a new labor contract law that became effective January 1, 2008. Among other key points, this law protects workers' legal rights by demanding a written contract. It is the country's first law governing the establishment, revision, and termination of labor contracts in the People's Republic of China. This new law is designed to mitigate poor working conditions, minimize labor-management disputes, and stabilize the job market. Under the previous labor contract system, employers could terminate contracts without notice, withhold workers' wages, and refuse to renew contracts. The new law is decidedly pro-worker, and includes many provisions that protect laborers who are in a disadvantaged position in the market economy.

Some key points:

- *Fixed term contracts*
  A written contract between the employer and employee is required; if no contract is provided then the employment relationship will commence from the employee's first day of work. A written contract should be signed within one month of starting work, and an employer who fails to provide such a contract after one month will be forced to pay the employee twice their monthly salary. The law only allows for two continuous fixed term contracts. Any further contracts must be, in general, open term contracts.

- *Labor Record Handbook*
  The labor record handbook - which should include information on working hours, holiday standards, overtime working, sick leave, medical care, security at work, duties and responsibilities, etc – should be signed by the employee along with the contract. This handbook assists with evaluating employee performance and can be used as testimonial proof should a labor dispute arise.

- *Working Hours*
Working hours must be in accordance with the local regulations, which normally are eight hours per day and 40 per week (if an extension it required for special reasons, it must not exceed three hours a day and the total extension per month must not exceed 36 hours).

- *Wages*
Employers may decide on salaries at its own discretion. The company shall also cover the employee's welfare, normally including pension, medical insurance, unemployment and injury, which should come from profit after tax. For overtime payments, the labor law states that employees must not receive less than 150% of their normal wage for extensions of regular working days; not less than 200% in extensions on day of rest; and not less than 300% for extension of statutory holidays.

- *Severance payments*
An employer must pay severance to any employee whose fixed-term contract is not renewed to the amount of one month of salary for each year served, unless the employee rejects a new contact on equal or improved terms. If the employee's monthly salary is three times higher than the average monthly salary of the previous year for this region then the employer is only obligated to pay a severance equivalent to three times the average monthly salary for each year served. In cases of unlawful dismissal, the severance payment outlined for lawful dismissal is doubled to two months' salary for every year of service.

- *Mass layoffs*
Employers must report the implementation of the mass layoffs to the local labor administration department. Before mass layoffs - defined as the laying off of 20 or more employees or no less than 10% of total staff (whichever is lower) – employers must give 30 day's advance warning, under certain specific situations provided by law, i.e. if the company has been restructured according to the bankruptcy law; or in the cases that an employer adjusts the way in which the company carries out its business, changes the nature of the business or makes technology based changes.

- *Non-Competition agreement*
An employee who leaves a company can be bound to a non-competition agreement for up to two years following termination, providing that corresponding economic compensation is paid to those employees on a monthly basis during the effective period of the non-competition agreement. This may apply only for senior managers, senior technicians and other people who have knowledge of the trade secrets of the employer. The employer should make sure to sign this agreement at the time the labor contract is signed or the agreement may be invalid.

- *Probationary period*
The maximum probation period is generally based on the term of the contract, thus:

Contract term	Probation Period
Less than 1 year	1 month
Greater than 1 year, less than 3 years	2 months
Less than 3 years	6 months
Open-term	6 months

Employers shall pay their employees at least 80% of their contractual salaries during the probationary period. This figure shall not be lower than the minimum salary set by the government for this particular region or provided by the employer for the same position.

- *Labor unions*
  As a country with a long socialist history, it would be natural to assume that trade unions would wield a significant amount of power within China. The single, centralized organization called the All China Federation of Trade Unions (ACFTU) is an organ of the Communist Party of China and, strictly speaking, companies with over 25 employees are supposed to establish their own chapter of ACFTU. Many companies take the view that this should only happen if there are requests from staff to form such a union. Aside from protecting the interests of the employees in the event of any dispute, there is generally minimal interference from the local chapter of ACFTU in the internal operations of a company.

Taxes

The People's Republic of China levies a wide range of taxes including income taxes (corporate income tax and individual income tax), turnover taxes (value-added tax, business tax and consumption tax), taxes on real estate (land appreciation tax, real estate tax and urban and township land-use tax) and other taxes, for example, stamp duty, custom duties, vessel tax and resource tax. The State Administration of Taxation (SAT) is the body responsible for tax administration throughout China. It drafts tax legislation, sets collection targets, and collects taxes (via the Regional State Tax Bureau). The Ministry of Finance issues occasional circulars affecting taxation, but only after receiving approval from the SAT.

Effective from January 1, 2010, all representative offices must pay corporate income tax in China, as well as business tax and value-added tax. For wholly foreign-owned enterprises, joint ventures, and foreign invested commercial enterprises, the main taxes to be concerned with are:

- Corporate income tax
- Withholding tax
- Value-added tax
- Business tax
- Consumption tax
- Other specialist taxes including property tax and stamp tax

Corporate Income Tax

Corporate income tax is calculated against the net income in a financial year after deducting reasonable business costs and losses. It is settled on an annual basis but is often paid quarterly with adjustments either refunded or carried forward to the next year. The final calculation is based on the year-end audit. The income tax rate for all companies in China, both foreign and domestic, is 25 percent. Industry-based tax incentives exist, which reward enterprises involved in the high or new technology sectors.

Withholding Tax

Withholding tax is a PRC tax levied on overseas companies providing services to China-based businesses businesses, as well as non-resident companies that receive dividends from a resident company.

The company based outside of China is required to pay taxes on the income it derives from supplying services to the client in China (including a China-based subsidiary). This tax is withheld by the client by deducting the amount payable from the gross invoice amount.

The withholding income tax rate for non-tax resident enterprises in China for passive income is 20 percent under the CIT law. This was reduced to 10 percent under the detailed implementation regulations of the CIT law.

Value-Added Tax

All enterprises and individuals engaged in the sale of goods, provision of processing, repairs and replacement services, and import of goods within China shall pay VAT. There are a few exemptions, such as self-produced agricultural products sold by agricultural producers, contraceptive medicines and devices, antique books, importation of instruments and equipment directly used in scientific research, experiment and education, importation of materials and equipment from foreign governments and international organizations, and articles imported directly by organizations for special use by the disabled.

VAT taxpayers are divided into general taxpayers and small-scale taxpayers. Taxpayers with an annual sales value exceeding the annual sales threshold for small-scale taxpayers must apply to the tax department for recognition as general taxpayers, while taxpayers who have newly established their business can choose to apply for recognition as general taxpayers.

The VAT rate for general taxpayers is generally 17 percent, or 13 percent for some goods. For taxpayers who deal in goods or provide taxable services with different tax rates, the sale amounts for the different tax rates shall be accounted for separately. If this is not done, the higher tax rate shall apply.

From January 1, 2009, the annual sales threshold for small scale taxpayers has been reduced from RMB1 million (for enterprises engaged principally in the production of goods) and RMB1.8 million (for enterprises engaged in the wholesaling or retailing of the goods) to RMB500,000 and RMB800,000, respectively.

Business Tax

This is a tax payable against turnover by all enterprises and individuals undertaking the following business: providing taxable services, including communications, transport, construction, finance and insurance, telecoms, culture, entertainment and service industries; transferring intangible assets; and selling real estate. Rates of business tax vary considerably, dependent on industry, but are generally between 3 percent and 5 percent for most services, with some special entertainment services receiving up to 20 percent.

Consumption Tax

This tax applies whenever certain luxury or other goods are manufactured, processed or imported. Unlike VAT which is levied across various stages of the value-addition chain, consumption tax is levied only once, with consumers ultimately carrying the burden of the tax. Tax rates vary considerably with the product and the tax paid is computed directly as a cost and cannot be refunded. Be careful if you are processing taxable goods for others, since you are liable to withhold and pay consumption tax based on the value of the raw material and your processing fee.

