

5

---

CHAPTER 5

# Determining factors for foreign investment

---

## 5

# Determining factors for foreign investment



This publication would not be complete without a short guide for business entrepreneurs who see China as an investment opportunity. It is a country with a very different culture, in which interpreting nuances can be just as important as getting used to the vast dimensions.

This chapter seeks to address some basic issues that should be very carefully taken into account during the initial steps of decision-making, when embarking on this adventure of economic investment and cultural immersion.

## 5.1. Restrictions on investment in certain industries

### 5.1.1. Direct foreign investment (DFI)

The open-doors policy which China first formulated in 1978 involved a transition from a centralised economy to a mixed one, in which the market took on a fresh and growing protagonism. Since then, the actions of a pro-market economic policy (especially with regard to promotion of foreign investment, easing of customs duties on imported intermediary goods and the reform of state companies) have played an essential role in China's new position on the global market. It is important to stress that the incipient liberalisation has not meant indiscriminate foreign Investment; instead a policy has been implemented of selective opening-up.

In the decade between 1980 and 1990, direct foreign investment (DFI) increased twenty-fold (from one billion to twenty billion dollars), and it has doubled again since then, to over fifty billion dollars by the end of 2002.

During the first half of the 1990s, most DFI came from neighbouring Asian countries, especially Hong Kong, Taiwan and Singapore. In the last five years, in contrast, it has largely been sourced in the United States, Japan and Europe.

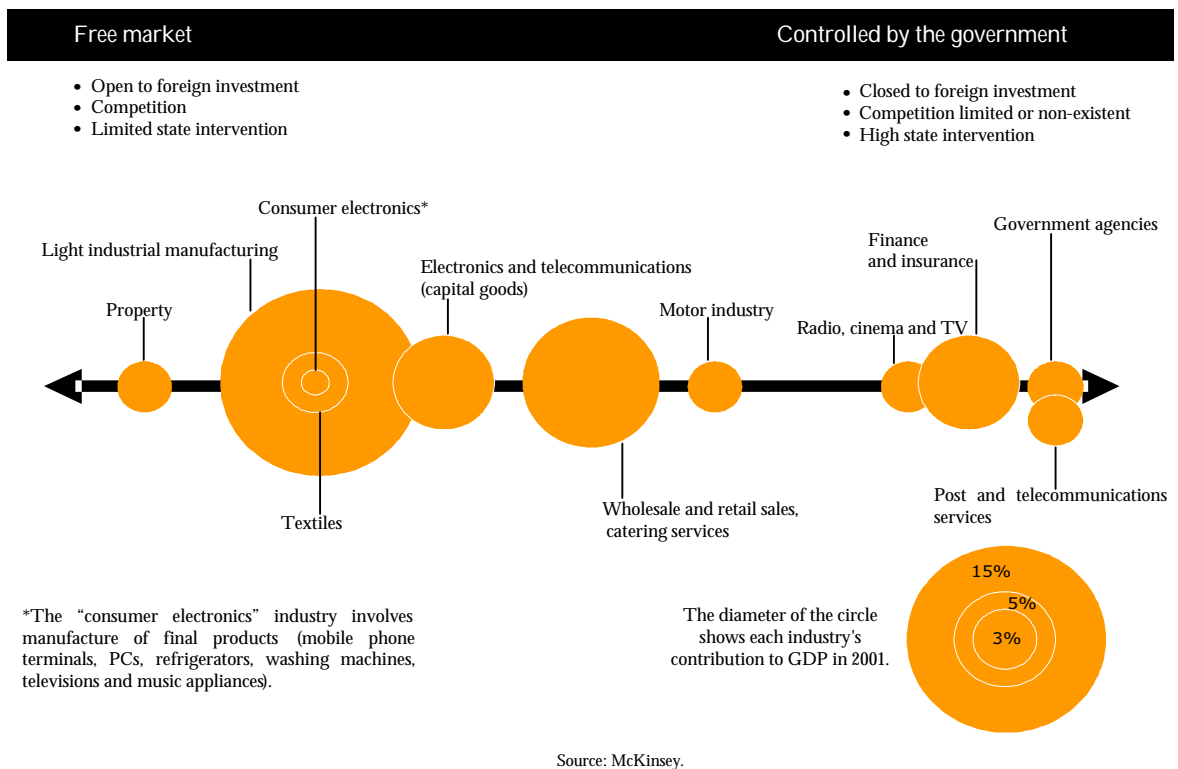
#### 5.1.1.1. Sectors

Under this policy of selective opening-up, foreign capital has been prevented from entering certain sectors deemed to be strategic, of which the most important are the financial, insurance and retail commerce industries.

