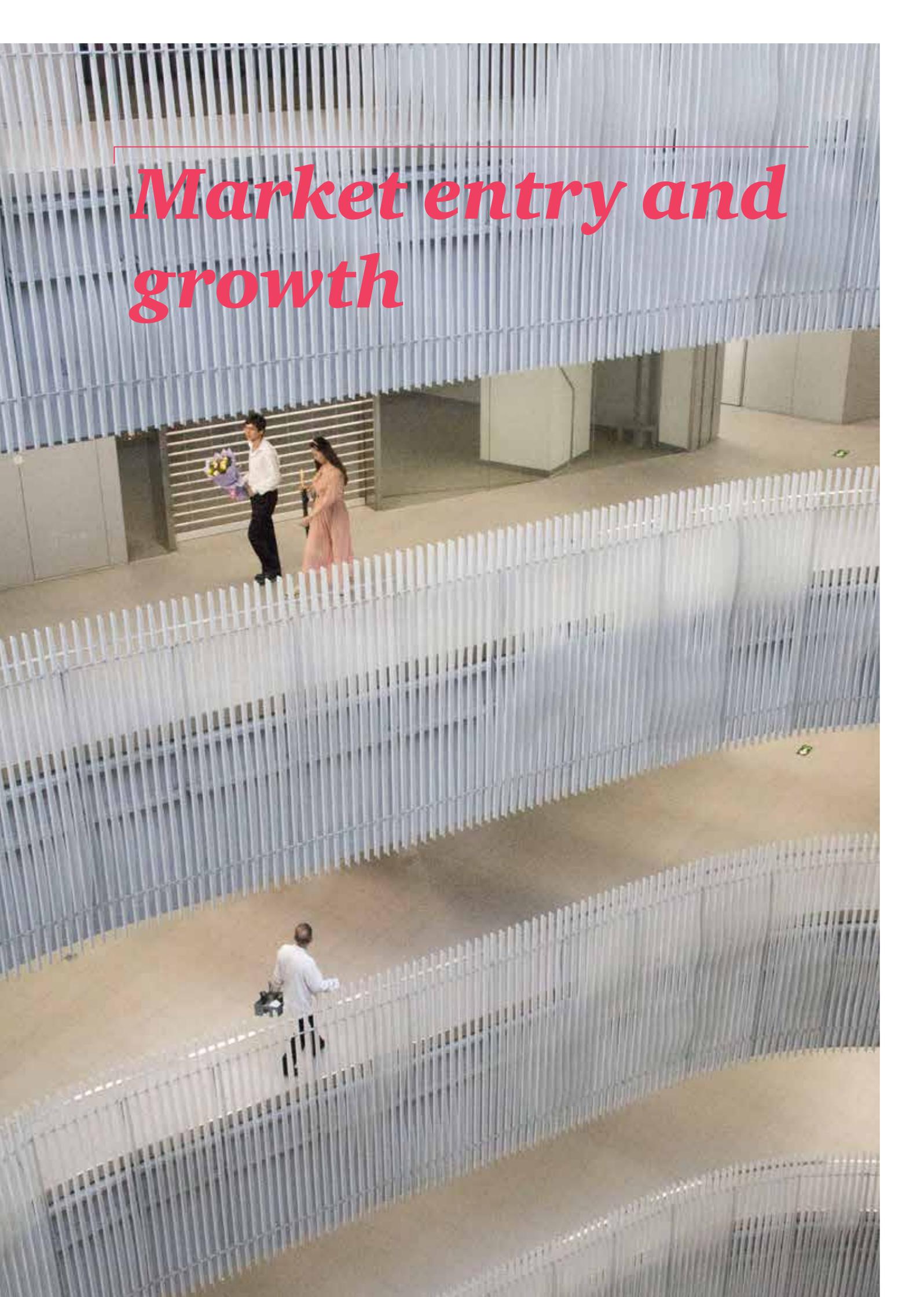


# *Market entry and growth*



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## Observations

1. China is not a single market. Profound differences can exist from region to region, from Tier 1 to Tier 4 cities, from industry to industry, and among different income levels.
2. Data availability and reliability are important considerations for any market study into China.
3. There are many trade-offs to consider before deciding whether to work with a partner (inorganic growth) or to pursue a go-it-alone strategy (organic growth).
4. China partners are increasingly calling on foreign counterparts to offer more attractive value propositions, including technology transfer and know-how, in return for local presence and assistance.
5. There is no defined formula for China entry; successful companies are flexible, and adapt quickly to the realities of their particular industry and market.

