Behind the China Kaleidoscope

A Guide to China Entry and Operations

based on results of the Swiss China Survey
with expert contributions and
illustrative cases of the following companies

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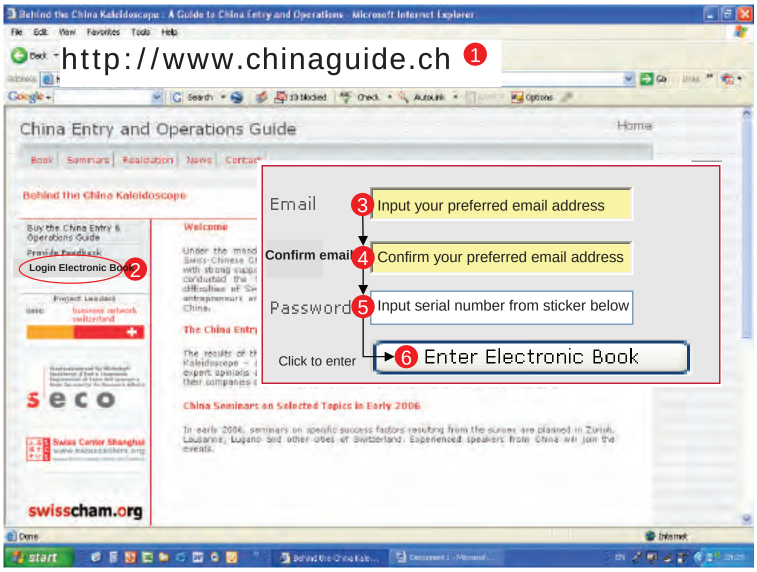

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Word of the Project Leaders

China - Opportunity or Threat?

The developed world is getting concerned about the 'Awakening Giant'. Millions of job losses in the US have already been blamed on China and a very animated debate on delocalization is taking place within the societies of our neighbors.

In Switzerland too, the discussion has started, sometimes bringing a bit of apprehension: will we lose all our factories to China?

Looking at trade figures, this does not seem to be the case; on the contrary, Switzerland's trade balance with China is positive, and becoming all the more so. The more the Chinese economy develops, the more machinery, watches and chemicals we sell. In 2004, Swiss enterprises sold almost twice as much to China (including Hong Kong) as they bought from the People's Republic (Switzerland currently enjoys a CHF 3 billion surplus on a CHF 7 billion trade volume). In the same year Swiss exports to the mainland increased by 25%, while Chinese exports to Switzerland increased by 17% (trade with Hong Kong remained almost stable in Asian terms, with a 4% increase).

This seems paradoxical, but Switzerland's expensive production base is protecting us to a large extent from the negative impact that China is having on other developed countries. Lower-cost, lower-tech activities in Switzerland have already been challenged: by Japan in the 70s and the smaller Asian Tigers (Taiwan, Korea and Hong Kong) in the 80s. To fight the high costs of Swiss production, manufacturers have already moved towards innovative, higher-added-value products 20 years ago.

Today, the pressure to innovate is still there, and China will add to it (see Chapter VII: International R&D in China – Opportunities and Risks). But Swiss enterprises are well into the process of doing new; more efficiently, and better, rather than cheaper. This is also emphasized by the results of the Swiss China Survey: 'low production costs' is placed towards the bottom of the list of reasons for Swiss companies to be active in China (see Chapter III Preparing for China: Defining an entry strategy, for the rating of reasons to enter).

On the opportunity side, trade figures also provide a reassuring picture: about 90% of Swiss exports to the Mainland and HongKong fall into the categories of:

- watches, jewelry and precious metals (a bit less than 50% of our total exports)
- machinery and instruments (a bit over 30%)
- chemicals and pharmaceuticals (a bit over 10%)

China's demand for these products will be growing strongly and steadily. Besides, in these three categories, it is unlikely that Switzerland will lose its advantages. For watches and jewelry, the label 'Made in Switzerland' will keep working its magic in China as long as it does worldwide - or even more so.

Chemicals and pharmaceutical production remains essentially capital-intensive so that China's lower cost production base might be no more competitive than the Swiss one. (See Chapter V Chemical industry, Ciba case study for an exemple.)

Finally, equipment remains a very strong competence of Swiss enterprises, due to the top precision, reliability and generally superior performance of their products. Should we keep this edge and adjust to China's evolving needs, our exports will continue to grow in this sector as well.

The results of this research reinforce this picture for the long term. Indeed, 'quality' is the most sought-after brand attribute for the new affluent Chinese consumers, while dynamism and innovation - the 'on the move' feeling - comes second (see Chapter I: China, Brands and Consumer Psychology).

To make good on China's growing opportunities, we simply need to maintain our spirit of excellence and keep '**on the move**'!

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Word of the Chief Editor:

China's Emergence: Trends, Consequences and Strategies for Swiss Enterprises

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This article retraces the development of China, key related trends and the impact that this emerging nation may well have on our global economy.

The consequences for Swiss enterprises, particularly for SMEs, are of major importance. Coping with competition from Asia, as well as making good on China's opportunity, are challenges that need be tackled in order to remain globally successful in the coming years and decades.

Paradoxically, Switzerland's high cost and quality production structure have brought its economy into a better position to benefit from China's development than the rest of the developed world. Nevertheless, it is time for Swiss niche leaders to develop their strategies to take a strong position in China and Asia, so as to achieve long term global success. In so doing, they will keep generating the margins and the innovations that support the Swiss quality of life.

Supermarket and workshop of the world

Having conquered the mass consumer goods markets (clothing, household appliances, electronics, among others), industrial components, machinery and all other types of equipment are becoming a growing part of Chinese exports.

China already produces 80% of the world's consumption of tractors, 60% of the penicillin, 50% of the vitamin C, 70% of the DVD players, 50% of the telephones, 60% of the artificial diamonds and 75% of the world's watches (among others)[1].

In the last ten years China has become a gigantic workshop for the world, where all sorts of products are manufactured, ever more competitively. The People's Republic is taking the role that Britain had around 1830, which was taken over by the US in the early 20th Century [2,3 4,] (interestingly, both Britain and the US became the dominant world powers towards the end of the 19th and 20th Centuries, respectively).