Property Tax

From January 1, 2009, foreign-invested enterprises, foreign enterprises and organizations, and foreign individuals have to pay the real estate tax. At present, this tax is only applied to enterprises with foreign investment, foreign enterprises and foreigners, and levied on residential property only. Taxpayers are owners, mortgagees, custodians and users of such properties. The tax is calculated on the residual following the subtraction of between 10 percent and 30 percent of the original value of the property. Details of the scope of the subtraction are determined by the provincial government, autonomous region or municipality directly under the central government.

Stamp Tax

Those liable for stamp tax include any enterprise, unit, individual, household, business, operator or other individual who executes or receives specified contract documents such as sales contracts and title transfer documents. The tax rates vary according the document in question but are generally between 0.03 percent and 0.10 percent.

Maintaining Chinese Financial Accounts

Incorrectly prepared financial accounts can be due to deliberate attempts to deceive, but is often also due to tax avoidance, incompetence or simply bad accounting practices. Whatever the reason for incorrectly prepared financial accounts, uncovering the true financial standing of a Chinese company is essential knowledge for those considering a merger or acquisition, or investing in another way. Below, find some common areas of inaccuracies in Chinese accounting books.

Practices Specifically for Tax Avoidance and Deferral

- *Two or more sets of financial accounts*
  Multiple sets of financial accounts are far more common in China than you may imagine. While these multiple books are quite often used to avoid tax, they are also sometimes used to cover up other inappropriate financial behavior within the company itself. Moreover, often the official set of accounts are prepared electronically whereas the other set is maintained manually, and accordingly, it is often very difficult or impossible to reconcile these accounts.

- *Revenue received "off the books" to avoid paying tax*
  Another method of tax avoidance that may have implications beyond those with the tax bureau - keeping payments off the books. Accounts receivable is usually under-reported in China in an attempt to hide sales to reduce taxable income.

- *Revenues received from invoices pushed* into the next reporting period to defer tax
  Similar to tax avoidance, pushing invoice revenue into the next reporting period is a common method of deferring tax, but is nonetheless a poor accounting practice that prevents outsiders from seeing a company's real financial standing.

- *Employees paid "off the books"*
  There will often be an ending balance in payroll payable, however many Chinese companies delay part or all of the employee salaries. Paying employees off the books can result in much higher liability for a company because of the IIT and social security liabilities. In the worst scenarios, fictional employees are paid.

- *Phantom assets and contracts; assets of the company owned privately by the shareholders*
  As case after case of due diligence reveals: the list of assets on the books is often quite different from the assets a company actually holds. This ranges from simple misreporting to cases of complete fraud.

  Often, a company's assets will become "mixed" with those of a shareholder, senior executive or related/ associated company, and vice versa. This discrepancy can go both ways - understatement or overstatement. Of particular note is the review of the major contracts of a company to ensure validity, enforceability and even existence.

- *VAT Practices*
  A constant source of confusion and misunderstanding. Special attention must be paid to the compliance practices of VAT taxpayers. VAT under reporting is rampant either as a result of deliberate avoidance or mistake.

- *Practices based on general industry practice or incompetence*
  Accounting undertaken on cash or invoice basis rather than an accruals basis. This point of incorrect preparation speaks for itself. This leads to cutoff issues, understatement and overstatement of assets liabilities, income and expenses. When two sets of books are being maintained, this issue causes particular problems.

- *Bad inventory control and management*
  The inventory control and management practices expected by Western investors are often a far cry from the reality of the stock rooms of Chinese companies. In many cases a company cannot update inventory movements in real time. Variances between actual stock and book figures have to be made manually.

  Physical stocktake is often not conducted thoroughly and any investigation work is not soundly performed. In many cases, there is simply a lack of communication between the shop floor and the accounting department in relation to stock control.

- *Accounting Management*
  Often the internal financial and accounting staff of Chinese companies is simply not equipped to undertake more than just a "bookkeeping" role. They lack up-to-date knowledge of accounting principles, treatments and standards including international GAAP rules. Furthermore, there is often a disconnect between the accounting and financial staff and the operating divisions resulting in a lack of coherence between the financial statements and the operating results of a company. In foreign-owned local companies, there is the perpetual problem of communication difficulties between the head office and the Chinese subsidiary.

- *Audit Practices*
  Local auditors often only act as a “rubber stamp” to local management rather than providing a reliable system of checks and balances to the Board of Directors and shareholders. Lack of audit planning and execution are the main problems. In extreme cases, we see that local auditors are on site for less than a day. Often local auditors are reluctant to make any adjustments which detract from the reliability of the overall audit. A further common complaint is the inability to prepare a local audit report in English, and the report’s nonconformity with the most basic of international forms and standards.

A two to three day site visit by an experienced auditor should show whether accounts and financial statements presented are indeed a statement of fact or whether there are areas within them that warrant further investigation. We advise you to contract a professional accounting practice that has experience supervising the local audit of Chinese companies. A well-planned and complete financial due diligence or financial health check is essential to discovering the true picture of Chinese companies.

Ch 5 Sector Opportunities

By InterChina Consulting

Overview

<table>
<tr><th>Sector</th><th>Opportunities</th><th>Forecasted Growth</th><th>Growth Drivers</th></tr>
<tr><td rowspan="2">Food & Beverage</td><td>Plentiful</td><td>High</td><td>Mainly Favorable</td></tr>
<tr><td>• ‘Mass market’ = large-scale and low-cost (i.e. lower/ middle class consumers, local production, modern retail, price competition, complex and expensive marketing, and low brand loyalty).
• Niche market’ = differentiation (i.e. affluent consumers, imported goods, high-end retail and marketing, emphasis on brand, origin, quality, higher brand loyalty).</td><td colspan="2">• Annual growth rate of 10-15%.
• Consumption patterns are modernizing and becoming more recognizable from a Western perspective.
• Economic development, increasing income and quick urbanization is quickly spreading consumption power from 30-40 Tier 1 and Tier 2 cities to China’s + 600 smaller cities and beyond.
• Raw material price remains high and is unlikely to retreat sharply, but leading enterprises could pass on increased costs to consumers, as they have strong bargaining power on their product prices, they may uplift the selling price. This is relatively easier in Tier 1 and Tier 2 cities rather than price-sensitive low tier cities.</td></tr>
<tr><td rowspan="2">Healthcare</td><td>Selected</td><td>High</td><td>Mixed</td></tr>
<tr><td>• Continued demand for high-end products in urban areas.
• Cautiously tapping new grassroots markets using price-cuts, localization, alliances/ M&A, as well as actively sourcing appropriate human resources.</td><td colspan="2">• Annual growth rate of 15 – 20%.
• For the 3 years from 2009 to 2011, an additional RMB 850 billion (US$ 125 billion) is being made available.
• Reform is being implemented with mixed results, a clearer picture will be visible in 2011.</td></tr>
<tr><td rowspan="2">Clean Tech & Energy</td><td>Selected</td><td>High</td><td>Favorable</td></tr>
<tr><td>• Equipment supplies for traditional and new energies; sourcing opportunities (solar).
• Short/Medium-term opportunities in renewable energy technology such as wind and solar.
• Localization of technologically advanced products for renewable energy.</td><td colspan="2">• The likely objectives expected to be seen in China’s 12th Five Year Plan (2011-2015) will raise the bar significantly compared to the 11th Five Year Plan, which already emphasized the diversification of China’s energy mix.
• The on-going cost cuts as a result of technology advancements have resulted in a tipping point for the wind sector over the past 5 years, and are likely to do the same for PV over the next 2-3 years.
• Short-term overcapacities in some parts of the value chain (especially on the supply-side).
• Evolving policy framework presents both a challenge, but also an opportunity (e.g. lobbying).</td></tr>
</table>

