PRAGMA

The China Newsletter

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Welcome to the April 2008 edition of Pragma's China Newsletter, prepared by Jesa Consulting

FOCUS ON: Decision making on whether to enter the Chinese market through a direct Investment


Shanghai urban landscape

There are many reasons why foreign companies may be willing to enter the Chinese market: to diversify risk, to achieve economies of scale, scope or cost, to get fiscal and legal advantages or to benefit from the market potential. Nevertheless, there are several factors to be taken into consideration and carefully evaluated before making the decision on whether to start doing business in China.

First of all, it must be reminded that the Chinese market is composed by independent regional markets in competition with each other. Between these different markets, there are social, cultural, linguistic and regulatory differences that might affect the way a company needs to implement its strategy.

Foreign Small and Medium Enterprises willing to penetrate the Chinese market have to face peculiar obstacles mainly due to:

- Dimension - Even if things are changing, a company has to be a certain size to be able to invest in China, mainly because Chinese operators see Joint Ventures as a mean to establish partnerships with big multinational companies;
- Business ethics - The main difficulties in dealing with Chinese partners may reside in cultural, linguistic, regulatory differences and geographic distance;
- Increasing competition - Chinese competition, especially in mechanic and electronic sectors, is soaring, making it more difficult and costly to gain market share.

For these reasons a company that wants to operate in China must prepare a detailed entry plan, which answers to at least five main questions:

1. Are we ready?
Management has to have the necessary skills and be able to comprehend the Chinese market; moreover the company has to have the right information and be aware of possible entry barriers.

2. Do we have a defined strategy and business plan?
The company has to identify the best strategy in a long-term perspective and be able to raise sufficient capital for the initial investments.

3. Is our product competitive?
The product has to be well-positioned and it has to have a competitive advantage in order to suit the local market.

4. Do we have the appropriate organization?
The potential partner must be reliable and the organization has to be

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What is Jesa?


Jesa's reception desk in Shanghai

Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources.

Jesa is currently expanding its services to provide support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

We also perform HR audit and investment analysis (trouble-shot analysis) to check performances in support to companies already established in China.

able to maintain a cooperative relationship with the locals, obtain and maintain control, communicate with other companies.

5. Are we compliant with the referential context?

The company needs the necessary licenses and authorizations according to the local laws and regulations and the staff must know the market and the local uses.

As regards strategy, companies need to operate in a long- term perspective, integrating sales and after-sale support with a capillary presence nearby clients, and targeting the market high-end, which rewards quality and advanced technology.

An important issue is to decide whether to penetrate the market through a commercial activity or to make a capital investment in China.

The main forms of commercial penetration are:

1. Distribution;
2. Franchising;
3. Representative Office.

The main forms of investment are:

1. Direct investment through Wholly Owned Foreign Enterprise or Foreign Invested Commercial Enterprise: this kind of investment is feasible when the company is characterized by a unique and competitive business model and limited economies of scale. The main issue is how to access the market without a Chinese partner;

2. Joint-Venture with a local company: both partners bring experience and complementary goods, while the Chinese partner gives access to its network. This is the best option in case of barriers to foreign capital investments but the company needs to protect its know-how and be sure that the partner is able to provide access to market and distribution. A proper Due Diligence is mandatory in JV even in case of long time relationship with the partner.

3. Merger / Acquisition of a local company: it is feasible if the company has capital available and if the transaction allows the complete control of the acquired companies and their distribution channels. The strategic importance of acquired assets has to be carefully evaluated.

Direct investment is often the preferred option because production management allows a higher market control compared to only exporting.

The choice of the geographic area for the setting of production facilities has to be made according to the localization of the principal suppliers, clients and competitors. Moreover, the conditions of the specific region must be taken into account, such as relationship with local politicians, cost of land and production facilities, presence of specialized personnel and ease of recruitment, cost of utilities. Taxation, which was a discriminating factor, has been recently uniformed and set at a flat 25% rate.

The New Economic Area of Guangxi

The Chinese government stated the green light for a new economic area which will be named “Guanxi Beibu Bay” and will be established in the Autonomous Region of Guangxi Zhuang. The Beibu Bay already host the economic zone, devoted to manufacturing processes, born thanks to agreement between China and ASEAN (Association of Southeast Asian Nations), but the approval of the plan by the Central Government will spur the development of the less exploited of the Chinese coasts.

In fact, even if traditionally the costal areas are the most prosperous, the economic boom concentrated in the three areas of the Yangtze River delta, the so called “Bohai Ring”, and in the Pearl River delta, leaving Guangxi Province almost untouched. The economic zone of the Beibu Bay will cover six costal cities until the border with Vietnam for a total of 42,000 squared Km of land, 130,000 squared Km of sea water along 1,595 km of coast.