With the cancellation of the global multi-fibers agreement and the removal of the textiles export quotas by the end of 2007, China is expected to become severe competition even for the poorest of the textiles producers, such as Indonesia. This is to the point that **some expect China's share in world textiles output to jump from 30% to 50%** within a couple of years.

Yet while China's world market share of the lowest-tech items grows, **by 2009 the country is expected to produce 74% of the world's mobile phones [5]** - at the high end of the technology spectrum.
China's ability to produce competitively, and in massive volumes, the world's cheapest and also some of the highest-technology products is made possible both by the size of China's working population and by the staggered economic development of the country, from the coastal east to the inner west. To understand China's potential impact on our world it is essential to realize that the country is far from being one unified market. It is actually a composite economy

at different stages of development in different areas, from the very advanced in Shanghai to the archaic ways in parts of Tibet.

The under-developed, very low cost areas are able to provide competitive low-tech products, which are then fed into the technology chain and into developed areas. Undeveloped China provides low living costs and components to the whole country, including the areas that produce competitive high-tech products.

Low production costs are here to last

300 million Chinese (a population about the size of the US) live in cities [6]. An equivalent number is estimated to have benefited from the economic development of the past 25 years.

Yet, about another billion (if we consider unofficial estimates) have seen minimal, or no, improvement in their lifestyles: they are waiting and hoping for better economic opportunities.

Bringing prosperity to this one billion countryside inhabitants is not an easy task: in joining the WTO, China has lowered its tariffs to the point where soya beans, for example, are cheaper when imported from the United States than homegrown.

To cope with the competition generated by China's integration into the world economy, her government is planning to urbanize 300 million surplus farmers in the coming 15 years. Again, this is roughly equivalent to the population of the US, newly looking for work. This is in addition to the demographic increase in the working-age population: about the population of Taiwan being added to the city labor markets every year for 15 years…

As a result, unemployment in cities is growing[5]. To compensate, families have put education as a top priority, slowly but surely spreading pressure to most levels of the job market: in Shanghai for instance, **newly-graduated students' salary expectations dropped by an extra-ordinary 30-50% between 2003 and 2004** [7].

After mostly negative, or very low, inflation from 1998 to 2003, the consumer price index increased by about 4% in 2004 and only 2% in 2005[5]. Yet these increases are probably mainly due to the global increase in energy and commodities prices. At any rate, they do not influence the competitiveness of the Chinese economy worldwide, as is demonstrated by the constant increase of Chinese exports.

Many expect the Chinese RMB Yuan to be further re-evaluated to reach a fairer international trade balance. Yet, such an adjustment would actually account for the steady loss in value of the US Dollar, to which the Yuan was pegged until July 21 2005. Besides, such a currency appreciation is bound to remain low – a few percent per year, considering the additional pressure that it would bring to Chinese farmers, already in competition with American soya bean and other agricultural products.

Still, even as the Yuan increases in value against other world currencies, it is very unlikely that China's cost levels will rise — within the next ten to fifteen years, at least — until her surplus labor is absorbed. (Also See Chapter VIII Sourcing & Purchasing for current cost levels and more arguments.)

Economic superpower candidate

The current middle class of about 100 million consumers is expected to grow to 400-500 million by 2012, making China a market bigger than the US [8].

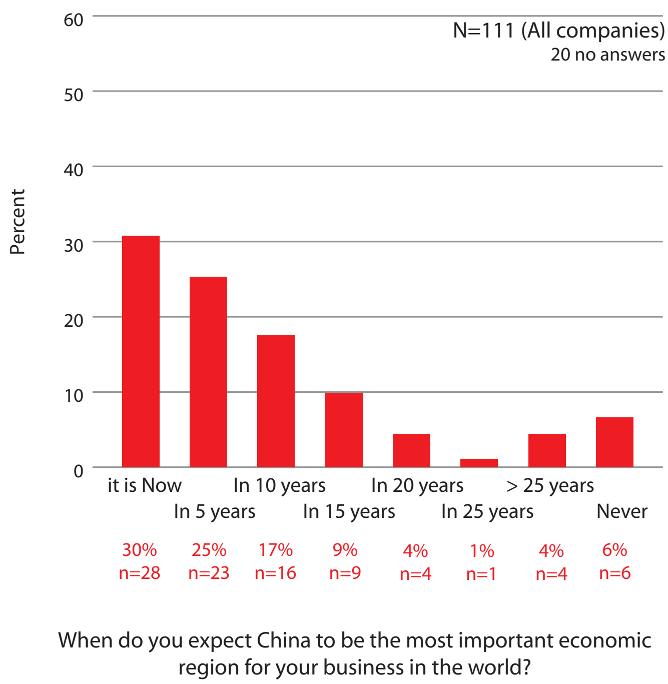
Meanwhile, the need for machinery and equipment to satisfy the production needs of this new 'Workshop of the World' is already a considerable opportunity for developed economies and Switzerland.

To provide sufficient work opportunities for China's population, her economists estimate that growth needs to reach a minimal annual rate of 7% for the decade to come. (GDP grew by 9.5% in 2004, and is expected to reach 9% in 2005[9].)

As a matter of fact, steady, rapid development in China is made necessary by dire social circumstances - public protests have steadily increased over the last decade[10]. Economic development is not only the 'irrefutable argument', as advertised on billboards in Shanghai, but it is - first and foremost - the main priority of the Chinese government in order to keep the one billion people living in undeveloped China waiting quietly for a better life. Yet, this works to our benefit: China's long-awaited domestic market is finally turning into a reality for Switzerland too.

Since 2001, China (including Hong Kong) has been buying more Swiss goods than any other nation in Asia. The bilateral trade balance (including Hong Kong) showed CHF 3 billion in Switzerland's favor in 2004 from a total bilateral trade of about CHF 7 billion. Moreover, imports by China and Hong Kong are growing faster than Chinese exports to Switzerland.