Sector	Opportunities	Forecasted Growth	Growth Drivers
Environmental Infrastructure	**Selected**	**Medium-to-High**	**Favorable**
	• High-end devices and chemicals (i.e. for water treatment) with higher efficiencies. • Specialized sewage treatment (e.g. cement factory sewage, paper/ pulp mill's wastewater treatment) is a fast growing market niche. • In solid waste treatment potential exists for non-landfill treatment methods, urban garbage collection and sorting systems, and industry waste treatment. • BOT projects in tier-2/3/4 of sewage projects.	• China's urbanization and industrial development provides a strong long-term momentum. • Newly promoted as one of the highly strategic industries by the Chinese government this year and would remain so in the next five years as part of the 12th five-year plan. • Strong governmental spending from 2011 to 2015 as part of 12th five-year plan.	
Luxury Goods	**Several**	**Medium-to-High**	**Mixed**
	• 1st-tier brands which update their brand and channel strategies. • Less-aware but still prestigious brands that put the right effort in marketing and channel development. • Increasingly present in lower tier cities in addition to 1st-tier cities. • Local investors will become more active in this sector.	• Annual growth rate of 10-15%. • China is already seen as the major growth driver of the global luxury goods industry. • Growth of the luxury market is directly supported by the growing development of China's upper-middle class and its strong and increasing buying power during the period of 2009~2011.	
Automotive & Components	**Several**	**Medium-to-High**	**Mainly Favorable**
	• Services to Chinese carmakers. • Component manufacturers with advanced technologies. • Energy saving or pollution mitigating components. • Companies have leading technology on components for alternative energy vehicles, such as PCU and BMS. • Companies active in the aftermarket, such as auto clubs, auto refit and roadside assistance services.	• There are no quick wins in China's automotive sector. However, we expect an average sales growth of 8-12% for the next 5 years, and that this growth will continue to create opportunities for foreign companies. • Specific drivers in 2011 will be the ongoing growth of the Chinese car market (especially for larger local brands), and a young, but promising electric car and bus industry.	

Sector	Opportunities	Forecasted Growth	Growth Drivers
Machinery & Machine Tools	**Several** • High-end machinery and machine tools. • Machinery used in environmental protection and renewable energy (e.g. wind energy) projects. • Machinery tailored towards smaller plants and factories, allowing higher flexibility for producers. • Machinery used in automotive related industries. • Specialized machinery and inspection equipment for railway maintenance sectors.	**High** • Annual growth rate of 10 - 20%. . • Automotive related machinery driven by the growing automotive industry. • High-speed trains and metro systems require railway maintenance machinery; whist railway manufacturing itself is characterized by moderate demand. • Governmental incentives are continuing to spur further machinery investments, i.e. construction equipment machinery. • Environmental protection projects include wind energy and hydropower, together with water treatment. • However, local competition will not be increasingly favored by governmental initiatives and policies due to its inferior quality and performance to international machinery counterpart.	**Favorable**
Chemicals	**Several** • M&A might be observed as a better option to enter or expand in China. One key focus will be to acquire the local middle-end players to penetrate into middle-end market. • High-performance chemicals, including niche specialty chemicals such as pollution treatment chemicals will lead the recovery. • Further penetration of new applications and restructured distribution networks.	**Medium-to-High** • Annual growth rate 10 – 12%. • Some downstream industries perform better than others. • 12th Five Year Plan, will encourage the development of advanced materials. • Value-added products such as high-performance chemicals will still enjoy impressive growth, including niche specialty chemicals such as pollution treatment chemicals.	**Likely Favorable**
Opportunities In Low Tier Cities	**Plentiful** • Starting with smaller cities around a larger city as a launch pad with operational synergy. • Consumption trade-up: e.g. packaged foods, RTD drinks, seasoning and flavoring products, infant products, personal care, consumer electronics and home appliances, footwear and fashion, and even automotives. • Relatively new consumption products (for low tier cities): e.g. tea based beverage (e.g. milk tea) and quick-service restaurants.	**High** • China will see a shift in its urban population from 46.6% in 2009 to nearly 70% by 2035. As a result, the population of China's cities will grow by 350 million people and reach approximately 1 billion over the same timeframe. • Consumption is being driven by the rising disposable income and explosive growth in size of the lower/ medium middle classes (incomes between US$ 4,000 - US$ 12,000 p.a.) residing in China's 600 largest cities. This group is expected to grow from ~200 million people today to ~600 million by 2020. • Low tier cities pose new challenges in terms of offering, marketing, distribution and competition in front of foreign companies.	**Mainly Favorable**

Food & Beverage

China is already one of the largest consumers of F&B products in the world, with the market expected to reach US$ 210 billion in 2010. The consumption of many F&B products associated with leisure-based, convenience and functional consumption is expected to grow at a rate of 10-15% in 2011 compared with 2010. Consumption patterns are modernizing and becoming more recognizable from a Western perspective.

This is being driven by fast urbanization, rising disposable incomes, international influence, busier lifestyles, greater product choice, health awareness and the experimental nature of the Chinese people.

As a result, consumers are showing an increasing sensitivity to brands and marketing, seeking better quality and hygienically packaged products, healthier and functional ingredients, and purchasing more from modern trade channels, with increasing demand on fast food, ready meals and quick food services. Given that this front-end is already relatively modern, the government is now driving the development of the back-end, encouraging backward integration, intending to avoid further supply chain scandals (e.g. Chinese melamine scandal in dairy products in 2008).

China already has many F&B categories that have become quite saturated and highly contested, resulting in thin margins and consolidation. This is especially the case with the more indigenous categories, some of which might also involve multinationals, such as beer, water and seasoning products. There are also many categories that remain in the early stages of evolution, and where per capita consumption has a long way to go to catch up with global averages. Some of these categories involve more modern products, such as flavored drinks, tea based beverages, bottled fruit juices, ready meals and other fast foods, dairy products, and other products more Western in nature, such as carbonated drinks, Wine & Spirits, Olive oil, bakery, chocolate and cereals.

Consumption used to be concentrated in the 30-40 Tier 1 and Tier 2 cities. However, economic development and urbanization is quickly spreading consumption power to China's over 600 Tier 3 and Tier 4 cities and beyond. The larger Chinese and Taiwanese F&B players, such as Wahaha, Mengniu, Master Kong and Want Want, are already well-advanced in reaching these lower tier cities. In addition to having to cover hinterland regions, this also means tapping traditional trade channels which remain dominant in these areas. Moreover, as the lower tiers mature, they are also becoming more heterogeneous, requiring tailored products and marketing. For most of the multinational F&B players, this is becoming the new frontier.

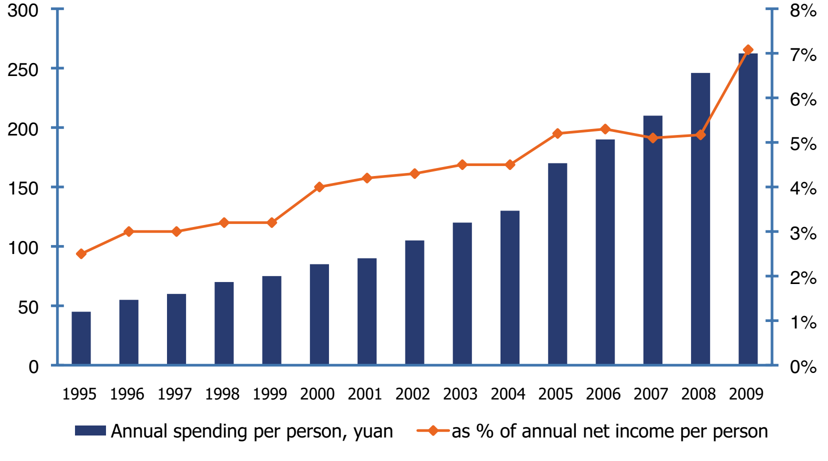
Such geographic expansion is needed for those F&B players taking a 'mass market' approach in China, which means large-scale and low-cost (i.e. lower/ middle class consumers, local production, modern retail, price competition, complex and expensive marketing, and low brand loyalty). The alternative approach in China is the 'niche market', which comes down to differentiation (i.e. affluent consumers, imported goods, high-end retail and marketing, emphasis on country origin, brand and quality, higher brand loyalty). Many F&B multinationals are currently stuck in the middle, but striving for the mass market. The solution should be carefully evaluated, as there is no quick path to the mass market. Companies might need to focus on organic growth as the major avenue of growth. The challenge for F&B multinationals conducting M&A, is to find acquisition targets, which are both attractive targets as well as acquirable. Those that are receptive are often looking for strategic investors with the capital and expertise they need to expand but are not so willing to sell outright.