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## Recommendations

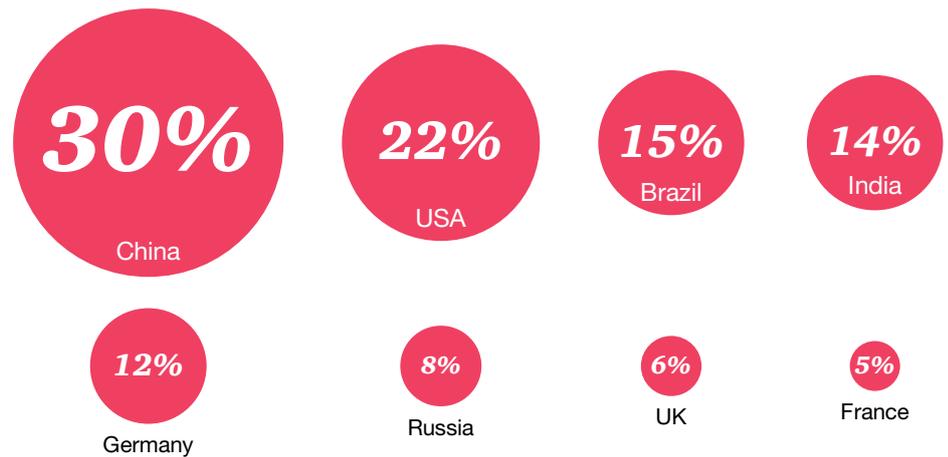
1. Relationships in China are helpful in aiding your due diligence and market research, particularly if your own investigative resources are insufficient.
2. When analysing market research, find an adviser who is sufficiently familiar with the local market and contextual subtleties to interpret the data correctly.
3. Properly localising your products and services for the China market takes a considerable amount of resources and research. Make sure you're ready to commit.
4. Clear communication and trust will guide the success of any business partnership in China.
5. Ensure that your business strategy and industry focus are in line with government policies on foreign investment.

## Coming up with the best-fit strategy

The sheer speed and scope of China's growth are what make the country so unique and the investment opportunities so attractive. Of the over 1,200 CEOs surveyed in PwC's 2012 Global CEO Survey, 30% have said that they are looking to China as one of their "top three important regions for their overall growth prospects over the next 12 months."<sup>1</sup> In a 2012 American Chamber of Commerce in China (AmCham-China) business climate survey, "82% of respondents surveyed plan to increase investment in their China operations in 2012, with 66% saying their goal is to produce goods and services for China, an 8% increase from two years ago."<sup>2</sup> That's why China is and will be a compelling place to do business.

Businesses setting strategies for entering or growing in the China market should seek out proper market analysis, capability building and investment structuring. This chapter will discuss these and other considerations for market entry and growth.

*The top regions for overall growth prospects over the next 12 months, according to 1,258 CEOs.*



Source: PwC 15th Global CEO Survey 2012

*An increasing number of foreign companies are trying to venture into China on their own, later discovering that, to accelerate growth, they'll have to work with local partners to leverage resources such as sales channels, customer bases and low production costs. Identifying the right local partner, aligning their interests and fulfilling their strategic intention, with assistance from external advisers, is often critical for market entry.*

Angeline Cheng, PwC China Consulting Associate Director

1. PwC. "15th Annual Global CEO Survey." 2012  
2. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

Consumer markets in China are heterogeneous, regionally divided and diverse in terms of income levels, taste and sophistication. The culture, customs and traditions of the Chinese people make up an integral part of business decisions and government policy. Understanding these differences, and adopting a flexible market entry strategy that can accommodate these differences, will go a long way in China.

There is, of course, no defined formula for unlocking the China market. Companies who have been successful in meeting their goals are usually those with an adaptive strategy. They are nimble enough to respond to changes in the fluctuating environment and innovative enough to approach China differently. They do not expect to use the same business strategy that had worked in their home markets, or from any other emerging market, even should that strategy be tried and proven.

“On business development, we would traditionally start with a standard product set and adapt it to the local needs,” says Lázaro Compos, CEO of SWIFT, an international network for the financial services community. “But in India and China, you need to forget the products that you’ve got and start from scratch. Start from what it is they need and build from there.”<sup>3</sup>



3. PwC. “15th Annual Global CEO Survey.” 2012

## Market research

Leading companies engage in a meticulous exploratory process when planning their China market entry strategy. Research as much as you can about how the Chinese business environment might affect your operations in your strategies, scrutinise your plans carefully and look at similar strategies that have played out in this market. Important issues to address at this early stage include competitor profiles, addressable market size, how products fit in or are differentiated from what exists, what their target market is buying, and why they're buying it. Figure 1 outlines the various issues you'll need to address from market analysis to entry into China.

As mentioned, China isn't a single market. Take into account the different geographies and markets within China – there are vast differences, for example, between relatively cosmopolitan Tier 1 cities, and smaller towns that are the Tier 3 and Tier 4 cities. Even urban markets in the same province have drastic dissimilarities. Compare Guangdong's Shenzhen, with its young migrant population of predominantly Mandarin speakers, with Guangdong's Guangzhou, and its older, more family-centred composition of Cantonese speakers. Each region must therefore be researched before entry, as customer preferences as well as regulatory and value chain considerations vary.<sup>4</sup> There exists a broad spectrum in income level as well, and new types of Chinese consumers are emerging, exhibiting unique spending behaviours. Plans are subject to change though, and some flexibility will be needed to account for the change in dynamics of these disparate markets.

Says Robert Koch, CEO of Koch Enterprises, on his company's entrance into China, "Probably the longest part was our preliminary investigations, learning more about the country, the culture, the geography, where our customers would be, where the competition might be, the quality of competition."<sup>5</sup> Relationships can prove particularly useful in helping you find out more about the market, particularly if you lack the appropriate investigative resources.