Astonishingly, over 50% of respondents in China to the Swiss China Survey estimate that the country will represent the most important economic area for their businesses within the next five years. The same research also clearly shows that low production costs are a far less important reason to enter China than acquiring local market share and preventing competitors from developing [11]. (See Chapter III Preparing for China, 'reasons to enter'.)



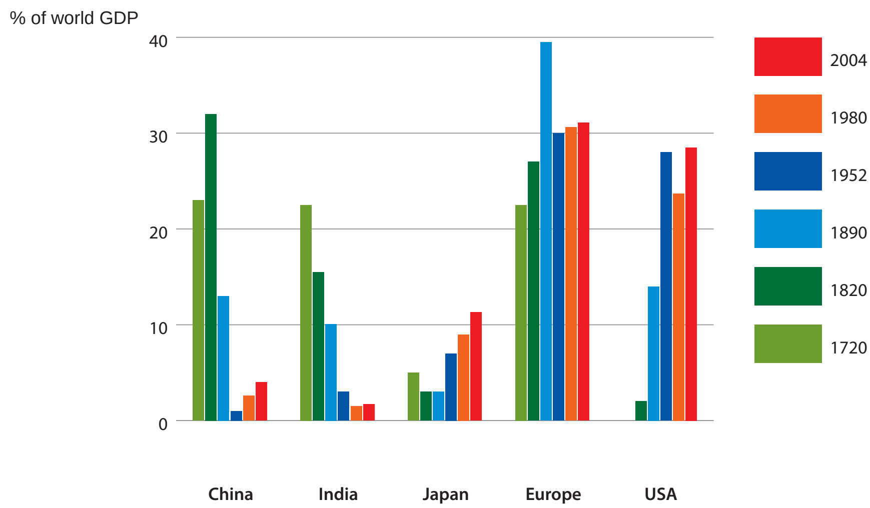
Survey Chart I - 24
Economic importance of China

Source: Swiss China Survey, 2005

Be it in 20 or 50 years, all signs indicate that China is on track to become the biggest world market and the first economic power, unless the current development process is halted by a social, political, financial crisis an epidemic or any other catastrophe.

China: Taking Back her Position in the World

Proportion of World GDP 1720-2004



As surprising as it seems to us, it is actually only natural for China and the Chinese that their country should be a superpower. **Indeed, the Middle Kingdom was the most important world economic power from 800 until 1820**, less than 200 years ago. At that time, the country accounted for over 30% of world GDP. Today, and after the 25 years of growth that we have just experienced, the People's Republic accounts for just about 4% of the global economy: all in all, **China's economic development has only just begun…**

Future R&D powerhouse

Paradoxically, Swiss high production costs and the shedding of the labor-intensive jobs in the 80s have put Switzerland in a better position than her European neighbors to withstand the shock of permanently low-cost Chinese products for a decade or more. Besides, Switzerland is well-positioned to tap the opportunities for the sales of production machinery, one of its economic pillars and one of its major exports to China with watches. Overall Switzerland has more to gain than to lose from China, as bilateral trade figures clearly show. (See previous contribution: China - Opportunity or Threat.)

Yet, if only through the constant pressure on prices and margins, the economic transformation of China will have deep global effects in all branches that are not luxury, high technology or containing high levels of well-protected intellectual property.

Particularly important to take into consideration is the increase in Research & Development (R&D) activity in China. Indeed with the increase of production it is only natural that R&D follows.

Large research centers have been setup by many multinationals over the past two to three years. R&D centers are currently opening at the rate of 200 per year. Domestic patent applications are growing at a rate of 20-30% per year[12]. China was fifth worldwide in the publication of scientific papers in 2003 (a yearly growth of 20.6%) while citation of Chinese scientific articles has increased by 30 to 40%[13], indicating a growing quality of the articles as well. The China-US Business Council reports that according to current trends, China will spend more on R&D than the EU by 2010[14]. (Also see Chapter VII Intellectual Property Protection and R&D, 'International R&D in China - opportunities and risks'.)

Japan's development from a good imitator to a world-class creator of technology may indicate the path that China will follow. A key difference, yet, is that China's salaries will take much longer to rise due its developed and very large undeveloped economies that coexist, giving it an unprecedented cost advantage for a long time to come.

Impact on International SMEs

Chinese producers are a major source of competition in consumer goods. They are increasingly beginning to dominate this sector of production, in volume at least. After producing for brands, they are actively developing their own names or finding shorter routes by acquiring foreign ones; the purchase of IBM by the Chinese PC manufacturer, Lenovo, is an example of what can be expected.

Yet, in many key areas of consumer goods (automotive, telecommunications and IT, life sciences), China's market is dominated by foreign players. Nestle, Roche, Firmenich, Volkswagen, Nokia, to name just a few, all have commanding China market shares in their areas of expertise. These brands have brought themselves into dominant positions to acquire and keep the lion's share of the Chinese market.

While the Chinese consumer goods market is the turf of large companies, and mostly a battle between Chinese and locally-established multinationals, the supply of equipment and industrial goods to the Chinese enterprises and the locally-established foreign subsidiaries is a market in the making; it presents considerable and growing opportunities for Swiss SMEs.

The smaller the SME, the more timing is of the essence: small firms cannot afford to invest too early and wait for returns, neither can they put up sufficient resources if they start late and try to catch up. It might be early for some international companies to start activities in China, in any case, an evaluation of the specific market is needed for most firms: in the words of Dr Heinrich von Pierer - Siemens' CEO, "*It is has now become a bigger risk not to do business with China than to do so*".

China leadership: the ladder to global leadership

As implied in this quote, not serving China's market early enough entails the risk of witnessing Chinese firms growing domestically and dominating the local market. In the case of industrial goods, domestic suppliers are encouraged to provide foreign multinationals in China (and their Chinese competitors) with cost-competitive, domestically-made goods, supported by local services.

When Chinese producers become able to serve international companies in China, they will inevitably start to export and become actors to reckon with on world markets. Chances are that they will also be fierce competitors to the Swiss niche champions. Conversely, and over the longer term, **being successful on the Chinese market will be necessary in order to achieve the economies of scale and competitive production for global leadership**.