Raw material prices remain high and are unlikely to fall sharply, but leading enterprises could pass on their increased costs to consumers. Prices of essential raw materials (e.g. sugar, palm oil and plastic) and agricultural products (e.g. corn, rice and wheat) continue to rise, which increases the cost pressure on the sector. Nevertheless, since the leading enterprises of each sub-sector have strong bargaining power relative to product pricing, they may be able to raise selling prices and pass on their extra costs to consumers; this might be more difficult in more price-sensitive lower tier cities. In addition, companies need to find a way to reduce costs, while maintaining good quality and food safety.

Healthcare

China's healthcare industry has been growing firmly at a rate of 15 – 20% annually. Currently, the Chinese pharmaceutical market accounts for almost 10% of the global market, and the medical device market for 4%, respectively. As such, China has become a globally relevant healthcare market, driven by the increase of disposable incomes (in urban areas, and

Out-of-Pocket Medical Spending Among Chinese Rural Households



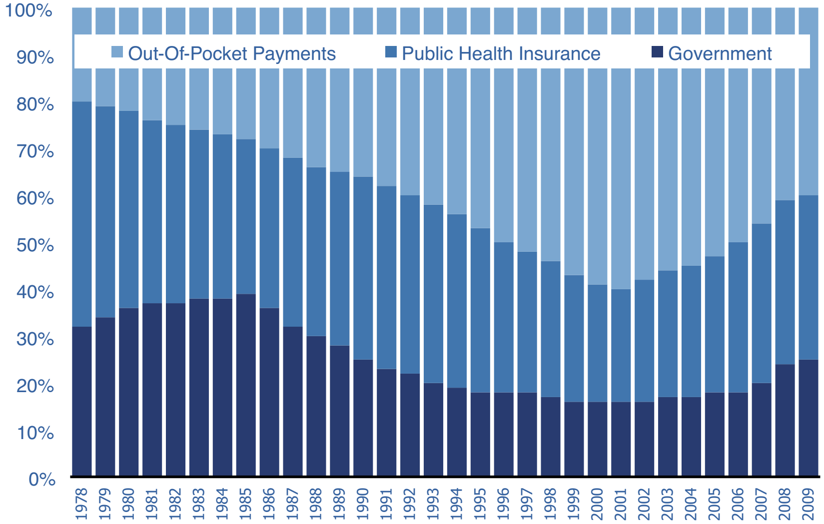
Source: The Economist, China Bureau of Statistics increasingly by rural areas), and the on-going healthcare reforms.

2011 will be the first year where real conclusions can be drawn regarding the impact of the pilot programs initiated in 2009 under China's healthcare reforms and whether such programs are having the desired impact. The process will not be easy, as hundreds of pilot programs have been initiated at various levels with a high degree of variance in their practical implementation.

We believe that China has made important steps forward. Firstly, the introduction of the NEDL (National Essential Drug List), has provided a mechanism to ensure a reduction in costs associated with the purchase and supply of a wide range of basic pharmaceuticals. Regulations have also been established for the purchase/tendering for drugs not on the NEDL and funds and subsidies have been increased for medical institutes to upgrade equipment and facilities.

BMI (Basic Medical Insurance) and RCMS (Rural Cooperative Medical Scheme) coverage has been increased countrywide, but financing remains limited. As such, benefits have yet to see significant expansion. In spite of greater training and relocation of doctors to smaller medical clinics, patient trust remains a problem, especially towards CHCs (Community Healthcare Centers) and THCs (Township Healthcare Centers) which are meant to

Breakdown Of Chinese Healthcare Expenditure By Source (1978-2009)



Source: China Bureau of Statistics

serve as primary care providers.

The reforms focused on the development of historically underfunded rural care, require "cheaper but better and more "accessible" supplies which multinational healthcare (and especially pharmaceutical) players are not yet able to provide as easily, or as cheaply as Chinese players. Despite previous rosy forecasts, many multinational pharmaceutical companies realized lower-than-expected sales growth in the first half of 2010. To date, most multinational pharmaceutical companies' have struggled to develop a solid business case for extending into the rural markets.

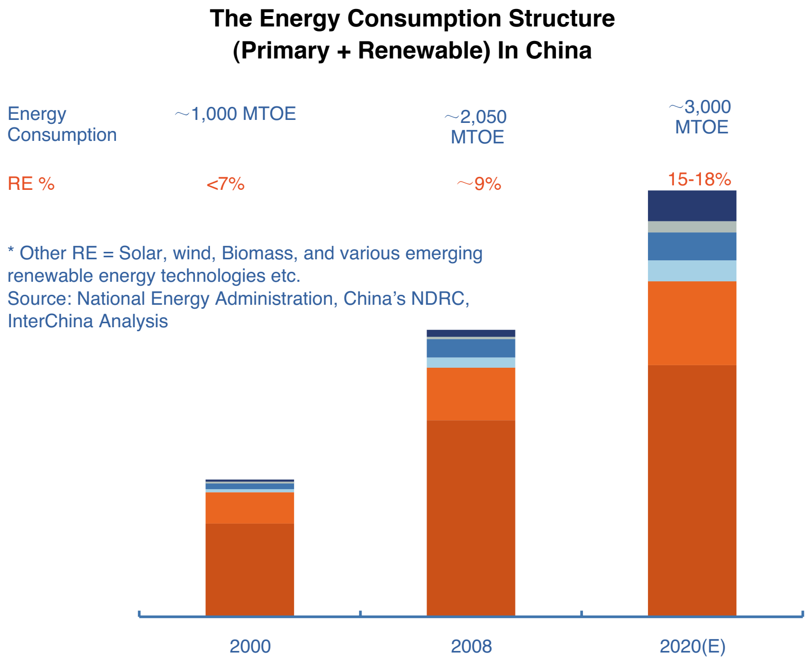
International medical device manufacturers appear to be in a much better position to support the reforms and are actively developing medium-to low-end solutions, with locally produced products designed to meet the needs of the market.

We believe that there are several strategic options for multinational healthcare players to tap into the potential of rural markets. The first is to respond to the requirements of the NEDL and cut prices in order to participate in and potentially win tenders. Price cuts have already been observed in 2010, and certain multinational pharmaceutical companies have aggressively reduced prices for some of their blockbusters. Second is to further localize products and production, in order to achieve the lowest-possible operation and production costs as well as to design products that specifically address the needs of the market. Thirdly, to align with or to acquire local Chinese partners to access their existing distribution networks and ties with the local governments. Additionally, multinational healthcare players need to focus on increasing their sales, marketing, and distribution capabilities to improve penetration and coverage of hospitals.

By the end of 2011, we expect to have a clearer picture of whether the reform attempts are working in the pilot cities, and to what degree the implementation has been successful. In any case, the reforms are expected to result in an increase in opportunities for a wide variety of pharmaceuticals and medical devices over the coming years. The question remains as to whether foreign healthcare players will be able to adequately and quickly enough address the needs of these markets or whether they will be content to leave them to their local competitors.

Clean Tech & Energy

China's energy consumption accounts for around 18% of world energy consumption, second only to that of the United States. While participation in the operation of energy infrastructure continues to be liberalized it remains fraught with economic feasibility issues, and should only be considered with a long-term outlook. The best opportunities are, and will continue to be, in supplying advanced equipment to China's numerous energy infrastructure projects. For foreign companies with cutting-edge technology and a cost advantage, we believe now is the time to take some initiative, for example in the wind power and solar photovoltaic (PV) sectors.



Source: National Energy Administration, China's NDRC, InterChina Analysis

In the policy for the 12th Five Year Plan (2011 – 2015), China places major emphasis on renewable energy development. This is mainly motivated by China's need to meet demand requirements due to its rapid economic growth and the relentless urbanization process. As the world's No. 2 economy, China is expected to have two-thirds of its residents (over 900 million) living in urban areas by 2030, compared with 46.6% (620 million) in 2009. To satisfy the strong desire for energy (including green energy), China will need to strengthen the role of renewable energy in primary energy consumption. With a planned investment of RMB50 trillion (US$ 7.4 trillion), it is increasing the targets for renewable energy to a conspicuously higher level than three years ago.