The main protagonist of investment in China is the manufacturing industry-not the services industry, as is the case in the bulk of developed countries receiving DFI. In 2000, 61% of the accumulated stock was concentrated in the manufacturing industry. In second place came property (23.6%), followed by domestic trading services (3.5%), construction (2.9%), communications and transport (2.4%), and agriculture (1.8%).

Table 48 shows, for each industry, the level of state intervention and the contribution each industry makes to GDP.

## Development towards a free trade market by industry.



### Notes

The Chinese public authorities continue to prohibit foreign investment in industries in which they feel it is not needed by the country or where their economic planning suggests that there might be production overcapacity. In contrast, they promote the influx of foreign capital into areas in which local companies are not investing because they lack capital or suitable technology, such as energy production, telecommunications, environmental protection and transport. Nonetheless, even in these industries there are severe restrictions and red tape of all kinds.

In the telecommunications industry, for example, China prevents investment in added-value services such as television, broadcasting, news and advertising, on the grounds of "national security". It also restricts investment in transport and even tourism. In all of these cases the foreign investor is usually obliged to take a minority share in a joint-venture with a local partner, which often means losing control over the investment it has made.

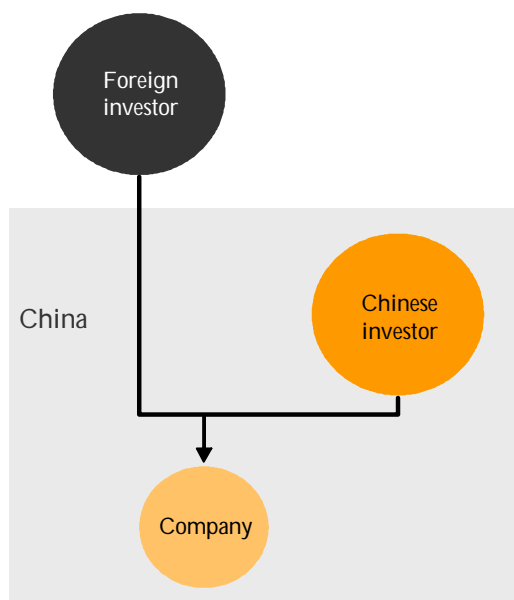
At the other end of the spectrum, despite the fact that the property industry receives nearly a quarter of all foreign investment, there is still a ban on foreign companies owning land. Some companies get round this ban by buying the usage rights to the land.

Finally, some foreign investors are mistrustful of the country's political regime, fearing possible government expropriation or intervention. However, an act passed in 1990 already establishes the need for reasoned causes and fair compensation in the event of expropriation or nationalisation of a foreign investment.

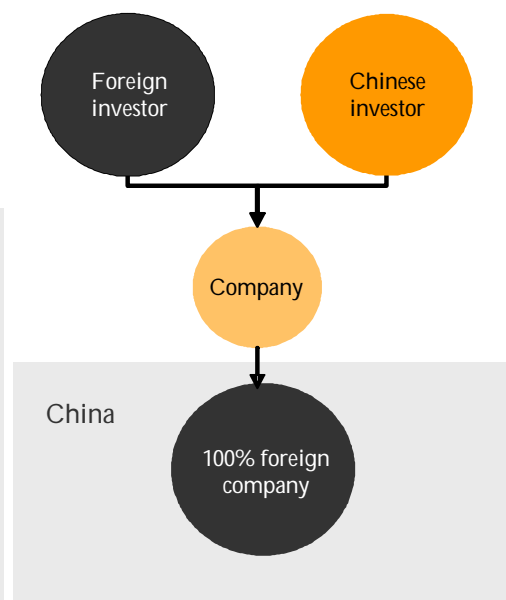
## 5.2. Need for a local partner

Any foreign investment in China requires a local partner. Until recently, common practice was to establish direct joint ventures. These agreements between the Chinese investor and the foreign investor might develop at two possible levels: creating a company in China with the local investor operating in the country or founding a company abroad, with both investors operating overseas, and from there, founding the subsidiary in China.