Considering a market that is potentially twice the size of the EU, the US and Japan combined along with China's strong and enduring cost advantages, it is safe to say that, in the future, market leadership for a particular product in the Middle Kingdom will eventually contribute in a key way to achieve global leadership.

In the coming decades, only the development of the rest of Asia — and particularly India's — could reduce the extent of China's global pre-eminence as a world market and production base. Yet, China's current head start in Asia and her key advantages (highest market potential and best quality/price ratio, both in a wide range of products) will also ensure that virtually every non-luxury or high-technology product will be more effectively produced in China for China.

As a result, practically all international producers - including SMEs - that do not set up in China may expect to face serious competition from this country - if not now, in the future quite certainly.

China's emergence as the workshop of the world and future economic superpower means that every international enterprise will not be able to ignore China: they will eventually need an Asian production base, at least, to serve China competitively. But setting up production in China will offer the additional advantage of being in the key market of the region.

To further insure themselves for a future successful international business, Swiss SMEs might as well aim at achieving a leading position in China and reduce the risk of facing Chinese competitors, globally active in the future.

Innovation: a must for enterprises in Switzerland

Establishing a successful Asia/China strategy may go a long way to develop business and prepare for the future. Serving global customers in different locations or offering a bigger range of products made possible by cheaper Asian production will support production at home (studies show that firms that delocalize maintain a bigger workforce at home than those that do not).

Yet it may not be enough for the home operation to overcome lasting price pressure from emerging countries: to maintain competitive production in the mother company, Swiss firms will need to continue their rapid pace of innovation - develop new technologies, new or better-performing products, new manufacturing processes and new business strategies.

However, in order to guarantee technological innovation, maintaining production in Switzerland will be crucial. Technology is intimately linked with industrial activities: it only lives and feeds innovation as long as production continues.

Moreover and since technologies feed and grow on each other, maintaining a healthy, varied and dense fabric of production technologies at home will be vital for the continued development of Swiss innovation.

Creating a strategic advantage for the Swiss economy

The internationalization in key emerging markets of Swiss SMEs and their innovation at home will maintain their margins and, ultimately, uphold Switzerland's living standards and quality of life. Swiss quality in every aspect may then continue to generate efficiency and added value in the virtuous circles that we have witnessed in the past decades.

China is certainly the most promising of the emerging markets but, also, it is one of the most difficult to deal with, for large and smaller companies alike.
The know-how necessary to develop the right concepts and be operationally efficient in China, the experience of the market and of the business culture remain the privilege of the few experts that have accumulated the necessary experience in the 25 years of China's opening.
By maintaining and developing their networks, by conducting practical research, sharing experience and developing support instruments for SMEs, Swiss institutions in China and Switzerland provide resources, China know-

how, guidelines for efficient operation and access to the best available specialists on China business. In so doing, these **support organizations strive to offer Swiss enterprises the key ingredients to develop the edge that they need for success in China**.

In addition, support to make good on China's opportunities offers Swiss enterprises increased competitiveness on global markets and the possibility to prevent the development of new competition in Asia.

Finally, the incomes generated by new China and Asian markets and the savings made on the lower-tech Asian products can be concentrated on innovation at home, ultimately ensuring that the Swiss economy benefits from a strategic advantage in the decades to come.

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The Purpose of This Guide

Making Sense of the China Kaleidoscope

The objective of this guidebook is to help decision-makers and managers in charge understand and learn from the plentiful, diverse and often contradictory experiences and opinions about doing business in China. This guide attempts to do so by looking at the experiences of successful Swiss companies active in different types of Chinese business environments.

The People's Republic is certainly one country and one reality, unified by millennia of history, tradition and culture as well as decades of uncompromising communist rule. Yet, **the last 20 years of economic development and freedom have made China varied, differentiated, multidimensional and complex in almost all aspects that affect the setup and practical operations of a foreign business**. Here are just a few examples:

A former Chinese PLA officer in his mid-forties, living in Shanghai and having spent all his life on the Mainland, will tell you that he feels more of a "culture shock" in dealing with his fellow countrymen 300 Km west of Shanghai than when visiting Switzerland for the first time.

Microsoft received the equivalent of USD 500.- in damage for piracy of one of its products while an American SME [1] was awarded USD 70'000.- to compensate for economic loss incurred when a Chinese company copied a videotape component protected by a patent.

Should you attend a China seminar and ask the managers of three different companies (all with extensive business experience in the country) whether, for instance, you can trust and retain Chinese employees, you are quite likely to get three different answers, two of which will usually be contradictory...

Both China success and horror stories now abound, creating the general perception that the most populated country in the world is also a land of economic paradoxes. To deal with these contradictions, the available lists of "dos and don'ts" for China business beginners may provide a fair introduction. However, they offer very little practical support to find the way towards success.

Varying from one point of view to another, China's business environment appears pieced together by an innumerable set of business realities, each following their own rules. They are like the countless pictures of a kaleidoscope, showing from every angle configurations that appear alike and yet are different, even though they are all brought together by only one set of related, colorful pieces.

Nonetheless, once the business environment and product of a particular enterprise are identified, the kaleidoscope can be held still. The reasons for the complex arrangement of a picture may be understood, dissolving in the process the apparent contradictions.

By analyzing the results of the Swiss China survey and drawing illustrations from case studies and expert opinions, this guide aims to examine and understand a set of different angles of the China kaleidoscope, each representing a different business environment.

All are defined by the type of activity a company may want to conduct locally (purchasing, selling or producing), industries and various types of markets (equipment and industrial goods, services or consumer goods, dominated by foreign or Chinese players).

We have selected this set so that a majority of managers may relate the specific situation of their enterprise and their intentions with some of the environments described in this guidebook. Each of the case studies aims to provide insights to identify and narrow down the key business elements, success factors and difficulties that need to be considered in their specific situation.

To reach our goal, we focus on success stories because they show how Swiss companies are successful and indicate paths towards other successes, while negative cases do not illustrate what can be achieved.