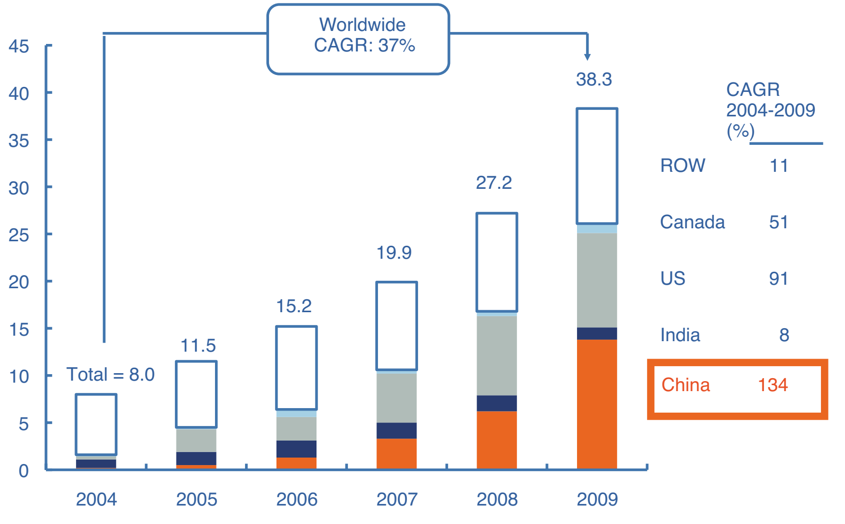
China's exploitable hydropower potential is estimated at 300 GW, and China aims to fully capitalize on this potential by 2020, more than doubling today's capacity. China's total wind power potential has been estimated at 2580 GW, and the target is to increase capacity to 150 GW by 2020, five times the previous target of 30 GW. The target for solar photovoltaic increased from previous 1.8 GW to 20-30 GW. Within the same timeframe, China is also planning a seven-fold increase in its biomass power capacity from its current level to 30 GW by 2020.

The remarkable growth of China's wind sector was highlighted by China's number 1 position in the global market for wind in 2009. China accounted for one-third of the world's new installations in 2009 and exhibited a compound annual growth rate of 37% during the 2004-2009 period. Even with the market nearing its mature phase given the current policy target, the growth rate of wind power installations may still maintained at around 15%. We believe M&A will be an unavoidable trend in the future as larger players with access to capital look for further expansion. Compared with onshore projects, offshore wind farms are still in the initial development stage but will grow exponentially, with a target of establishing 30 GW of offshore capacity by 2020, up from only 100 MW in 2010.

In China's PV sector, ninety-eight percent of solar PV equipment/components production has been exported to overseas markets over the past several years. Things are likely to change due to the growth in PV projects (which started in 2009). This growth was stimulated by a large decrease in cost structures and government policy (e.g. generous financing support). This is a clear sign to us, that the sector is ready to take off. We believe It is a good time for international players to enter the market for both the supply side and project management side to expand their capacity and acquire more market share as quickly and cost-effectively as possible.

In fact, multinationals are taking initial steps to enter this market across various

Annual Newly Installed Wind Capacity by Country (2004–2009)



Note: CAGR = compound annual growth rate
Source: Global Wind Energy Council

parts of the value chain. Some foreign wind turbine giants have invested several tens of million Euros on facilities in China, while some of them also have engaged in wind farm development and operation. One PV MNC from Belgium even won a PV farm project in Gansu province, and became the first foreign enterprise succeeding in competition with local players in a national public bidding through a partnership with Chinese SOEs.

In the mean time, we see an increased activity in company establishments and production facility expansions. Both traditional energy power giants and those specialized in alternative energy are tapping into the market and are sourcing onshore/offshore wind farms or PV farm projects. Many of them are being formed through joint ventures or technical partnerships in order to avoid policy regulation issues, while a few top producers choose to act more aggressively by manufacturing and selling their products independently.

However, given the level of government intervention and the lack of a coherent policy, foreign companies should consider market entry carefully. The policy environment of the industry is still evolving and is still far away from maturity. In particular, pricing policy remains a strong reason for caution with regard to renewable energy projects. On the other hand, this may be a good opportunity for top players (including MNCs) to lobby the government towards a more transparent and equal tendering system.

To summarize, equipment and component opportunities are generally more accessible than farm project development, especially for those companies having a technology advantage. Cost effectiveness is another key success factor for acquiring market share. We believe localization and scale production will help to narrow the price gap, in order to meet localization requirements for national bidding processes, as well as to enhance after-sales service. A global supply base can even be considered given the huge potential of the rapidly expanding local market.

Environmental Infrastructure

From 2005-2010E, this sector has undergone 15%-20% CAGR, which is likely to result in a market scale of RMB 500 billion in 2010. It accounts for approximately 1% to 1.4% of current GDP.

China's massive urbanization and industrial development continues to be accompanied by significant challenges in the area of environmental protection, which presents large opportunities for investment. In order to achieve sustainable economic growth, the Chinese government is likely to invest more than RMB3 trillion in environmental infrastructure during the 12th 5 year plan (2011-2015).

In water treatment and sewage BOT projects, the penetration by foreign players has been low and slow, with foreign players having an 8-10% market share. Opportunities will come from 2nd, 3rd, and 4th-tier cities where investment remains insufficient. However, high-end devices (i.e. pumps reactors, agents etc.) and chemicals (i.e. water treatment chemicals) are a straight-forward market opportunity, covering fresh as well as waste water treatment. In addition, a recent policy update suggests strong opportunities in the area of solid waste treatment.

Overall, opportunities for foreign investors exist in three key sectors.

Sewage treatment: A major reason for China's water shortages is the lack of viable sewage treatment systems. 70% of China's large cities now have sewage treatment capabilities while the combined rate for all cities across China may be as low as 36%. China currently consumes three times more water than developed countries to produce a similar quantity of industrial products. Population growth and the booming economy have dramatically increased the amount of sewage and the government has identified sewage treatment as a pressing need.

In the upcoming 12th Five-Year Plan (2011-2015), the central government has set a target for building a new sewage pipeline network with a capacity of 200,000 km, new sewage treatment facilities with a combined capacity of 90 million tons increasing total capacity to 190 million tons. Additionally, China's infrastructure includes a large amount of aging water treatment and sewage treatment facilities & infrastructure, which will require upgrading or replacement.

The government is keen to attract foreign capital, technology, and expertise to achieve this objective. Attractive opportunities lie in:

- New sewage treatment plant installations, especially in medium sized cities;
- Existing sewage treatment plant utilization and pipeline system modification;
- Industrial waste water treatment (e.g. chemical, metal, pulp/paper manufacturing);
- Equipment and technology sales.

Solid waste treatment: China's solid waste presents perhaps the largest volume in the world. Total waste consumption reached 0.11 billion tons at the end of 2009, while total industrial solid waste reached 2.04 billion tons, a 5-year CAGR of around 11%. The overall treatment rate has stagnated around 60-70% over the past few years, far behind the rest of the world. As a key factor in the government's efforts to balance economic growth and environmental protection ambitious goals have been established. Some impediments exist to their successful attainment including: 1) Landfills, China's most commonly used method for garbage disposal, are limited by a shortage of available land and stricter pollution controls, especially in large cities, 2) A lack of an efficient garbage collection and sorting system and high operational costs means waste power generation has limited profitability 3) China currently lacks advanced and cost effective technologies for industrial solid waste treatment.

According to MEP officials, the investment scale is likely to quadruple from RMB200 billion for the period 2005-2010 to RMB800 billion from 2011-2015. Already, some pioneering foreign players such as Veolia and Richway have established themselves in China, gaining a strong first-mover advantage.

Foreign companies can help overcome many of these impediments by providing:

- Advanced garbage collection, sorting, and treatment systems.
- Specialized industrial (cement, metal paper making etc.) waste treatment.

Water treatment: On July 26th, 2010 the Ministry of Environmental Protection released figures showing that only 56.8% of state-monitored rivers were classified as grade 3 or better. It indicated that as much as 43.2% of water is not suitable for human contact, a further deterioration of statistics from 2009, at 42.7%. Water shortages exist in over two-thirds of China's 600 cities and in 110 of those cities the water supply is in critical condition.