## Product/service localisation

KFC, owned by American Yum! Brands Inc., owes much of its success to its flexible business strategy, designed specifically for the Chinese market, for Chinese customers. From the time its first stores first appeared in 1987, KFC's menu has grown to include not just their traditional fried chicken, but beef, seafood and rice dishes, fresh vegetables, soups, and breakfasts – choices that appeal more to local palates. Today, KFC has nearly 3,800 restaurants in more than 800 cities throughout China, and continues to open an average of one new location per day.<sup>6</sup>

Localisation can be one of the most important ingredients for rapid market growth in China. According to PwC research,<sup>7</sup> China and India are the two markets in which multinational CEOs are most likely to modify or develop their own products specifically for local needs, due to their size. Nestlé's R&D centre in Beijing, for instance, is collaborating with Xi'an Jiaotong University to research the nutritional benefits of traditional Chinese herbal ingredients. General Electric has set up innovation centres in Shenyang and Xi'an, with a third Chengdu centre targeted at the local health care market, aimed to help the government reduce local medical costs.<sup>8</sup> Only 25% of CEOs say their products and services in China are the same as that of their headquarter's market.

But unless a company has made sufficient commitment to China and is prepared to invest the necessary funds to research and develop localised products and services, its China unit will operate at a disadvantage to their local competitors. Often, China-based executives struggle to build a case with headquarters to secure the funds needed for proper localisation. Many businesses find it difficult to justify committing scarce resources to "question mark" China units that yield limited profitability. And with a number of China subsidiaries of foreign multinationals currently accounting for a small percentage of global revenue, businesses must make a decision on whether to settle with limited growth or fully commit to this market.<sup>9</sup>

4. See also Appendices for a quick overview of China's regions and city tiers

5. PwC. "Building a presence in today's growth markets: The experience of privately held companies." 2011

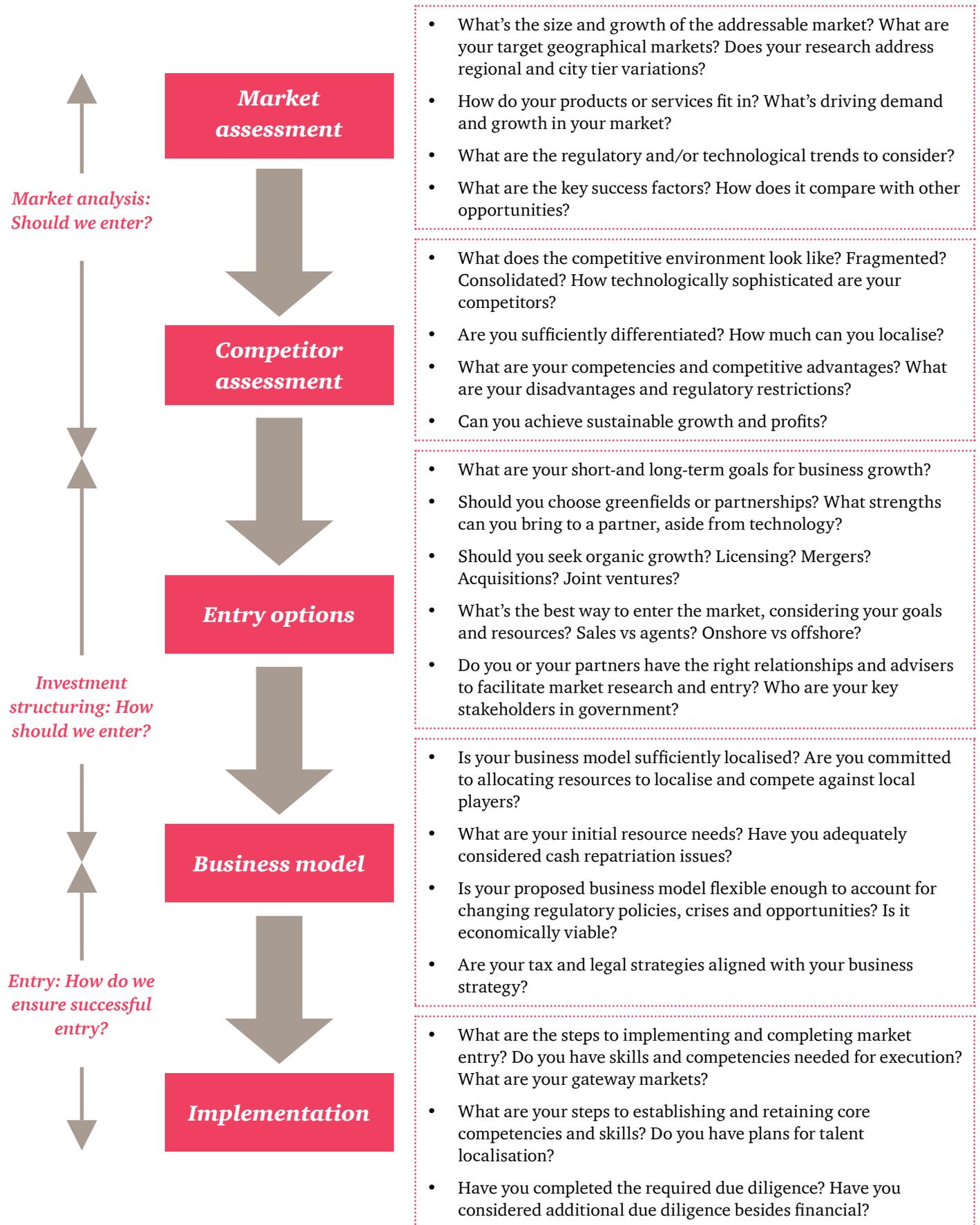
6. Yum! Brands. *Yum! China*. 2012. <http://www.yum.com/brands/china.asp>