Each experience is unique and will never apply, except as a reference, to another company's situation even if circumstances are similar. **This guide provides a roadmap of some of the key highways across China business**. They are useful to determine a position in the landscape, to picture the frames of specific business environments and the difficulties related to them.

To ensure a timely and safe journey towards success, we strongly recommend to make use of professional advice and conduct specific research. Only detailed, customized information allows to navigate the ever changing maze of country roads, alleys and shortcuts that a detailed China business map would show, if it ever could be drawn...

Nevertheless, this guide intends to help those responsible for setting up or overseeing a business in China realize how diverse this country's business environment has become, particularly when dealing with the practicalities of managing locally. Used thoroughly, it will also provides the necessary pointers not to get lost in China's kaleidoscopic complexity.

Additionally, this guide aims at saving valuable time for managers involved in a China venture. It does so by enabling them to understand their specific China environment, to identify the best directions to follow in their particular situation, to evaluate relevant experience and opinions and to find out how best to obtain adequate support.

Source

1 Jason Precision Components in Asiaweek of June 13, 1997.

Contribute to this ongoing project

China's business environment is changing as fast as the country is developing. This roadmap will need updates within a couple of years. Do not hesitate to send us your comments and opinions on the quality of the contributions, their validity and accuracy. Should you have discovered interesting new routes and wish to contribute to this 'business geography', let us know about your own experience so that we may record them for a future edition.

www.chinaguide.ch info@chinaguide.ch

To Whom This Guide is Intended

Doing Business in China, Why?

"It is has now become a bigger risk not to do business with China than to do so" Dr Heinrich von Pierer, Siemens CEO

Indeed, every enterprise with an international vocation should consider a China entry. This guide is intended for the managers who are faced with this necessity or are interested to evaluate China's opportunities.

On the other hand, recently appointed managers of existing China operations will also benefit from this work by learning faster about their environment and the experiences made previously by fellow executives.

China is unique, to date, in presenting a set of two extraordinary opportunities:
- The potentially largest economy and market in the world
- The best quality/price ratio in the procurement of a wide range of consumer and industrial goods.

However, these opportunities do not come without a threat. Chinese companies may also well become the world's most efficient producers of goods and services and, eventually, challenge every one of the international Swiss companies on the world stage.

Though there are other large potential economies (India, Russia and the CIS, Brazil and South America), none of them hosts companies that present the threat of Chinese enterprises, active in a fast widening range of goods and services. India, possibly the next contender to China's status, has established fame worldwide only in the outsourcing of software and call centers yet.

Therefore, more and more Swiss companies have a third good reason to set up business in China: preventing competition to grow. (The respondents of the Swiss China Survey rate preventing Chinese and foreign competitors of from developing to be a key reason for activity in China in third and fifth position out of 10 at 62% and 69%. Also see Chapter IV Preparing for China, 'Reasons to enter'.)

Indeed, in addition to selling their products and procuring components more efficiently, these Swiss companies compete with local producers on equal local terms. In so doing, they prevent competitors from developing by making it more difficult for them to serve global clients established in China. This, in turn, reduces the risk of Chinese companies challenging Swiss producers in their traditional markets in future. (Also see the previous contribution, 'The emergence of China, consequences for Swiss economy and strategies for enterprises'.)

As Heinrich von Pierer implied, in today's world, practically every entrepreneur and every company with an international vocation needs to consider an involvement in China in order to reduce future risks.

This guide aims to pilot the China newcomer and help him find his way efficiently. Therefore, it is meant for all international enterprises that do not yet have a presence in China and for those in need to review and increase their presence there.

Naturally, a majority of potential readers are leading SMEs, the largest group of international enterprises in Switzerland, yet currently the least represented businesses in China.

Moreover, since most Swiss international SMEs are active in the equipment and industrial goods sector while China has enormous needs for such products, this guide provides more information for readers specifically interested in this large field.

Executives of multinationals may find considerable interest in the trends revealed by the Swiss China Survey. They may also benchmark their operations and learn from case studies contributed by fellow managers.
Recently appointed expatriates will also find a picture of their local business environment helpful to speed up their learning process.

Acknowledgements & Project Participants

The Swiss China Survey and 'Behind the China Kaleidoscope' could not have been realized without the support and joint efforts of many persons and organizations whom we warmly thank here.
We sincerely hope that the result meet everyone's expectations!

Participants of the Swiss China Survey

We particularly owe the results to all the managers of Swiss companies, in China and Switzerland, who participated in the Swiss China Survey. They dedicating their management time and shared their experience for the benefit of the Swiss-China business community and allowed a better understanding of Swiss business activities and trends in China.

Interview Partners of Case Studies

Special mention must be made of the following managers who spent additional time to receive our research team for in-depth interviews, discussions and reviews that brought all of us the very enlightening case studies of this guide:

- **Mr Andreas Wagner of ABB Engineering (Shanghai) Ltd. - Turbocharging** page **275**
- **Ms Michelle Huang of Beijing Bien-Air Medical Instruments Technology Services Co., Ltd.** page **235**
- **Mr Robert Heiniger of Ciba Specialty Chemicals (China) Ltd.** page **250**
- **Mr Heinrich Berger and Mr Zhu Tie Zhong of Dolder Shanghai Trading Co., Ltd** page **449**
- **Mr Felix Muntwyler of Gate Gourmet Shanghai** page **364**
- **Mr André Brülhart and Mr Michael Ma of Jesa Shanghai Trading Co., Ltd.** page **457**
- **Ms Yoshiko Iwata of Jura Elektroapparate AG** page **211**
- **Mr Walter Akeret of Kuk (China) Ltd.** page **320**
- **Mr Joachim Diezl of Saurer Textile Machinery Co., Ltd.** page **302**
- **Mr Bernard Schwegler of Schindler (China) Elevator Co., Ltd.** page **330**
- **Mr Victor Chiam of Sulzer Shanghai Ltd. (Chemtech)** page **287**

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- **Embassy of Switzerland Beijing (www.eda.admin.ch/beijing)**
- **Consulate General of Switzerland Hong Kong (www.eda.admin.ch/beijing)**
- **Consulate General of Switzerland Shanghai (www.eda.admin.ch/beijing)**
- **Regional chambers of commerce and industry (www.cci.ch), especially St. Gallen-Appenzell and Fribourg**
- **SinOptic (www.sinoptic.ch)**
- **Swiss Business Council Hong Kong (www.swiss-biz.org)**
- **Swissfirms (www.swissfirms.ch)**
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How to use this guide

Covering the scope of interest on China and providing information of direct use that allow forming the bigger picture at the same time is not an easy task. To do so, China's business reality need to be reduced to understandable pieces while still offering the holistic view that is necessary for a successful approach.