In the area live almost 12.5 million people and it represents a link not only towards Vietnam but also towards the Taiwan Strait and the Hainan Island, and it is developing a commercial port for the commerce with other ASEAN countries.

The ASEAN countries, as well as Japan and Hong Kong, for this reason, could constitute an obstacle for European investors. Data are clear: the foreigners that have the most important presence in the area are Japan and USA, and following France and Germany. Yet, there are good preference policies in the area to attract foreign investments: A part from big infrastructure, the foreign companies using new technologies, as well as those importing raw materials or components to be assembled for export or that invest in agriculture and breeding enjoy a custom taxes and VAT on imports exemption. Companies involved in agriculture can see the tax-free period doubled.

Negative elements are the extreme poverty and poor infrastructures. The interest of the Chinese government in Guangxi is demonstrated by its mention in the last five-years plan (2006-2010) in which the area is defined as "one of the priorities in the development of the West of the country".

Environmental Awareness in China: Threats, Opportunities and New Developments

Hebei Province: Cyclists ride through a cloud of pollution produced by a nearby factory

In recent years, China is keeping an eye on the environmental impact brought by the recent growth of the country. The Chinese government is reinforcing pollution standards, making them stricter and sometimes more rigid than those of developed countries. Although these policies vary according to provinces or even industrial areas, a general trend of increased environmental awareness is becoming more and more evident. Apart from a more efficient exploitation of current available energy, what about the government's idea regarding new power sources? In particular, will these policies consider the impact that the past environmentally incorrect Chinese growth is having on the rest of the world?

More and more venture capitalists and entrepreneurs around the world are focusing their attention on what could become a big business: the business of clean and renewable energy in China. Even if this trend might not take the form of another ".com" bubble, it is to be said that China is applying this concept on a large scale. Last year, China added to its energy grid 3.4 GW generated through wind power. Within 2010, China will see its nuclear capacity grow of 400%, from 10 to 40 GW. Currently, both for wind power and nuclear energy, China holds the record of the highest growth rate in the world.

However, China's progresses in renewable energy could deceive optimistic people who dream a future without coal. Indeed, the growth rate of energy demand is so high that it can be satisfied only by the combustion of huge additional quantities of coal. The International Energy Agency estimates that, between 2008 and 2030, the increase in oil consumption in China will reach the current total oil consumption of India.

The government's goal is to add 1,300GW of energy generation capacity by 2020, of which 25-30% should come from clean and renewable technologies. Yet, even if these objectives were reached, 70% of electricity in China would still come from coal combustion anyway (currently, this rate is 78%).

The reason why China is so energy addicted is that, starting from 2002, the country embraced a growth pattern mainly based on heavy industries, such as cars, steel and aluminium production, all highly capital intensive businesses that need vast amounts of energy.

Five years ago the ratio between industrial output and GDP was 55%; last year, it reached 120%. As a result, China cannot be considered an efficient energy user and, taking into consideration the output for each consumed GW, it falls behind the US, Japan and other developed economies. With the aim to increase the efficiency by 20% in the next 12 years, the Chinese government ordered heavy industries to develop more judicious consuming strategies and local governments to implement the standard used in construction of new buildings and shopping centres to make them less wasteful. To do that, it is developing solar, wind and biomass so rapidly that some experts say that the country could soon become a world leader in renewable energy. Even so, forecasts show that these sources will amount to less than 4 percent of the energy supply by 2020.

Moreover, there is another reason for China's enormous need of energy. For tens of million Chinese, the middle-class dream is becoming true: they are buying their first cars, computers and other electronic appliances. As an explanatory example, consider the Three Gorges Dam project that created a new source of clean hydraulic energy by moving millions of peasants living in the areas now submersed by water: according to estimations of the Beijing's Sustainable Energy Program, the energy demand coming from air conditioning appliances purchased by Chinese during 2008 will exceed the total energy capacity of the three Gorges.

In conclusion, even though China is making its best to develop new and renewable sources of energy with remarkable results, these policies will result only in a small contribution to energy production due to the insatiable power bulimia of the country. Nevertheless, the new direction that China's policy is taking could affect also foreign companies seeking to invest in China. One suggestion to those companies is to keep an eye on future development and valuate carefully the environmental impact of the company's operations before selecting the location of investment remembering that, despite what foreigners may think about China, sometimes environment protection policies lead to standards stricter that in the rest of the world.

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