7. PwC. "15th Annual Global CEO Survey." 2012

8. *Xinhua*. "GE to build innovation center in Chengdu." 18 January 2011

9. See also Supply chain strategies chapter for a discussion on the benefits of R&D centres

**Figure 1. Approach to China market entry strategy**



# Open and closed industries for foreign investors

Normally, a foreign-invested enterprise (FIE) is set up for a specialised purpose with a specific business scope. An FIE refers to equity joint ventures, cooperative joint ventures with limited liability, wholly foreign-owned enterprises and foreign investment companies limited by shares. Foreign investors have traditionally set up FIEs for trade or production, but have expanded quickly into service, wholesale, retail or other types of business in China.<sup>10</sup>

There are opportunities and restrictions for foreign investors in different industries in China. These sectors are designated by the government as encouraged, permitted, restricted or prohibited. The 2011 Catalogue for the Guidance for Foreign-Invested Industries reflects which industries are open to foreign investment (see also the *Catalogue for the Guidance of Foreign-Invested Industries* found in this chapter).

## Encouraged

Priority industries that are encouraged include high tech, environmental protection and new energy. The Chinese government offers preferential tax treatment and other incentives to foreign investors in these growth industries. This policy is designed to attract new advanced technologies, equipment and management know-how to the sectors.

## Permitted

Industries not listed in the three basic categories of “encouraged,” “restricted” and “prohibited” are considered permitted, which acts as a default category. These industries are open to foreign investment, unless other PRC regulations state otherwise.

## Restricted

Restricted industries include financial services, mining and media, where the government controls foreign investment. Foreign investors in the banking industry, for instance, are barred from owning more than 20% of a local bank, while commercial banks cannot be more than 25% foreign owned. Further, foreign investors can only invest in up to two commercial banks in China. These policies are designed to restrict foreign investment that will impair China’s sustainable development. Foreign investment in low-technology, resource-intensive and heavily polluting sectors are no longer encouraged.

Tighter restrictions are placed on foreign investors on the approvals process and on the amount and nature of a company’s capital contributions. In order to access these restricted industries, multinationals may be required to enter into a joint venture with a Chinese enterprise or other partnership with local shareholders. Setting up an investment project in restricted industries in China requires careful planning – particularly in areas such as raw material sourcing and distribution – and an assessment of the tax implications.

## Prohibited

The sectors that are prohibited from foreign investment are quite specific. They include cultural, sports and entertainment industries, certain types of scientific research, and education.

10. See also Tax management: planning and compliance chapter for tax implications

### *Making sense of the numbers*

Chinese consumer markets may be comparatively easy to observe and research, but these also evolve quickly. A continuing challenge lies in accounting for changing and shifting needs and tastes. Relevant research in industrial trade, manufacturing or other markets may be more difficult to find, if you don't have the right people with appropriate and localised industry experience. All these factors make it difficult to set strategy.

Data availability and reliability are also important considerations for any market study. The urban migrant population can be difficult to track, while some Chinese consumers are becoming more reluctant to disclose personal details. Market statistics might either be region-or industry-specific or too broad or out of date to be useful. Researchers should also note that much of the useful market information may be in Chinese.

A commonly used public data source of market information is the National Bureau of Statistics, but specific industry sources vary. A quick starting point can be to refer to the government ministry overseeing that industry as well as the reports and research of respective official industry associations.

Participating in industry conferences can also give you a sense of who is particularly active in a particular industry. Researchers looking for Internet-related information, for example, might start with the Ministry of Industry and Information Technology, as well as the China Internet Network Information Centre. Entrants looking at greentech markets may reference the China Greentech Report and associated white papers released by the China Greentech Initiative, which details opportunity assessments in the various cleantech markets in China.

Companies will need to develop an understanding of how research data are gathered. This can help them to correctly interpret the data, an exercise which can approach another level of art. Commonly, the locally based analyst should have an in-depth familiarity with China, as well as an understanding of the background of that particular industry in order to penetrate the inherent subtleties of the information and the background government policies. This analyst can then help you correctly distill the data into useful conclusions that can be integrated into your entry strategy.

After going through this research process, you may decide, for instance, that it's too difficult to enter the market yourself and that you may need to partner with an existing local company. Or you may decide that due to the competitive environment, you cannot afford the risk of losing intellectual property by working with a partner. Only after thorough consideration of your business objectives and market strategy should you begin considering options for your mode of entry into China.