Achieving this goal entails dealing across a number of dimensions:

- **the environment**, variable in different regions and cities of different tier
- **the market and products**
- **the activities** (purchasing, selling or producing)

In addition, factors of success and difficulties indicate key elements for which an understanding should be provided to maximize success:

Resources (and how to acquire or maintain them):

- **human resources,**
- **intellectual property**
- **financial means**

Preparing and **acquiring support** for a business venture in China

Finally, a practical guide would not be complete without giving a feel of 'how it all can work'.
Therefore, a description is provided on how to:

- **export** to,
- **purchase** in and
- **produce** in China

All the elements mentioned above give the occasion of a particular chapter (or of part of one). These numbered chapters are complemented by the **Swiss China Survey** initial chapter and by important forewords and contributions from the project leaders to provide:

- **a perspective of the global frame in which China and Switzerland interact**
- **the purpose of this project and**
- **to whom it is destined**

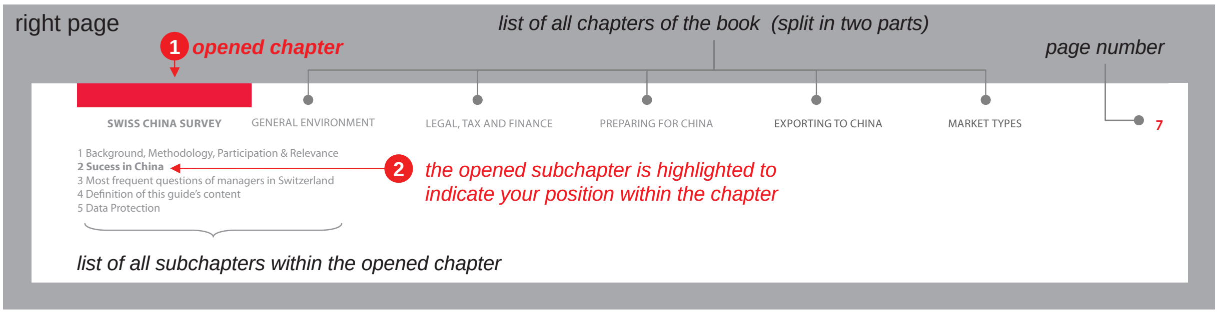
Tables of Content

In order to easily understand the content of each Chapter, a **Table of Chapters** follows this introduction and includes the summaries of each chapter. It serves as well as an **Executive Summary** of the complete project. For a deeper understanding of the guide's content a **Table of Contents** follows, listing 5 levels of titles and subtitles within every chapter. (Chapters may contain up to 6 sub-levels.)

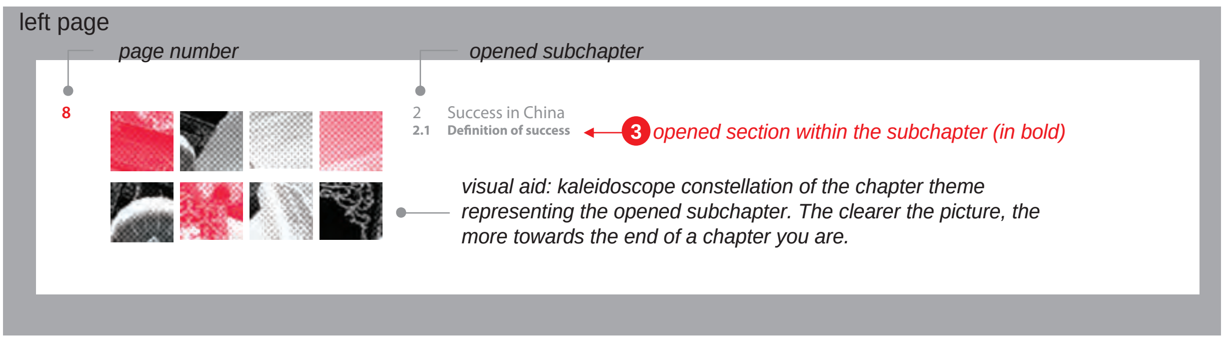
Visual Navigation

The subjects treated in the chapters are naturally linked to others. **To make following cross-references easy, all chapter names are mentioned in an index at the top of every right page of the guide**.

Additionally, **subchapter titles are listed below the indexed chapter name**. Besides, the opened subchapter name is bold, providing navigation information in which subchapter the book is opened, as illustrated below.



The bold subchapter title is replicated on the top left page of the guidebook. And beneath it, sections of the subchapter are listed as well, showing in bold in which section the book is opened, as illustrated below.



This allows users to navigate from chapter to section via subchapter visually, by simply leafing through the book and looking at the top of the pages. If needed, subchapter table of contents maybe found visually as well, by finding the first page of each subchapter, in bold at the top of a right page.

Case Studies and Expert Contributions

Case Studies and Expert Contributions are recognized in the acknowledgements, just preceding this text. The Case Studies' page numbers are indicated as well for a quick direct access.

Besides, to be recognized visually, case studies are printed over a pink background.

Index & Web Search

An index is also provided at the end of the book for a quick referencing. The content may however be searched more efficiently online, through the website whose access is restricted to owners of a copy of 'Behind the China Kaleido-scope'.

Executive Summary

0 Swiss China Survey, Determining Content

Through about 350 questions, the Swiss China Survey reviews the experience, opinions and concerns of:

- 107 managers based in Switzerland with an interest in China and
- 111 managers of Swiss subsidiaries in China.

Subjects cover reasons to enter, the importance of China when compared to other regions of the world, intellectual property management, subsidiary management, costs and factors of success, just to name a few.