Opportunities for foreign investors to address this worsening situation exist in two categories:

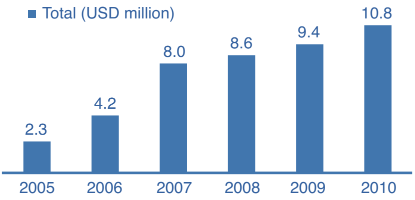
- Primary water market: To increase volume, hundreds of new water treatment plants will have to be established, especially in medium-sized cities and China's northern and western regions.
- Secondary water market: Water supply systems in most cities have low efficiency or are currently under construction. Leakages and contamination will necessitate system upgrades.

Most large international players, such as Veolia and Suez, already have a strong China presence, especially in the primary market; however, many unexplored opportunities, such as the construction of small/middle scale water purification plants and piping system design and supply, continue to exist.

Luxury Goods

China's growing upper-middle class has created a boom for luxury goods. Despite the economic slowdown in 2009, the increased purchasing power of this group has helped the luxury goods industry, achieve an annual growth rate of 10 percent. China's luxury goods sector is projected to grow at a rate of approximately 15% between 2010 and 2011, substantially higher than the 4% growth rate projected globally.

Market Value of Luxury Goods in China (2005~2010)



Source: World Luxury Associate, China Association of Branding Strategy

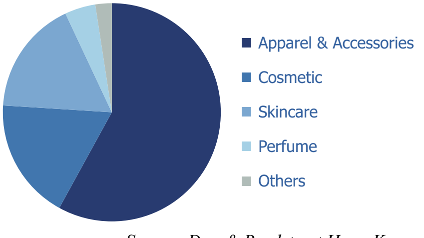
1st-tier cities and other larger cities in China are already crowded with luxury brands, and competition is fierce. Existing players increasingly face problems of securing good locations and shelf-space, whilst paying high rent for space, or entry costs to department stores.

2nd and 3rd-tier cities offer a higher availability of good locations at lower costs, provide more room for growth and potentially higher profits. More importantly, China's upper-middle class is increasingly located in these cities expanding from their traditional markets of Beijing, Shanghai, Guangzhou, and Shenzhen, and will be key drivers for the luxury goods industry.

Contrary to the developed world, the majority of luxury goods users in China are below the age of 45, and typically more open to the purchase of luxury items. They are also more easily persuaded to try new concepts via new channels, especially over the Internet.

Branded apparel & accessories, cosmetics, skincare and perfumes represent the majority of the products purchased. Other luxury goods categories such as jewelry, watches, sports cars, home decoration, and service related items (cigar and wine clubs, Spas, etc.) are also realizing strong growth.

Breakdown of Luxury Goods China (2009)



Source: Dun & Bradstreet Hong Kong

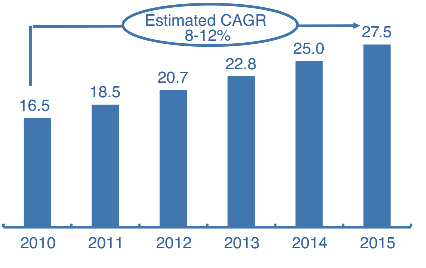
1st-tier global luxury brands will further upgrade their existing stores and propositions in the larger cities, and add further boutiques and outlets in second and third-tier cities. Moreover, first attempts on local brand extensions and adaptations for the local market will begin to take place. In 2010 Hermès launched a sub-brand specifically designed for China, called "Shang Xia" ("topsy-turvy" in Mandarin). If such a concept bears fruits, other luxury brands could follow suit.

China's luxury consumers happily pay the prices for top brands, whilst less prestigious brands have a tougher time in the market. Such brands often require more investment than anticipated to create appropriate levels of awareness and to realize their market potential. They need to employ alternative channels (e.g. internet blogs, social networking, internet sales, etc.) while minimizing cost and promotion expenses.

Automotive

China is the largest automotive market, largest producer of commercial vehicles and the second largest producer of passenger cars In the world. During 2009, China's domestic automotive market maintained a positive growth rate of over 10%, despite the effects of the global financial turmoil. By the end of 2010, China will have produced a record 16.5 million units, up around 21% from the previous year. China's automotive market is so attractive that many multinational carmakers, including Volkswagen, Toyota, and General Motors, consider it the most

Automotive Sales Forecast, in million units



Source: InterChina Consulting

important growth opportunity for the entire company.

Competition in the passenger car sector (including basic cars, MPV, and SUV; excluding mini-bus) has become even fiercer with market share (within the competitive landscape) continuously shifting. Based on the sales in the first 8 months of this year, the market leaders are Shanghai GM, Shanghai VW, FAW VW, Beijing Hyundai, Dongfeng Nissan, Cherry, BYD, Toyota and Chang'an-Ford-Mazda. In terms of their market share, Toyota and GAC Honda dropped significantly over the same period last year, while BYD and Chang'an-Ford-Mazda's performance increased.

Manufacturers with more car models in the less than 1.6L segment achieved better sales performance in 2010 (50% growth rate in the first 8 months vs 30% growth rate for the passenger car sector) largely due to the continuation of favorable government incentives (i.e. reduction on the car purchase tax from 10% down to 7.5% of the net car purchasing price for small-engine cars (≤ 1.6L)). Meanwhile, exports of made-in-China cars increased significantly in 2010. By the end of August 2010, the export volume had increased to 260,000 units, 40% bigger than in 2009.

As far as the domestic market is concerned, we remain confident that demand will continue to grow at 8-12% over the next 5 years. In 2011 demand may reach growth rates of between 10-15%. One of the additional growth drivers is likely to come from tier-3 and 4 cities. Already many OEMs are focusing their efforts on penetrating these new markets. However, these tier-3 and 4 cities present unique challenges and require a locally tailored sales approach.

Another significant change seen in 2010 is the development of M&A efforts and activities by Chinese local enterprises. The Central Government announced the "Adjustment and Growth Plan for China's Automotive Industry" in March 2009 which clearly indicates that the government will support M&A activities among Chinese local carmakers, with the target to further reduce the number of carmaker groups (whose total sales occupy 90% of the market) from 14 to 10. This has already resulted in 2 M&A deals, with GAC (Guangzhou Automotive Corporation) acquiring Changfeng, and Chang'an acquiring China Aviation Auto in late 2009. More M&A can be expected in 2011. Meanwhile, with the impact of the economic recession in North America and Europe, some brands (such as Volvo, Opel and Hummer) experienced financial difficulties. Many Chinese manufacturers have become more aggressive in their international M&A efforts. The 2010 Geely – Volvo deal represents a breakthrough as it was the first deal of its kind to be closed successfully. Although there were also failed cases like Sichuan Tengzhong's bid for Hummer, Geely's success will be a big encouragement for Chinese carmaker's global aspirations.

For automotive component manufacturers, many of the structural problems, including fragmentation and lack of innovation, will remain. The trend is towards a more consolidated, structured and competitive auto component supply base. In 2010, auto component exports recovered greatly.

After the crisis, the global sourcing of auto OEMs regained momentum, especially from suppliers having strong cost advantages.

For new energy cars and buses, the Central Government has shown a strong supporting attitude whilst several local governments including Beijing, Hubei, Chongqing and Shanghai are now more active in taking practical measures. We expect that the electric car/bus sector will evolve in China sooner than other alternative energy technologies (hybrid and fuel cell). However, given the lack of other supporting policies or infrastructure, it will take around 5 - 10 years to see many electric cars and buses on Chinese roads.

The after market is also an opportunity. In an auto market with annual sales volumes in excess of 10 million units, more and more car owners will want to "decorate and fit-out" their cars, therefore accessories and interior decoration parts for cars will experience sustainable growth in the coming years. Other opportunities exist in auto refits, auto clubs and roadside assistance services, which are all still in their early stages of development.