Localised structure in China.

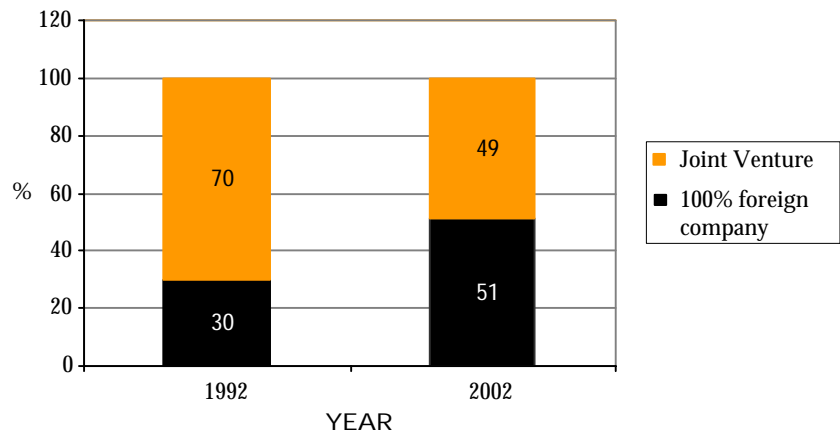


Outsourcing structure.



However, on the basis of investors' experience, this trend is now changing towards more sophisticated channels which to some extent insulate the local partners against unwanted interference in foreign investment.

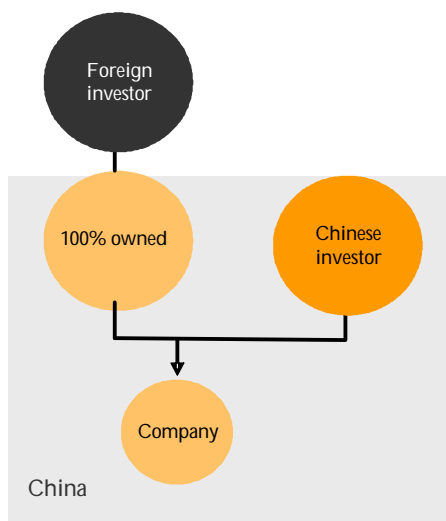
Structure of foreign investment (as a percentage).



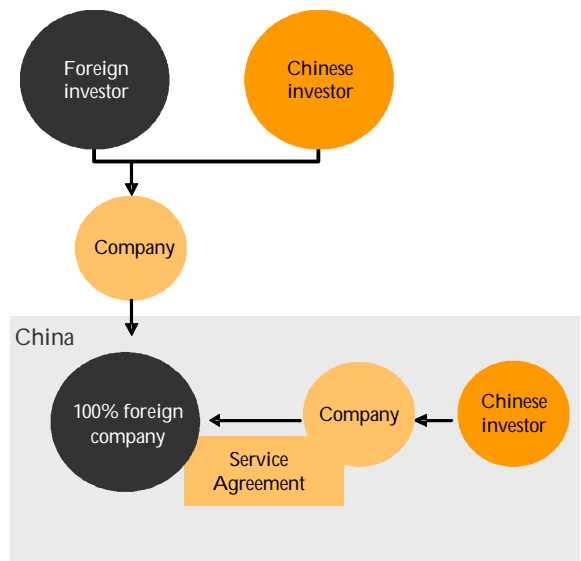
Source: McKinsey.

The most commonly used legal frameworks in recent years are shown in Table 51.

Localised structure in China.



Outsourcing structure.





It is not clear what the ultimate reasons are behind this shift in the investment preferences of foreign businesspeople, although it seems clear that difficulties in reaching an understanding with a local Chinese partner are one of the basic causes. A recent study by the consultancy firm McKinsey pointed to the following reasons given by the executives themselves:

- **Distribution:**
  - There are no good local distributors.
  - Those that do exist don't think in the long term.
  - They are unwilling to invest.
  
- **Mixed company:**
  - Few partners have good technicians and managers.
  - Their knowledge of the local market and distribution channels is not so great.
  - Their connections with the government are not what they seem.
  - The partner may be pursuing job creation or internal policies and not necessarily seeking to develop the market.
  
- **Staff:**
  - Many Chinese managers do not know what it means to work in international companies.
  - Chinese managers often succumb to peer and group pressure.
  - There is the possibility of fraud because of the granting of responsibility without the exercise of control.
  - There is a very high staff turnover, regardless of the incentives given to employees.
  