Answers to the questions provide a deep insight in a fairly representative sample of Swiss companies in China, including their size, location, organization, legal forms, financial returns, level of success, concerns, difficulties and plans, among others.

Relations between success and company characteristics are examined. For instance the success rate of Swiss companies is analyzed across different locations and legal forms.

Success factors for China entry and operations are identified across industries, activities and regions, providing useful informations on what to pay attention to when operating or starting a business in China.

The survey results have been used to determine the content of 'Behind the China Kaleidoscope': experts contributions, case studies and practical check-lists. The most valuable results are described with data charts and analysis in the relevant chapters.

The survey methodology representativeness and evaluation of success is shortly described.

I General Environment & Trends

Understanding the local business ways, laws and regulations and the Chinese culture are success factors are rated consistently high by the managers of Swiss companies in China. As a result, the category 'Knowledge of the local environment', composed of environment related factors is a top three, key category of success factors.

To support enterprises in their dealing with the Chinese environment and business ways, this chapter (and the next Chapter II Legal, Tax & Finance) go deep into the aspects of China's business environment that are quite different from what a Swiss manager is used to.

The impact of Chinese culture is an important underlying basis to understand Chinese business ways. Therefore, one section attempts to explain the cultural traits and paradoxes of Chinese culture that are unfamiliar to the West.

The Chinese who form the emerging middle class are also described, through contributions about brands and their values; indeed these Chinese are the most important group to most Swiss businesses in China, as consumers or key employees.

A description of China's key economic regions as well as details and trends of Swiss business activities in China uncovered by the survey are provided for additional insights and interesting benchmarking

II Legal, Tax & Finance

Legal and financial aspects are a source of constant headaches for managers in China. The following contributions provide a first understanding of the differences and difficulties.

- The Chinese Government structure
- Differences of the Chinese legal system
- Dispute Resolution In China
- The Customs System and bonded areas
- Differences between the Chinese, International and Swiss Accounting Systems

- China's Banking and Currency System for Foreign Invested Enterprises
- Summary of Major PRC taxes
- Foreign Investment and Corporate Tax Rates
- The Importance of Chops
- Establishment of Trading, Distribution, Retail and Franchising Operations in China
- Transfer Pricing among Related Companies
- Mergers and Acquisitions in China
- Foreign Investments in Capital Markets

III Preparing for China

The complexity, the lack of transparency and consistency of local regulations combined with the competitiveness of the business environment make it particularly important to effect careful preparation and planning while setting up a business in China.

China is very much a 'Do It Yourself' ground; Swiss companies that invest directly, without a partner are more successful than those who work with licensees, franchisees or joint-venture partners.

Conducting initial research to define adjustments to the products and ways they should be sold and establish a strategy and concept are of key importance so that essential pointers are provided for this purpose.

The selection of a location has a major influence on success, since it defines essential aspects of the future business - human resources and the quality of law enforcement, among others . Ten criteria for location evaluation are proposed to ensure a right choice.

Key findings about the opportunities, risk and difficulties of Swiss firms in China, reasons for doing business, the type of agents and partners as well as joint-ventures, are also analyzed for the benefit of a better preparation.

IV Exporting & Office Set-up

China's sales opportunities have excited the imagination of business people since they are looking at international markets.

However, ever since these times as well, China's potential sales have rarely materialized in the expected ways. The fact is that the country and its people have always been able to produce for themselves at quality levels that match or surpass what is produced elsewhere.

Today, China's trade balance is in her favor again worldwide. However, China has started to purchase very interesting amounts of luxury goods, machinery and chemical/pharmaceuticals from Switzerland (about CHF 7 billions, incl. Hong-Kong) creating also a very positive balance for Switzerland. This trend should amplify for Switzerland and provide more opportunities in the years to come with the development of China's middle class.

The market, however, remains the most competitive in the world, so that possible products and distribution strategies are described to deal with this situation.

Factors of success as they are rated by companies exporting to China only are listed for an understanding of what other managers selling into China consider of major importance.

Two further contributions focus on the legal aspects of imports as well on steps for the set-up a representative office, the preferred way, up to now, to handle exports to China by foreign companies. (A description of China's customs system is provided in Chapter II Legal, tax and finances.)

A case study on Jura Elektroapparate AG's automatic coffee machines exports to China focusing on distributor selection closes this Chapter.

V Market Types and Logistics

This chapter intends to provide framed information on selected industries relevant to Swiss enterprises as well as in-depth analysis of a set of successful companies for the reader to be able to go behind general descriptions of little value for supporting the development of strategies.
As much as available, the industry trends and success factors uncovered from the Swiss China Survey provide additional light on key market types.
The following fields and case studies are covered:

- Bien-Air
- CIBA
- ABB Turbocharging
- Sulzer Chemtech
- Saurer
- KUK
- Schindler
- Gate Gourmet

VI Setting up a production

In order to compete globally, eventually setting-up a production in China may become necessary, for all international companies including SMEs. (Also see 'The Emergence of China, Consequences for Swiss Economy and Strategies for Enterprises', in the introductory pages.)
A China production may serve the local market and the rest of Asia competitively, while it may also support the parent company with cheaper materials, components and lower range products than those made at home. Producing with the local advantages may also deter local Chinese producers from growing into challenging competitors going on international markets.
The set-up and operation of a production requires the complete set of China skills for a success as well as project management and financial resources.
As such it is the most demanding activity, the one with most long term promises but also the most difficult in China terms. It needs research and preparation for a right strategy, human resources selection and management skills, purchasing knowledge for localization of components, project management for the physical setup of a facility and the design/implementation of production and operation systems that fit to the Chinese situation.
Technology transfer need to be carefully planed to avoid the loss of intellectual property.
Yet, if pitfalls are avoided, a local production is the ultimate strategy in China operations and it offers the best long term advantages.
Due to the comprehensiveness of local operations, this Chapter is a capstone that refers extensively to most of the others. It includes the detailed steps to setup a production operation in China.