Machinery

2011 will continue to show healthy growth for machinery related to the wind energy, automotive, construction and energy sectors, whilst other machinery sectors (such as railway manufacturing, and aeronautic) are nearing their completion phase in terms of capacity building .

2010 was a good year for many machinery makers active in the Chinese market, thanks mainly to the effects of the government's stimulus package which came into effect in H1 09.

In fact, China's machinery industry output grew by 16% yoy to RMB 10.7 trillion in 2009, a strong rebound following the 2008 recession according to the China Machinery Industry Federation (CMIF). Growth was even stronger in the 1st half of 2010, with growth of 37% yoy to RMB 6.9 trillion. For FY 2010, the CMIF estimates the growth rate to be about 20%. However, sales of new machines and equipment vary significantly across sectors. Government purchasing cycles need to be offset against private demand. For example the Chinese railway industry will grow further but has completed most of its large equipment purchases, creating a latent production overcapacity. Other industries, such as automotive component makers are continuing to expand capacity and replace old inferior machines with those of higher quality.

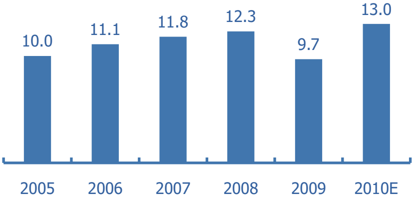
The localization of international machinery manufacturers' production facilities in China has advanced to the point that they now account for almost one third of China's total machinery output. However, in the machine tool industry for example, imports continue to represent around 40% of the local demand, albeit with a strong shift towards more expensive and complex equipment.

Governmental incentives on industrial equipment and machinery purchases will remain a crucial stimulator in 2011. We believe that the policies the Chinese government is currently implementing will not only favor machinery made in China (by both Chinese-owned or foreign-invested factories), but also imported machinery.

Over the 2007/2008 period, we saw a trend of foreign companies localizing their machinery production in China, and we believe that foreign companies will pick up on this trend again in 2011. In various machinery sectors, foreign companies are looking for ways to tap into the medium quality customer segments and are specifically designing machines for this segment. This trend can be observed in construction machinery, production equipment, print/packaging equipment, electric discharging machines, and textile machines. Foreign players are adopting strategies which reduce their sales of imported equipment to China and look toward supplying the local demand with machines made (or at least assembled) in their Chinese factories.

After the 2009 recession, China is regaining its export growth, which is forecast to reach US$ 215 billion in 2010 – over twice the amount of 2005. There are

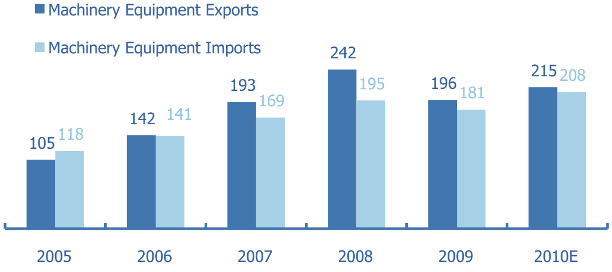
Machine Tools Import Into China, in US$ billion



China Machine Tool & Tool Builders' Association

clear signs that China is about to become a player in worldwide machinery markets. Compared to leading machinery export nations Germany, USA, and Japan, which jointly assume 35% of all machinery value internationally traded in 2008 (down from 45% in previous years), China increases its share to 15% in 2008 from 5-6% in previous years. In certain sectors, such as scales, woodworking machinery, precision instruments, fittings, garment and leather technology, mining machinery and welding technology, China is already in the higher ranks of export volumes. Much of the export power currently demonstrated by China can also be ascribed to foreign-

Machinery Equipment Exports from & Import into China, in US$ billion



Source: China Machinery Industry Federation invested production capacities in China, which make up around 60% of China's total machinery exports by value. Nevertheless, Chinese machines in all categories are recognized in various markets as new and aggressive competitors.

For 2010/2011, China's exports are likely to regain their previous growth rates last seen during 2006/2007 as China continues to invest in developing its export markets and international markets start to recover. Machinery imports into China will continue to grow as will demand in order to take advantage of the RMB4 trillion stimulus package which, continues to provide promising opportunities for international machinery builders.

Opportunity	Product Examples	Demand Drivers
High-end machine tools High-end machine tools	5-axis machines High-accuracy machine tools	The aviation / aeronautics industry is one of the major drivers behind the growing demand for high-end machine tools, as domestic producers' machines are still not sufficient in quality and performance to support the needs of the market. Demand for high-end machine tools reached a peak in 2006/2007, and then dropped a bit in 2008/2009 due to the crisis. In 2010, demand rebounded (though not as strong as in 2007), and we believe the trend will continue into 2011. China's Jumbo Jet Program will certainly need more high-end machinery after 2013.
	High-end CNC machining centers (lower accuracy requirements, but higher automation requirments)	As Chinese producers continue to upgrade their quality in 2011, there will be further opportunities for high-quality CNC (possibly imported, but more likely those locally assembled). Increased (but now rather stabile) labor cost will be an issue for factory managers to consider, and factories will need to explore options leading to higher degrees of automation. In many Chinese regions, favorable conditions (e.g., import tax refunds etc.) for customers importing machine tools have been (mostly) abolished, and customers are turning to international quality products made in China – hence to machine tool makers who already assemble or produce in China.
Machinery used in Environmental Protection Projects	Engines and gearboxes for windmills	Both local and foreign players are aiming to further localize their supply chains to meet local content requirements and to reduce production costs. Increased machining demand for larger and more efficient wind turbines could bring opportunities for imported machinery in high-end and high-speed applications..
	Oversized Equipment for hydropower stations	China intends to increase the share of hydropower in its energy mix. In addition to mega projects, small hydropower stations are encouraged in China. Chongqing, for example will build 470 small hydropower stations (installed capacity below 25,000 KW) by 2010.
	Wastewater treatment equipment	Sewage has become one of biggest threats to China's marine environment, with more than half of all wastewater pumped untreated into the sea. China has promised to treat about 70% of its urban wastewater in the coming years and to decrease pollutants by 10%. In coastal areas alone, there are around 145 wastewater treatment plants under construction.

Opportunity	Product Examples	Demand Drivers
Construction	Construction machinery and equipment (excavators, etc.)	Despite short-term financing bottlenecks in 2009, the construction boom in China is continuing, especially in smaller cities and inland provinces. Whilst some residential development in larger cities may be stalled, further investment into infrastructure will compensate for this decrease and the need for construction equipment will continue. Although at higher prices than domestic equipment, foreign importers will find a market through lease offerings. At the same time, control instruments/units will be mostly imported, whereas the rest of the equipment will be produced locally. Domestic construction companies continue to require specialized imported equipment for ambitious large-scale projects (e.g. tunnel construction, infrastructure projects).
Automotive	Automotive related machinery (including the auto mold&die)	China is in the midst of a boom in the automotive sector, which has continued into 2010. In 2009 China surpassed the USA to become the No. 1 automotive market in the world, faster than expected. In 2009, China produced more than 13 million vehicles, a 48% jump from 2008. We have heard many OEMs (e.g. VW plant in Guangdong, Volvo localization plan etc.) are planning to expand their capacities, to meet the continuing strong and increasing demand.
Railway maintenance	Railway maintenance machinery and measuring & inspection equipment	China has built the largest high-speed train network in the world, and is continuing to expand its rail network. Additionally, more than 25 metropolitan areas are building their own subway systems. Given the tremendous amounts of traffic now running on the national rail infrastructure, there is also a promising market for railway maintenance machinery.
Mining	Special / high-tech mining equipment	Chinese mines are pursuing mechanization of mining processes and implementing control and safety systems to increase safety and avoid catastrophic and tragic disasters. At the same time, market consolidation will continue as smaller mines are closed and larger mines become more productive and internationally competitive. This is also driven by governmental initiatives. The opportunities for foreign producers are in the provision of special / high-tech equipment, whereas standard systems and equipment will be supplied by domestic producers.