- **Others:**
  - The Chinese partner generally prioritises quick profits, in contrast to the foreign partner, whose aim is the long term establishment of a market share.
  - Erroneous belief by the foreign partner that control of capital means control of the running of the business.

As a result, some western companies are considering-among other options-the possibility of training second generation Chinese in their countries of origin, who know the Chinese language and culture and after preliminary training and hiring in the West, to post them to the company's subsidiary in China. Others argue that in order to invest in China, you need a mind set capable of dealing with another way of thinking and doing businesses. Western practices and customs do not apply. The process of setting up a company in China and obtaining profits from it is hard and requires constant supervision, as well as a capacity to react.

## 5.3. Cultural and linguistic barriers

### 5.3.1. Context

The epithet "Asian giant" is an appropriate one: China is a country of truly colossal dimensions: it is 19 times larger than Spain and, in addition to Mandarin Chinese, the official language, some 450 other languages are spoken, not including regional dialects. The dominant ethnic group are the Han, although they share the country with another 55 groups. Chinese culture is marked by Confucianism and Communism.

In the People's Republic of China, the official party-the CCP-has over sixty million members and controls practically all executive, legislative and legal powers. In the cultural area, too, the CCP has had such a large influence during the second half of the twentieth century that it has practically wiped out any trace of any previous or different culture. This further accentuates the differences between East and West.

### 5.3.2. Business area

There is a palpable interest in China and its commercial opportunities not only at state level, but also among private business owners and investors. However, given the cultural differences, it is important to study the terrain carefully before diving in. For example, it is impossible to get any business done in China during the first week of October, when the country comes to a complete standstill to celebrate the national day.

Various features of the Chinese way of doing business need to be born in mind<sup>1</sup>:

- Rules are not rules. Everything is negotiation and constant change. Neither previously arranged appointments nor contracts are respected.
- Negotiations and visits to customers tend to move to restaurants where, as well as fèting the customer with typical Chinese dishes (entrails included), they will try to get him or her drunk.
- It is common practice to pay suppliers without having been paid by customers.

In short, one cannot hope to introduce western ways of operating; one has to adapt to eastern culture. The experience is the same for Chinese students who have received a western education when they go back to their home country. Commonly known as "the turtles", when they go back home they have to combine the new ideas learned in Europe or the United States with the modus operandi of China<sup>2</sup>.

It is also necessary to accept that corruption is a cultural feature, which has been furthered by the economic boom.

#### Notes

1. La editorial Robinson Books ha publicado un libro muy ameno sobre el choque cultural entre inversores occidentales y empresarios chinos. Autor: Tim Clissold. Título: Mr. China.