### Modes of entry

There are multiple channels of entry open to foreign investors, but they must fundamentally be backed by your company’s business objectives. Knowing what you’d like to achieve in China will help to determine the entry vehicles that can help take you there.

There are a number of options open for business operation after you have decided to enter China. The subsequent section discusses more common options for foreign investors. Additionally, based on your decisions as to which operation model to choose, one or more of investment vehicles should be set up. We will also detail the most commonly employed of these vehicles. Figure 2 illustrates some of the most common business operation options and investment vehicles.

Figure 2. Modes of entry

Typical investment vehicles Typical options for business operation	Representative office (RO)	Wholly foreign owned enterprise (WFOE)	Foreign invested commercial enterprise (FICE)	Joint venture (JV)
Greenfield (alone or with a partner)				
Acquire an existing business (minority, majority or 100% interest)				
Licensing to distributors / franchise				

### Catalogue for the Guidance of Foreign-Invested Industries

As one of the key tools used by the Chinese government to direct foreign investment into the country, the Catalogue for the Guidance of Foreign-Invested Industries<sup>11</sup> outlines sectors where foreign investment is encouraged, restricted or prohibited. Major changes from the latest revision, effective 30 January 2012, are shown below.

The encouraged category describes sectors in which China will push for dominance. It shows where the Chinese government wants foreign investment to go. In the same way, the catalogue shows which sectors the Chinese government has decided to limit or reduce. The restricted and prohibited categories show the sectors that are limited to foreign investment. Even for those who are not considering investment in China, the catalogue gives insight into the government's strategies.

For the developed regions of China, the goal of the catalogue is to steer foreign investment towards: 1) investment in high-value-added, non-labour-intensive businesses, 2) investment in technically advanced manufacturing, and 3) investment in low pollution and energy saving technologies.

The intention of the Chinese government towards foreign investment is clear. Foreign investment is intended to support China's manufacturing sector by providing access to modern advanced technology. There is no longer a focus on job creation and less interest in foreign investment in the sectors outside the areas that will help China develop. Foreign investors should take this into account as investing against the trend in China seldom succeeds.

Figure 3. Major revisions to the Catalogue for the Guidance of Foreign-Invested Industries

Newly encouraged	Newly permitted (previously restricted or prohibited)	Downgraded to permitted (previously encouraged)	Newly prohibited
<ul style="list-style-type: none"> <li>Vocational training</li> <li>Venture capital enterprises</li> <li>Construction and operation of vehicle charging stations, new energy vehicles and battery changing stations</li> <li>Construction and operation of water treatment plants</li> <li>New types of high-technology materials including glass, nanomaterials, special textiles and new materials (for aerospace and aviation)</li> </ul>	<ul style="list-style-type: none"> <li>Production of carbonated soft drinks</li> <li>Construction and operation of oil refineries</li> <li>Commercial companies engaged in franchise business, commission business and business management</li> <li>Automobile wholesale, retail and logistics</li> <li>Medical institutions</li> <li>Financial leasing companies</li> <li>Import and distribution of books, newspapers, journals, audiovisual products, e-journals and Internet music services</li> </ul>	<ul style="list-style-type: none"> <li>Automobile manufacturing</li> <li>Coal and polysilicon chemicals</li> </ul>	<ul style="list-style-type: none"> <li>Domestic express parcel services</li> <li>Construction and operation of villas</li> </ul>

11. National Development and Reform Commission (NDRC) and the Ministry of Commerce of China. "The Revised Catalog of Industries for Guiding Foreign Investment." 24 December 2011. [http://www.gov.cn/fifg/2011-12/29/content\\_2033089.htm](http://www.gov.cn/fifg/2011-12/29/content_2033089.htm) (accessed November 2012)

## Typical options for business operation



Investors are often faced with an essential question when deciding on their business operation model in China. That is:

### *Do you plan to work with partners (inorganic) or without them (organic)?*

Typical trade-offs between organic and inorganic growth include speed to market, upfront investment, control and management, competition, leveraging of existing customer base, and valuation and integration requirements. Some cases involve companies having to pursue greenfield investments due to either a lack of existing acquirable businesses that have similar business models or the need to build a new production site using specific technology. No one-size-fits-all guide exists to help companies decide on the proper route to take.

That said, an increasing number of companies coming to China have chosen to look beyond a purely organic method of growth. They are starting to consider the possibilities of working with (or even buying into) local companies, in their attempts to pursue faster growth or eliminate competition.

On the other hand, local private companies that had once been small enough to acquire have now grown too large for outright acquisition and management. These companies now seek attractive value propositions from foreign partners before entering partnership discussions. We'll discuss this in further detail in the Doing deals chapter.

### *Greenfield (going it alone, or with a partner)*

Once you're certain that the opportunity is in China, your team on the ground will need to engage in a market and competitor assessment, and build relationships. You might want to first set up an entity, whether in the form of a representative office or a wholly foreign-owned enterprise (WFOE).

