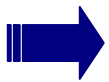




Welcome to the September 2009 edition of Pragma's China Newsletter, prepared by Jesa



News from Jesa: China and Italy



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Chinese outbound direct investments have experienced a strong increase in the last five years, spurred by the *Go Abroad policy* launched by the Chinese Government in 2002. In 2003 the total Chinese outbound direct investments amounted to 2,7 billion dollar, in 2008 they were totally around 52,2.

Europe is the fastest growing area for these investments and even if Italy represents only a small part, it has been catching up quickly.

Most of the companies established in Italy are small and medium enterprises established by immigrants, mainly restaurants and small shops, but the figure of the phenomena is deeper.

The interest toward Italy has been demonstrated by several bilateral meetings. One of the last ones was hold in Rome last July: 300 Chinese entrepreneurs, led by the Minister of Economic Affairs of the Republic of China, met 500 Italian counterparts to reach commercial agreements.

Manufacturing, automotive, new technologies, construction and logistic, tourism are only few of the industries Chinese are interested in. Several important companies, worldwide players in their industries, have already chosen Italy to establish trading centres, R&D centres or production and logistic hubs.

In 2008, the acquisition of Cifa, Italian leading producer of cement-working machines, by Zoomlion signalled an important step and it is the largest Chinese acquisition in Europe. Anhui Jianghuai Automobile, has established its Italian Design Centre in Turin and in 2005, Qianjian, leading motorbike producer in China, took control of Benelli. Chinese Companies are also very interested in logistic investment, as shown by Cosco, a joint venture between Coscon Shanghai and Fratelli Cosulich in Naples and Milan as well as China Shipping Company that has office in Genoa.

These are only few examples of Chinese presence in Italy.

The reason that attract Chinese Companies in Italy is mainly the awareness that Europe is one of the most strategic markets with some of the leading players in many industries; Italy is a central hub, even if the market share is not the most important.

On the other side of the coin, the weak point of the Italian system is mainly represented by the lacking of support in bureaucracy and effective investment promotion. To improve the quality of the investments, a ground layer of facilities should be developed, starting from the visa policy among the countries passing through tax relief and considering the intercultural training.

The lack of human resources in Italy able to deal with Chinese culture and background in order to play the role of moderator in the intercultural integration of the players involved and the poorness of intercultural training programs for Chinese managers and local workforce are obstacles to the development of such investments.

With more than 10 years of experience between foreign customers and Chinese counterparts, Jesa is developing an intercultural training service that is addressed to Chinese and foreign management team in China as well as abroad.

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What is Jesa?



Pragma's and Jesa's logos 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 save 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 financial resources and time.

Jesa is currently expanding its services providing 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-shooting analysis) to verify performances in support to companies already established in China, and we provide tax and accounting consultancy.

Healthcare in China: some room for investments

China, the third largest economy of the world, is recovering its health-care sector with a brand new blueprint leaving room toward genuine innovation process and representing an opportunity for investors. After having suffered from a recent bribery scandal involving the former head of the State Food and Drug Administration (SFDA), Zheng Xiaoyu, as well as some product safety issues moved against its pharmaceutical industry, the Asian country needs to take important steps to provide basic health care as a "public service" to its population.

The Central Committee of the Communist Party, jointly with the State Council, issued this month the Guideline on Deepening the Reform of Health-care System after almost three years of laudable debates and revisions. The plan will guarantee, by the year 2020, its 1.3 bn citizens with a "safe, effective, convenient and affordable" health service both in rural and urban areas. It accounts investments for 850 billion Yuan, approximately 124 billion U.S. dollars, in order to guarantee the 90% of its population with a basic medical insurance coverage within the year 2011.

The Background - After 1949, the founding year of PRC, the government had covered about 90% of medical expenses only to urban resident, leaving rural areas to a simpler and ineffective free health care system. Some years later, with the beginning of the economic reform in the '80, the system was dismantled, leading the country to a more market-oriented health care system. New rules were established for doctors at state-run hospitals, where they would be responsible to generate income despite decreasing government funding (in fact they dropped from 36.2% to 20,3% of total income). These had led many doctors to prescribe highly-profitable but unnecessary drugs and treatments, representing now days from 50% to 90% of a hospital's income. Several consequences arose.

Statistics from the Ministry of Health (MoH) show that, for an average Chinese, personal spending for health has double since 1980 going from 21,2% to 45,2%. Other evidences are that, between 1980 and 2005 annual disposable per-capita income increased by almost 20 times while health expenditure per-capita has increased of about 133 times. The absence of a social safety net has lead many to increase their level of saving by reducing personal consumption, exposing the economy to foreign trade volatility.