2. Véase el artículo "The Turtles", en la revista The New Yorker, julio 11-18, 2005.

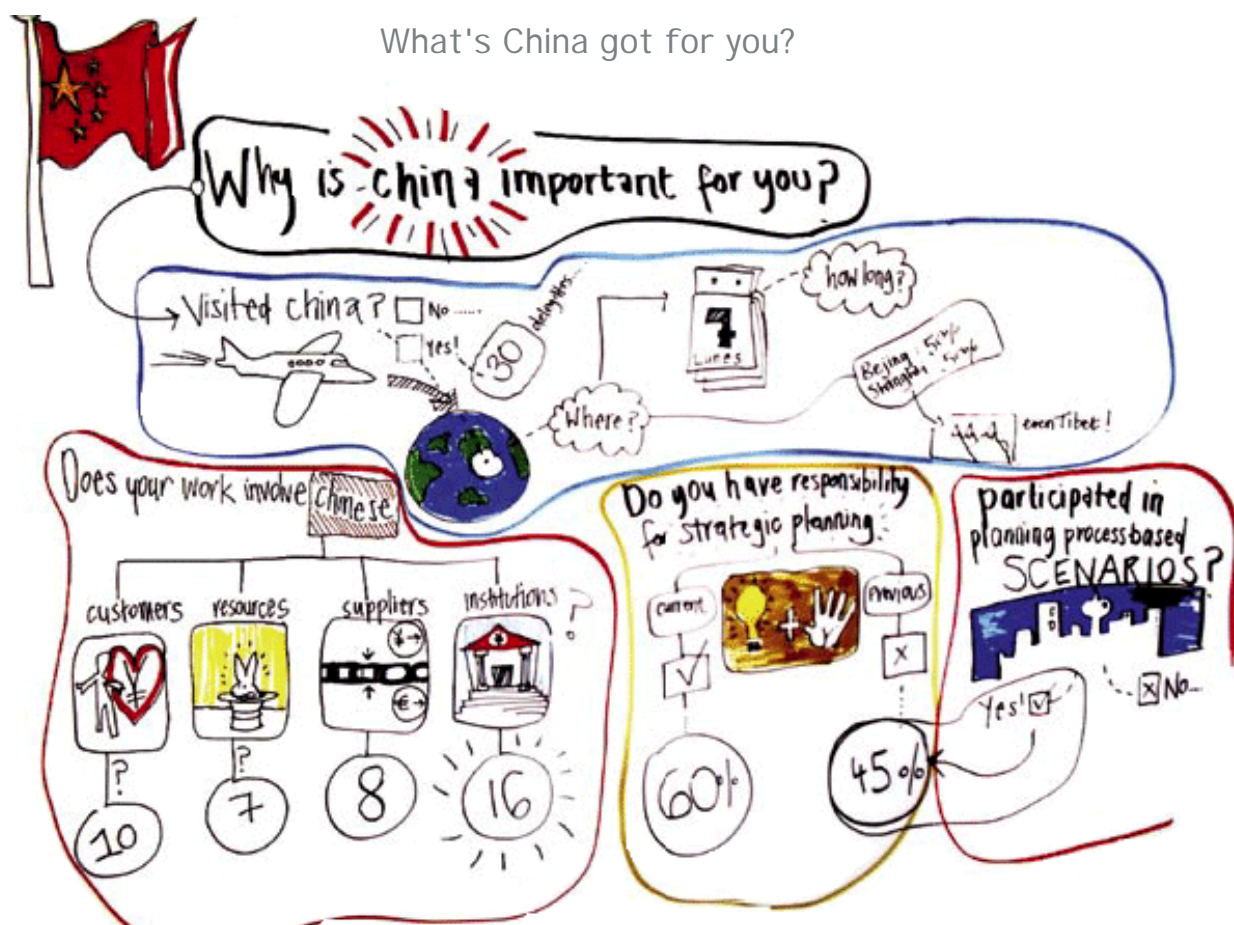
### 5.3.3. Legal area

We recommend that private investors and business owners examine and analyse not only current national legislation but also the specific laws of the province where they want to invest or set up business. Remember that, on the one hand, China has a centuries-old culture, while on the other, especially since it joined the WTO, it has a deep desire to modernise and find a permanent place for itself on the world stage. This is leading to implementation of a set of anti-corruption laws designed to put an end to certain business practices that tended to undermine investors' confidence. In Hong Kong, for example, the investor is protected by the Prevention of Bribery Ordinance, while in mainland China (albeit with possible regional differences) there is the Criminal Law of the People's Republic of China<sup>3</sup>

China is a vast and very disparate country (see the section "The Four Chinas"); laws and regulations vary between administrative regions or provinces. Regulations that operate in Hong Kong may not apply in Beijing.

3. For further information on this area, see A guide for Businessmen in Shanghai and Hong Kong, published by the Shanghai Municipal Prosecutor's Office and the Independent Anti-Corruption Committee of the Special Administrative Region of Hong Kong.

## 5.4. Mini-manual for the foreign investor in China



### 5.4.1. Acquisition by foreigners of shares and assets: regulations on acquisitions by foreigners of shares and assets in institutions in the People's Republic of China

#### 5.4.1.1. Assessment

- The value of the transaction must be guaranteed by an independent institution that uses a commonly accepted valuation methodology.

- The value of publicly-owned shares and assets will be determined in accordance with the relevant regulation established by the State Commission for Asset Regulation and Management.

#### 5.4.1.2. Payment

- The foreign investor must make good all payments to the national seller in a space of three months following obtention of the licence for opening the new company.
- The foreign investor may request postponement of the payments provided it settles payment of at least 60% of the debt in six months and the total in a period no greater than one year following obtention of the licence.
- The foreign investor may make the payments in shares or in cash on authorization from the State Administration for Foreign Currencies.