After an assessment of the competition and resources available, companies may decide to pursue greenfield investments out of a lack of available resources or capabilities on the ground. At this stage, they can opt for either one of two choices:

1. Going it alone in the greenfield investment, or
2. Finding a local partner to work with you on that greenfield.



- Finding and building the right relationships within the government<sup>13</sup>
- Establishing your sales and distribution networks, customer base and relationships
- Setting up robust logistics, transportation, facilities and other supply chain infrastructure<sup>14</sup>
- Localising your products and services to tailor to local market needs, and accepting a slower speed to market as a result
- Planning for a longer-term time horizon: building capacity in China is likely to be a long and drawn-out process, while short-term returns might be difficult to realise

Having local partners working on your greenfield projects would help address these business issues. Leveraging their existing local teams, networks and other tangible/intangible resources can help accelerate the start-up process. Those who intend to build a new production site with advanced technology, for example, can rely on their local partner to help facilitate land acquisitions, apply for construction permits, obtain banking facilities and possibly even secure downstream customers. Note that the local partners may seek technology transfer or financial considerations in return.

Choosing to work with a local partner will mean that the joint venture (JV) will be your entry vehicle. You and your partners can then pool capital and relevant assets into this JV.

In choosing the first option, businesses often cite the loss of control or technology transfer risks as important considerations. There are challenges to this choice, however, some of which may include:

- Complicated setup processes and high costs, particularly for government-related licences or registration processes and procedures
- The need to commit the necessary skills and expertise from headquarters to initially manage your operations and programme succession plans<sup>12</sup>
- Building a local team with the right competencies and skills, as well as local knowledge and connections

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12. See also Human resources and talent management chapter

13. See also Government relations, regulatory compliance and stakeholder alignment chapter

14. See also Supply chain strategies chapter

## **Acquiring an existing business**

There has been a recent resurgence in interest towards acquisitions and buy-outs over the past few years, as foreign investors recalibrate their entry strategies. There are many reasons why a foreign investor might pursue this route, as equity-based partnerships hold the promise of tapping a local partner's infrastructure, resources and networks, boosting their speed-to-market and localisation potential. Partnering with a Chinese company also allows improved access to domestic sales channels – and you can grow your market faster.

Essentially, there are four common acquisition scenarios:

1. Minority ownership (less than 50%)
2. Majority ownership (more than 50%)
3. Equal share (exactly 50%)
4. Buy-out (100%)

The following are some common issues to consider when deciding which scenario to plan for:

- **Regulatory constraints:** In some restricted industries, including commercial banking, foreign companies are only allowed a minority stake. Certain business licences are also available only to local companies or entities that are minority foreign owned.
- **Control of the business:** Majority owners would typically assume control over the business, and hold decision-making ability on key matters.
- **Control of the operation:** The ability to appoint key management roles (such as general managers, finance controllers, production and supply chain managers) is subject to negotiation and agreement among the foreign and local parties.
- **Revenue consolidation:** Majority ownership enables revenue consolidation into the parent company or the foreign group.
- **Injection of intangible assets:** Majority ownership can more readily allow a transfer of intangible assets (including know-how and technology licensing) from the majority owner to the business.
- **Willingness of the local companies to cede ownership:** The local partners might be unwilling to relinquish control (at least not immediately), which means the foreign company may have to settle for minority ownership.

### **Common acquisition scenarios:**

- 1. Minority ownership (less than 50%)**
- 2. Majority ownership (more than 50%)**
- 3. Equal share (exactly 50%)**
- 4. Buy-out (100%)**



Many foreign companies would prefer majority ownership, mainly due to reasons of control and revenue consolidation. Some may opt for a 100% buy-out.

It's worth noting, however, that a 100% acquisition, or even a majority interest, can carry significant risk if your company lacks the sizeable operations and competencies on the ground to run that acquisition. Owners of most local companies are often also their managers, who typically hold the keys to driving the company forward. If these owners subsequently sell all their shares to the investor, that would mean that they've essentially cashed out of the business, and you will need a team to quickly fill the gaps and replace them during the transition period. Otherwise, you may risk losing complete control of the company or key personnel to the departing management team. Managing a successful majority/buy-out acquisition will therefore require the right base of capable managers and infrastructure on the ground to absorb the additional operation.

There are also cases in which foreign companies might choose to take a staged approach to acquisition, starting from a minority stake, then gradually transitioning to majority ownership and finally to a buyout over a three-to-five-year time frame. During this period, foreign companies can gradually develop and establish their capabilities to run and manage this business, while offering sufficient incentives (properly structuring earn-out provisions, for instance) to retain the local core management team. One incentive is to offer an international career and role in the group to the former target manager, who can then transition from being a general manager of a promising privately owned enterprise to an executive of a worldwide enterprise.

An "equal share" joint venture (50:50) is sometimes a compromise solution between both foreign and local partners. Aside from the limitations in revenue consolidation, this type of arrangement may result in neither party wielding the necessary power to make decisions at the board level. Equal share

joint ventures may occasionally even hinder the growth potential of the business in the event the relationship turns sour, and thus should be entered into with a high degree of caution. Note that a joint venture can be formed through:

1. A completely new legal entity to which both parties can assign relevant assets, or
2. A transformation of an existing local company entity into a foreign joint venture (either through the buyout of an existing share from the local shareholders, an increase in its capital, or a mixture of both).