Finally, in 1997 the State Council introduced, for the first time, a basic medical insurance covering urban employees (200 million), unemployed urban resident (100 million) and a new cooperative medical scheme for farmers (800 million), rising from a value of 80 Yuan to 120 Yuan per person. Indeed, the final outcome was a complete failure, in fact only 300 million where effectively covered until 2008. Many factors were blamed for causing the impasse, such as: enormous development gap between cities and rural areas, low government funding and widespread corruption, weak facilities at grassroots levels, and increasing disease burdens. The upcoming plan can be seen both as an answer to these issues and, once more, a great chance to recover the economy from the international downturn.

The Opportunity - The health market is expanding in China as the population double its life expectancy within the past 60 years. China's total expenditure for the sector accounts for just 4,7% of its GDP against 15,4% of U.S., 8,8% of Brazil and 5% of India. With the new blueprint, the government will pass from 15 Yuan to 20 Yuan per person invested in the sector by 2011, representing a compound value of 26 billion Yuan by the end of plan in 2020.

Also, the demand for private health management services is already of 10 bl Yuan per year and it has grown of an average of 25% in the past decade. The industry will most probably double over the next three to five years. Besides, 1.3 billion people representing a unique market opportunity for any company in the world.

Moreover, Chinese awareness for personal health is increasing with the improved economic condition of its people. Some statistic from the Southeast University of Nanjing is showing that the 79,9% of the survey's respondents, 3000 among corporate executive, senior civil servants and others with annual income exceeding 50,000 Yuan, would be willing to pay between 2,000 and 3,000 Yuan per year for private health management services. Real life examples of companies taking step toward this direction are eHealthcare Co. or Guokang Co., both providing health tips and info on diagnosis centers on line. Their revenue had increase dramatically since their establishment in 2003.

The Blueprint - The following priorities will be faced by the plan: public health system, rural health development, essential medicine policy and primary health facilities.

The first step is to extend insurance coverage also in case of retirees from bankruptcy or financially troubled companies, as well as for migrant workers and self-employed. This will lead to a complete coverage for the 90% of population by 2011.

Secondly, promises of good management and supervision of funds is insured to the plan, as well as reducing prescription costs by promoting a list of 300 or 400 essential medicines, recommended by the World Health Organization (WHO), to be of mandatory use for state-run hospitals. The essential drugs will be sold under controlled prices in order to cut cost for hospital services and uproot corruption.

For what concern construction and upgrading of facilities, the government is giving priority to the **construction of 2,000 new country level hospital in compliance with national standards**. Also 29,000 new township hospitals together with the upgrading of already existing 5,000 once are foreseen in the project. Moreover, 3,700 community health center and 11,000 community health stations would be set up or renewed in major cities and rural areas.

Last but not least, Chinese schools will provide training to 1.37 million village doctors and 160,000 community doctors to employ in the new facilities. Then, setting up a universal medical records database and mandatory pre-natal check-up with the aim respectively to conduct statistical analysis and prevent genetic and hereditary diseases.

In Conclusion - The blueprint is a solid base from where to start, but it will take efforts to upgrade the country's healthcare system and the results will not be an overnight success. Both, national and foreign firms belonging to the private health sector are facing a new great business opportunity. For example, already existing high quality care services can be enforced for China's growing middle class, as well as providing training program to new doctors or expanding current business to rural areas. But opportunities will arise also for the insurance, medical equipment, education and IT support sectors. As a matter of fact, now in China there are only 100 medical schools, insufficient for the demand of 1,32 million new trained doctors needed by 2020.

Furthermore, technology will play a crucial role in order to increase efficiency and reduce cost. New services such as: store electronic patients records, remote healthcare, special medical education, standardization of tech platform and so on, have to be provided and implemented. Some of the gaps can be filled by the western companies, foreign entrepreneur and venture capitalist who are brave enough to aggressively enter in the Chinese Health-care market from the very early moment and achieve their first mover competitive advantage to seek outstanding returns.

M&A in China: related risks

During the 80's, many M&A deals conducted by foreign firms in China have been carried on primarily as a source of low-cost labour. The phenomena started in 1985, when the Red Dragon's economy opened up to the world with its first M&A transaction reaching a total value of US\$124 million. Since then, many changes have occurred. Today, after having entered the WTO and possessing a potential market of 1.3 billion people with growing purchasing power, the value of M&A transactions topped US\$160 billion. This shows an average growth of 30% per year within the past 5 years. Moreover, the ongoing global economic crisis has not significantly affected the market; as a matter of fact its value has increased 44% in 2008. Many are the players involved in this game, such as big and medium sized foreign firms from the financial and industrial sectors, and Chinese entities their self.