Chemicals

Thanks to the fast GDP growth of 11.1% in the first half of 2010, which resulted in growing demand in various downstream sectors, the chemical sector has experienced strong continuous growth since late 2009. According to the CPCIF (China Petroleum and Chemical Industry Federation), the value of chemical production in the first half of 2010 (excl. petroleum and refining sectors) was RMB2.4 trillion. This represented growth of 35% over the same period in 2009. During this same period, foreign companies in China surpassed the average growth rate and achieved a 43% growth rate.

In 2010, China began the development of its 12th Five Year Plan covering the period of 2011 – 2015. As part of its development, the chemical industry has played an important role, as this sector feeds into almost every major industry in China.

With a targeted annual GDP growth at approximately 8% over the next five years, China's chemical industry is estimated to grow by 10% -12% annually from 2011-2015. However, different sub-sectors will have different growth prospects due to various demand characteristics as policy directions being taken. Specialty chemicals such as advanced materials are likely to have great development opportunities, due to the demand from economic transformation and government policies that encourage the development of such chemicals. The agrochemical sector, (e.g. fertilizers and pesticides) are likely to have solid demand due to their ongoing demand. For other traditional chemical products, growth is likely to continue to remain stable.

Foreign chemical companies have also expressed confidence in their plans for China. Industry leaders such as AkzoNobel have announced annual growth targets of 10 – 20% for the next five years, which suggests a doubling or even tripling their revenue in China over the next 5 years.

This strong growth is likely to be facilitated by companies adding new applications to their existing product portfolio and establishing new (or consolidating existing) distribution networks to further drive sales in China. For example, we see a more positive market for performance materials in 2011, i.e. in sectors such as water treatment.

Multinational chemical players could once again be hungry for expansion via M&A in China, especially for developing further into the medium-end market and gaining market access. Strong Chinese brands exist in this segment, and can provide multinational players immediate market access. However, both the number of suitable targets and the challenges in managing the deal execution process should be carefully evaluated and managed. To facilitate their development in China, foreign companies also plan to establish or have already established R&D centers in China. The motivation behind this is beyond the simple rational of trying to gain a cost advantage, but rather to begin to develop products locally as China itself begins to generate a larger proportion of these companies global revenues.

As they pursue their growth plans, chemical producers and downstream industries that use polluting chemicals will experience increasing scrutiny from SEPA (State Environmental Protection Administration of China). According to CPCIF, the main measures related to environmental protection include strengthening ecological protection and highlighting green chemistry, particularly in those arid and ecologically fragile areas; taking comprehensive treatment measures on waste (e.g. waste, slag, and polluting residues); enhancing production safety; forming a cyclic economy and improving comprehensive utilization; paying attention to the reduction of greenhouse gas emissions. As such, environmental considerations will increasingly affect the operations of both foreign and domestic players in the chemical industry.

U.S. Commercial Service

The United States Commercial Service is the trade promotion arm of the International Trade Administration within the United States Department of Commerce.

The U.S. Commercial Service consists of a network of International Trade Specialists in U.S. Export Assistance Centers in more than 100 locations throughout the U.S.. Overseas, our Commercial Officers, Specialists, and other staff are located in U.S. Embassies and Consulates in more than 150 cities in 80 countries.

Our mission includes promoting U.S. exports of goods and services, supporting U.S. commercial interests abroad, and promoting investment into America. In China, the U.S. Commercial Service has locations at the U.S. Embassy in Beijing and at our Consulates in Chengdu, Guangzhou, Shanghai, and Shenyang. We also have partners in 14 additional cities to help you take advantage of the emerging markets in China's dynamic second tier cities.

To support U.S. companies, the Commercial Service in China offers a range of services including partner identification for U.S. exhibitors at select trade shows, individualized counseling and advocacy.

You can visit our website **www.export.gov/china** or call 1-800-USA-TRADE or send a question to chinabic@trade.gov for more information.

DEZAN SHIRA & ASSOCIATES

Corporate Establishment, Tax, Accounting & Payroll Throughout Asia

www.dezshira.com

Dezan Shira and Associates is a specialist foreign direct investment practice, providing legal, audit and tax services to multinationals investing in China, Hong Kong, India and Vietnam. Established in 1992, we are a leading regional practice in Asia with nineteen offices in four jurisdictions, employing 170 legal, accounting and audit professionals. We have services over 1,700 international clients in establishing and maintaining their presence in Asia. We are members of The Leading Edge Alliance of global accountants and auditors. We also provide useful business information through our media and publishing house, Asia Briefing.

Beijing Office:
Sabrina Zhang
Regional Partner
beijing@dezshira.com
+86 10 6566 0088

Dalian Office:
Adam Livermore
Regional Manager
dalian@dezshira.com
+86 411 6299 0101

Qingdao Office:
Liming Zhang
Senior Associate
qingdao@dezshira.com
+86 532 6677 5461

Tianjin Office:
Richard Hoffmann
Manager
tianjin@dezshira.com
+86 22 8787 7998

Shanghai Office:
Olaf Griese
Partner
shanghai@dezshira.com
+86 21 6358 8686

Hangzhou Office:
Helen Ye
Manager
hangzhou@dezshira.com
+86 571 5685 9956

Ningbo Office:
Lily Wang
Manager
ningbo@dezshira.com
+86 574 8733 8682

Suzhou Office:
Fabian Knopf
Business Development Associate
suzhou@dezshira.com
+86 512 8686 8717

Guangzhou Office:
Rosario Di Maggio
Manager
guangzhou@dezshira.com
+86 20 3825 1725

Zhongshan Office:
Linda Liu
Manager
zhongshan@dezshira.com
+86 760 8826 9592

Shenzhen Office:
Alberto Vettoretti
Managing Partner
shenzhen@dezshira.com
+86 755 8366 4120

Hong Kong Office:
Joe Sze
Manager
hongkong@dezshira.com
+852 2376 0334

ASIA BRIEFING

Regional Business Intelligence

www.asiabriefingmedia.com

InterChina Consulting

InterChina is a leading strategy and M&A advisory firm specializing in the Chinese market. Since being founded in 1994, InterChina has emerged as one of the leading advisory firms in China. Our specialized strategy & M&A advisory practices combine to provide a suite of comprehensive and complementary services helping our clients better understand and penetrate their markets in China and supporting them on buy and sell side acquisition projects, as well as strategic and green-field investments. InterChina has offices in Beijing and Shanghai, supported by liaison offices in Madrid and Washington D.C.

InterChina Consulting
1401 New York Avenue NW
Suite 1225
Washington DC 20005
Tel: (1 202) 463 7735
Fax: (1 202) 861 4784

Shanghai
Suite 3110 Haitong Securities Tower
#689 Guangdong Road
Shanghai, 200001
Tel: (86 21) 6341 0699
Fax: (86 21) 6341 0799

Beijing
Golden Land Building,Suite 1106
#32 Liangmaqiao Road
Chaoyang District
Beijing 100016, P.R. China
Tel: (86 10) 8451 2088
Fax: (86 10) 6467 1943

www.interchinaconsulting.com
interchina@interchinaconsulting.com

Beijing - Office
U.S. Embassy
No. 55 An Jia Lou Road,
Chaoyang District
Beijing 100600, China
Tel: (86-10) 8531-3000
Fax: (86-10) 8531-3701
Email: Office.Beijing@trade.gov

Chengdu - Office
4 Lingshiguan Lu, Renmin Nanlu Section 4
Chengdu, Sichuan 610041, China
Tel: (86-28) 8558-3992
Fax: (86-28) 8558-9221
Email: Office.Chengdu@trade.gov

Shanghai - Office
Shanghai Center, Suite 631
1376 Nanjing West Road
Shanghai 200040, China
Tel: (86-21) 6279-7630
Fax: (86-21) 6279-7639
Email: Office.Shanghai@trade.gov

Shenyang - Office
52 Shi Si Wei Road, Heping District
Shenyang, Liaoning 110003, China
Tel: (86-24) 2322-1198
Fax: (86-24) 2322-2206
Email: Office.Shenyang@trade.gov

Guangzhou - Office
14/F China Hotel Office Tower, Room 1461
Liu Hua Road
Guangzhou 510015, China
Tel: (86-20) 8667-4011
Fax: (86-20) 8666-6409
Email: Office.Guangzhou@trade.gov