For more on joint ventures, please see the description of joint ventures in the subsequent section on *Typical investment vehicles*.

### ***Licensing to distributors/ franchising***

Another way in which a foreign investor can enter the Chinese market and establish instant brand recognition is by finding a local distributor to manage their products for them. This can be a relatively quick and simple way to manoeuvre your products into the market, and to start generating revenue with minimal resource commitment. If the local distributor already has a network set up, then they can sell any type of good. The downside is the resulting reduction in your managerial control and input into the way in which your goods are marketed and/or handled.

However, as a foreign investor, your responsibility lies in setting up and monitoring a system to ensure that your partners handle these goods appropriately and comply with your standards. There is much greater risk inherent in this option: You would be relinquishing some control to your distributors, as you would receive payments upfront (subject to actual negotiations with the distributors).

To manage your distribution risk, manufacturers may also wish to work with more than one distributor in China. You may need to consider whether or not to grant exclusivity to the distributor or dealer. Typically, signing two distributors to the same market is not practical, so businesses might consider limiting the territory of distribution to one or several provinces. Other options include one-year term limits, or annual sales target requirements, as prerequisites for licensing contract renewal.

### ***Master franchising***

While many international franchisers in China set up joint ventures or wholly foreign-owned enterprises (see *Typical investment vehicles*) for their franchising model, some may choose to sell master franchising rights to a local company.<sup>15</sup> This model involves giving up a large amount of control, and placing a lot of trust in the local master franchisee. Local connections and knowledge will be valuable in finding the right partner, and determining the right fit will take time.

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15. International Franchise Association. "Franchising industry in China." 2010

## Typical investment vehicles

### Representative offices

While businesses can't conduct any real business with representative offices, they're easy and relatively inexpensive to establish. As a result, they're effective for testing the waters and gauging a true market need.

A representative office is comparatively simple and faster to establish as there are fewer regulations and no capital requirements. It's also a lower-risk option for foreign investors and a common way to enter sectors that have recently been opened to foreign investors. Some regulated industries, including the finance industry, require the setup of a representative office first before undertaking other forms of investment in China.

However, representative offices are somewhat limited by the fact that they are not legal business entities. They're only permitted to engage in "non-direct business operations" in China such as conducting market research or acting as a business liaison for the parent company. They cannot be used for any actual sales, generate any revenue or enter into any contracts.<sup>16</sup>

### Wholly foreign-owned enterprises (WFOEs)

Wholly foreign-owned enterprises (WFOEs) are the preferred vehicle for businesses with an established product or service that can be easily imported and sold in China. Establishing a WFOE is becoming a leading option as a mode of entry for investors. In the 2012 AmCham-China survey of MNCs,<sup>17</sup> 66% of respondents said their parent companies had established a WFOE in China.

WFOEs are attractive options as they give investors 100% equity and control. Without having to share with a partner company, a WFOE has complete jurisdiction over its internal decisions, operations, human resources and corporate culture. This independence also allows you to align your strategies closer to your parent and sister companies. WFOEs also lower the exposure of risks of working with a partner.

In contrast to representative offices, WFOEs have the ability to do business legally in China. They can conduct sales, issue invoices and receive revenues. They are also capable of converting renminbi (RMB) into other currencies, which is a necessary function for remitting money to your parent companies outside of China, upon fulfilling certain documentation and procedure requirements.<sup>18</sup>

However, establishing a WFOE can be a time-consuming process. Greenfield operations will require talented local staff and expert advice if it is to be set up properly.

The Chinese government does restrict WFOEs from certain industries. In the securities industry, for example, a foreign entity cannot own more than 49% of a Chinese securities trading and underwriting company. This, however, is an improvement on the 33% ownership limit set previously.<sup>19</sup> In such industries, you'll need to work with a local partner and share ownership.

### Foreign-invested commercial enterprises (FICE)

The foreign-invested commercial enterprise (FICE) is a popular variant on the WFOE. The China FICE can distribute either imported or locally manufactured products throughout their wholesale, retail and franchise systems. They can also provide related services such as storage and warehousing, training, and inventory management. Branch offices can also be opened and operated anywhere in the country. They cannot, however, change the nature of the product they've purchased for sale – a FICE registered to sell shoe products cannot sell food, nor can it alter its products. There are two main types of China FICE: the wholesale FICE and the retail FICE.

16. See also Tax management: planning and compliance chapter for more on representative offices

17. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

18. See also Finance and treasury chapter for more on cash repatriation

19. McMahon, Dinny, and Bob Davis. "Beijing loosens some foreign ownership limits." *Wall Street Journal*, 4 May 2012

## Intellectual property in joint ventures

The protection of intellectual property is often a headline issue for joint ventures and mergers. In the due diligence process, you may need to assess the uniqueness of the technology you're bringing to the joint venture. In general, the less unique or cutting edge your technology, the lower the risk.