In 2006, the Ministry of Commerce (MOFCOM) introduced the "*Regulations regarding the Acquisition of Domestic Enterprises by Foreign Investors*". As a direct consequence, the market opened its doors to sectors previously protected. Furthermore, the outstanding economic growth and increasing regulation of financial matters are creating an interesting economic environment for this kind of integrations.

These novelties has lead companies worldwide to look at China for new purposes, such as: investing in R&D projects, as a primary source of external growth, or consolidating their market position in a competitive environment characterized by overcapacity and shrinking margins. On the other hand, solid Chinese private firms and State Owned Enterprises (SOEs) with increasing cash flows and growth potential are looking outside in search of new markets, managerial and technological know-how, and access to resources, efficient distribution channels and partners for outsourcing projects.

Evaluation Method and interrelated issues

Valuation and pricing analysis is underdeveloped in China. Still, many Chinese enterprises do not understand or accept conventional western approaches and principles. For example, analytical methods are usually complicated by several issues related to the calculation of the "real profit". In order to find it a "normalization process" has to be performed. At the same time, it is difficult to apply the comparable method, which by definition is the closest to market value, because China is too much of a young market for this kind of approach. The main issue is to identify comparable transactions of public companies to be used as a historical benchmark for any given industry.

In order to avoid distortion, any potential buyer must consider all possible scenarios for the future developments of the sector he belongs to. The best approach would be to integrate different methods giving the buyer more flexibility and allowing him to verify possible future consequences on actions taken today. Of course, the aim is to avoid overestimation of the Chinese market potential and therefore paying an abnormal price.

Risks in facing the due diligence process in China

In developed markets, due diligence usually consists of two teams. The legal one has to verify the status of the acquisition candidate and identify all potential liabilities; the accounting, has to conduct extensive due diligence on financial documents. As a matter of fact, deal mortality is high in China: only 20% of them proceed over the due diligence phase, against 50% in western markets. This is related to difficulties found in acquiring in-depth knowledge of the target company. Main reasons are:

- *Not-reliable accounting practices*

Unfortunately, international accounting standards are not widely adopted. Generally speaking, accounting books have purposes sometimes different from merely disclosure. In some cases, the aim is to show lower profits in order

to minimize fiscal charge, while in other circumstances they present higher profits to impress potential buyers. In this muddy environment, often not even the CEO of the target firm knows whether to rely or not on his internal financial reports. Moreover, common practices like employees salary given off the books, revenues pushed to the next period, costs anticipated to present period, as well as fake "fapiao" (invoice), are making the financial evaluation of target companies even more complicated.

- Unavailability of public records

The second issue is the unavailability of public records on legal matters, such as: legal title to land-use rights, breadth of current business licenses, existence of ongoing litigation, HR regulations and incentives. Also, an extensive secrecy policy adopted by SOE and private firms makes it even more difficult to receive information from employees. Therefore, in order to minimize risk, it is mandatory to verify whether any previous situation like chattel mortgage, collaterals, access to property, land use rights, and company welfare, may occur.

- Concept of Corporate Control

In China, as some decisions have to be taken unanimously by statute, corporate control is not strictly related to the share percentage owned by investors. In many cases, shareholders with a mere 5% can unblock the board of its decisional power, affecting current and future strategy implementation. This situation affects decision making also at managerial levels, where it is mandatory to keep tight control over the key corporate roles after the merger.

- Unclear legislative system and governmental requirements,

As a result of the different interpretations of local authorities, foreign companies have to face many difficulties when walking in China's regulatory maze. Therefore, when conducting M&A transactions one must assess all the potential obstacles in the approval steps and be fully aware of the various regulations and authorities that could come into play during the process, as well as the time required. The same phenomena occur on fiscal matters.

Conclusion

In the Chinese business arena characterized by high levels of uncertainty and information asymmetry, it is crucial to conduct extensive due diligence on each and every aspects of the deal: from financial to operational, from legal to human resource. One "*condicio sine qua non*" for investors is the understanding of present and future reciprocal expectations, intentions and interests.

Too many times, foreign investors rely on Chinese partners that they do not completely know. We like to say that, signing a JV is like getting married, you "*don't want to sleep in the same bed with someone you don't know*". Moreover, Western negotiators are heavily stressed by time constraints and anxiety to close the deal that can lead them to huge evaluation mistakes. Take your time when doing business in China. The direct consequence is that mergers don't achieve their expected results and most commonly they fail after just a couple of years. This phenomenon occurs because the early excitement disappears and all the related issues come out.

For these reasons, we suggest strategic support of a competent and reliable third party from the first steps of the deal. In China ordinary cases do not exist. Proper attention must be given to the smallest details of the customer's unique situation. That is why the service provided must be tailored on the customer's needs.

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