#### 5.4.1.3. Obligations

- In the case of a share purchase, the foreign investment company established must subrogate the national company acquired in all its rights and obligations.
- In the case of an acquisition of assets, the Chinese company must assume all the original rights and obligations.
- The foreign investor, the Chinese company and the credit institution may reach additional agreements on the settlement of rights and obligations.

#### 5.4.1.4. Limit on investment

- Foreign investment in share purchases may not exceed:
  - 10/7 of the registered capital of the newly created foreign investment company if its equity is less than 2.1 million US dollars.
  - Twice the registered capital of the newly-created foreign investment company if its equity is between \$2.1m and \$5m.
  - 2.5 twice the registered capital of the newly-created foreign investment company if its equity is between \$5m and \$12m.
  - Three times the registered capital of the newly created foreign investment company if its equity is greater than \$12m.

#### 5.4.1.5. Application process

- The foreign investor must submit the following documents, among others, to the relevant authorities:
  1. Application to set up a company of foreign capital.
  2. Agreement of shareholders and company statutes.



3. Definitive agreement for the purchase of shares/assets.
4. Documentation identifying and accrediting the foreign investor.
5. Business licence of the acquired/selling company.
6. Human resources plan for the staff of the company acquired/selling.

■ In the case of a share purchase:

1. Unanimous approval by all shareholders in the Chinese company or motion approved at a meeting of shareholders approving the intended transaction.
2. Audited financial statements of the Chinese company.

■ In the case of purchase of assets:

1. Consent from the owner or legal representative of the Chinese seller.
2. Notification by the Chinese seller to its creditors.

#### 5.4.1.6. Anti-trust

■ The foreign company must apply for approval to the Chinese Ministry of Commerce and the State Authority of Industry and Commerce for acquisition of a company provided that:

- its existing assets in China are in excess of CNY 3bn; or
- its sales figures in China exceed CNY 1.5bn; or
- the market share of the foreign company combined with that of its associates is in excess of 20% or, after the purchase has been made, in excess of 25%; or
- the foreign investor has made more than ten purchases in related industries in China in the last year or has participated in more than fifteen companies in related industries once the purchase has been made.

■ The foreign investor may apply to be exempted from an anti-trust investigation if the purchase in question:

- improves the level of competitiveness on the market;
- reforms a company that is generating losses and guarantees jobs;
- imports advanced technology and talent management, and improves the level of competitiveness;
- favours the environment.

#### 5.4.2. Issues to be taken into account: key questions for investors

##### 5.4.2.1. Structure of mergers and acquisitions

- Holding structure v. independent institutions.
- Onshore v. offshore.

- Strategic/minority investment v. controlling package.

- Listed company v. unlisted company.

#### 5.4.2.2. Corporate management

- Understand the existing corporate management/management structure and change them if necessary..

- Unify the interests of management with those of the investors.

- Create a new and effective business culture, a corporate structure and an incentive plan for employees.

- Monitor management and efficient operation.

#### 5.4.2.3. Restructuring

- Need for restructuring of the company, its operations, its balance and other considerations in public companies.

#### 5.4.2.4. Public property

- There is no clear representation of shareholders. The management can turn to foreign shareholders to protect itself against arbitrary decisions imposed by the public-sector shareholders.

#### 5.4.2.5. Financing

- The availability of financing in local currency opens up alternative paths for obtaining capital:

- Capacity to run up debts within China.

- Possibility of financing in credit instruments on the domestic market: foreign investment companies can trade on the A stock market.

- Take into account problems with hedging when opting for national or foreign currency.

- Manage the cash flow between different institutions.

#### 5.4.2.6. Tax Issues

- Understand the Chinese tax system and use effective investment structures, such as investments at accounting value, to minimise taxes.

Notes

- Make use of the local tax regime for foreign investment; for example, the exemption for the first three years and the 50% reduction during the following two years.

- Changes in the tax system following membership of the WTO; for example, the elimination of preferential tax deals.

#### 5.4.2.7. Repatriation and exchange rate control

- Channel the investment in China along the most suitable path.

- Make yourself familiar with the State Administration of Foreign Currency's regulations on repatriation of funds.

#### 5.4.2.8. Initial considerations

- Initial possibilities include trading on the domestic or international markets, or sale to a private investor.

- Be aware of the restrictions imposed on repatriation of investments and break-up of joint-ventures.

#### 5.4.2.9. Intellectual property

- Extended protection of intellectual property rights through new laws and regulations.