Without patent protection, common solutions to protect your IP include implementing security controls that can help reduce the risk for replication or theft. These include ensuring that the partner is not present when calibrating machinery, or integrating technology in a way that's either difficult to reverse engineer or incorporates easily identifiable "call signs" in the event of litigation. You might also opt to hold your intellectual property offshore, licensing in the technology through a royalty/licence fee arrangement.

## Joint ventures (JV)

In the 2012 AmCham survey, 25% of respondents said their parent companies had established a joint venture in China.<sup>20</sup> There are generally two forms of joint ventures in China – equity joint ventures and cooperative joint ventures. In an equity joint venture, the profits, risks and losses are shared in proportion to each partners' equity stakes. In general, businesses should expect a six-to-12-month process to negotiate a joint venture.

Timing is driven by two factors, the time it takes to prepare the regulatory and legal documents, and the time it takes for approval. This timeline can be extended beyond 12 months, depending on factors such as the industry in which the JV will operate and whether the partner is a state-owned enterprise.

Ownership is normally determined by capital contributions. Foreign investors must invest at least 25% into the JV for it to be treated as a foreign-invested enterprise.

A cooperative joint venture is different. It has more flexibility; e.g., the sharing of profits is governed by the JV contract.

Note, however, that under the regulations of the People's Republic of China (PRC), any joint venture partner has the right to sell their ownership interest to a third party, without the partner's consent. Your only recourse would then be to purchase that ownership interest.<sup>21</sup> This may potentially place you in a difficult situation, so make sure to deal with this issue directly in your joint venture agreement.

Some licences are even available only to Sino-foreign equity/cooperative joint ventures. For example, as the government heavily regulates the Internet sector, basic Internet service providers must be at least 51% owned by a state-owned enterprise. Therefore, a foreign investor must choose a state-owned enterprise as a JV partner. In addition, if a foreign investor has over a certain number of retail stores that distribute certain products such as books, newspapers and medicines, then their ownership in the enterprise is limited to 49%.

Because of a lack of one unified source in China to assess the reputation of a company or management team, finding a partner in those with whom you have an existing working relationship can lead to a higher chance for your joint venture to succeed. The challenges of a joint venture often start at the negotiation stage. Establishing a joint venture is time consuming, and plans may go off track at any point in the talks. There's also a risk of confusion on the legal framework of a deal, which may give rise to distrust. Clear communication and a trusting partnership are critical in executing management decisions. Make sure the other party understands who will exercise control over the JV.

Partnerships in China are also about balance. At the negotiation stage, investors need to navigate the fine line between incentivising your local partner and ensuring they have enough control of the operations. Make sure you have enough incentives for your partner to continue putting in their fair share in the joint venture, but don't give up too much control.

20. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

21. *Provisions of the Supreme Court on several issues concerning the trial of disputes involving foreign funded enterprises*. Article 11 (Supreme People's Court of the People's Republic of China, 5 August 2010)

Multinationals should also consider what they want out of the partnership, which could lead to an eventual exit strategy. Successful joint ventures in the past have been established and amicably wound up by companies that eventually bought out their partners. Starbucks, for instance, announced in 2006 that it would buy out its local partner, Beijing Mei Da Coffee (owned by H&Q Asia Pacific), in a then-joint venture that operated 60 coffee shops in Beijing and Tianjin.<sup>22</sup> In the early 1990s, Coca-Cola bought out the shares of all its bottling plants. Negotiations with the Chinese government were lengthy and challenging, however, and often involved assisting its state-owned partners in developing their own branded beverages.<sup>23</sup> Winding down a joint venture while maintaining good will with the Chinese partner is thus often as important as starting one in good faith.

Control over the board of directors may not be particularly helpful, as the board usually has little say in the running of typical Chinese corporations that may lack Western corporate governance structures. And while it's not advisable to rely on the JV contract or legal stipulations to exercise overall authority, companies should still ensure there are legal provisions for an exit strategy in the case of a deadlock, or provide for non-competition clauses in case the partner or its affiliates start a competing business. Businesses should also have a localised and experienced general manager on the ground that can facilitate communication, supervise the joint venture and represent their interests.

There are other considerations and risks aside from selecting the right partner and aligning expectations. Since due diligence is a less common practice in China, the process may have to be explained to a potential JV partner. Consider how the organisational structure will be set up, how you'll handle human resources and staff issues (including potential pay inequity between expatriate and local staff), and how you will manage accounting, financial and other operational reporting. The liquidity of your partner is paramount in your review. If your partner has liquidity issues, the risk for fund misallocation rises. The compliance profile (particularly in the area of tax compliance) of their business can also be a good barometer for how they'll conduct their business.

A more detailed listing of your entry methods, of course, is dependent on the nature of your business, home territory and industry. Deciding on an investment mode of entry into China is not a simple task and needs to be formulated in conjunction with numerous other considerations.

In the other chapters of *Doing Business and Investing in China*, we'll take a deeper dive into the other factors that you need to be aware of when planning your business strategy in China.



22. *The Economic Times*. "Starbucks acquires control of China JV." 25 October 2006

23. Mok, Vincent, Xiudian Dai, and Godfrey Yeung. "An internalization approach to joint ventures: The case of Coca-Cola in China." *Asia Pacific Business Review*, 2002