VII Intellectual Property Protection and R&D

Loss of intellectual property has made more than one international businessman sorry to have ventured in China.
Yet, lawyers strongly recommend registering patents and trademarks as they are convinced that the legal situation has improved in such a way that filing and disclosing patents is more a strength than a threat.
Syngenta won a law suit against pesticide counterfeiters in the summer of 2005. Prada, Chanel and other luxury brands made headlines in December of that year by winning important reparation from a landlord renting space to a shop selling counterfeited goods. Swiss companies indicate that they are successful in fighting IP infringements in more than 50% of the cases, on average.

The considerable increase in R&D activity from multinationals in China also shows a growing level of confidence in managing IP rights in China.
Besides, whereas multinational companies' attractive products and trademarks are regularly counterfeited, few reports of SMEs show that they are losing know-how in China.
Risks are however much higher than in the traditional Swiss business environment. Indeed, advertising (as a measure to protect trademark) and avoiding bringing critical technology in China to protect know-how are rated almost as high as legal measures.
As a result, management of IP as well as careful preventing of access to technology and know-how must be ensured.

VIII Sourcing & Purchasing

Low costs and good quality are some of the key opportunities that China offers today. Strategic plans of international companies in terms of low cost production and purchasing indicate that China will receive 50% of investments made for this purpose in the years to come.
Yet, Swiss companies operate in China mostly for strategic reasons — to serve their clients and win the market before the competition. This certainly indicates an opportunity for the Swiss economy to benefit more from purchasing in China.
A question that is of key importance for making purchasing and other decisions is: how long will China's current low costs last? Probably for the next ten years, in terms relative to the rest of the world, allowing for a long term China strategy.
Good price/quality ratio is the most important element but there are disadvantages and difficulties in purchasing in China. They are highlighted together with purchasing criteria including most aspects of costs and time for transportation.
The choice of suppliers and their management is essential for a successful activity, so that suppliers' selection criteria and elements for managing supplier relationships are described.
To understand the complicated situation of international trade with China and the way successful companies deal with it, a set of purchasing models fitting the different purchasing cases are provided. These sourcing and purchasing situations are then illustrated through the case studies of two successful Swiss SMEs in China:

- Jesa SA, purchasing components for production in Switzerland and finished products to supply own customers within a cheaper segment
- **Dolder AG, trading pharmaceuticals and fine chemical materials around the globe.**

IX HR Selection & Management

The elements related to the selection and management of human resources are the set of success factors most consistently rated of decisive importance.
'Quality and qualification of the management team' is almost unanimously ranked as the most important factor of success. (See the initial Swiss China Survey chapter, for details on factors of success.)
To ensure high quality management, a foreign company needs to attract excellent managers who are also able to share the mother company's culture. Assessing and selecting the most suitable candidates is more an art than a business science: psychological evaluations are difficult to conduct, particularly within a foreign culture.
Additionally, for an excellent match a favorable 'chemistry' between the local managers and the mother company also needs to develop. This allows the local management team to be understood and properly supported.
To provide the most important elements to build and retain good Chinese management, this chapter proposes contributions on the legal labour situation, the management of human resources as well as the selection of employees.

Important results of the Swiss China Survey are also listed, particularly in terms of remuneration trends in regions and which functions are given to foreigners in Swiss subsidiaries.
Interestingly big cities are not necessarily seeing faster salary increases than second tier ones. Actually, the cost of the personnel most difficult to find (the middle management) is growing slowest in Shanghai and Beijing.
Yet and considering the importance of human resources for success, the elements provided cannot replace the need to work with professionals to start up an operation in China.

X Support for China

"We shall be unable to turn local advantages to account unless we make use of local guides."

Sun Tzu, The Art of War

In China and in Switzerland, a rich diversity of private and governmental organizations, institutions, foundations, project managers and experts offer support in all aspects of the establishment and maintaining of business activities with China.
In addition to results of the Swiss China Survey on support aspects, this chapter provides an overview of these players and organizations. It highlights their fields of competence in one chart for a rapid evaluation of which institution or instrument may be considered for what need.
Organizations are described individually with the services they offer and their contact information. (These descriptions were submitted by the organizations themselves.)
By understanding, evaluating and making use of the competencies of specialized partners for specific needs and situations, managers will save valuable time and avoid costly mistakes, unavoidable in a environment as difficult as China.
(Also see Chapter III, Preparing for China, to understand difficulties met by respondents to the Survey and how to avoid them.)

Contents

Swiss China Survey, Determining Content

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The survey methodology representativeness and evaluation of success is shortly described.

By Nicolas Musy and Patrick Schaufelberger, members of the editorial team

1 Background, methodology, participation and relevance

1.1 Swiss China Survey objectives

The Swiss China Survey was initiated by the project leaders Osec, Seco, Swiss Center Shanghai, Swisscham China and Swiss Chinese Chamber of Commerce in Switzerland, to understand Swiss SME's needs to enter and operate in the Chinese market, to identify factors of success, difficulties, motives and trends reported by Swiss companies in China and to devise a practical decision support tool in terms of China operations and entry. The survey results have been used as a main source of information to prepare this guidebook and to determine the rest of its content.

1.1.1 Aim of the survey

The survey intends to:

- Identify China opportunities, challenges and trends as seen from Swiss enterprises
- Analyze Swiss enterprises in China to yield a clear understanding of factors of risk and success for enterprises doing business in China
- Compile a list of most efficient possible steps for the support of Swiss businesses in China
- Establish a practical catalogue of possible courses of action and strategies to obtain best results when entering China in a set of specific circumstances, covering most SME cases

1.1.2 Scope of the survey analysis

The survey covers following aspects in order to reach the aim:

- Intentions, expectations and reasons (not) to enter China from managers of companies not yet active in China
- Activities in China and global aspects of China business from headquarter managers of companies which are active in China
- Experiences, success factors, perceived risks, opportunities and trends from managers of successful Swiss operations in China
- Difficulties and lessons learned from managers of less successful Swiss operations in China
- Company characteristics, activities, entry reasons and entry modes
- Level of perceived entry support and satisfaction with services provided by existing institutions
- Experiences and concerns in the field of Intellectual Property (IP) Management

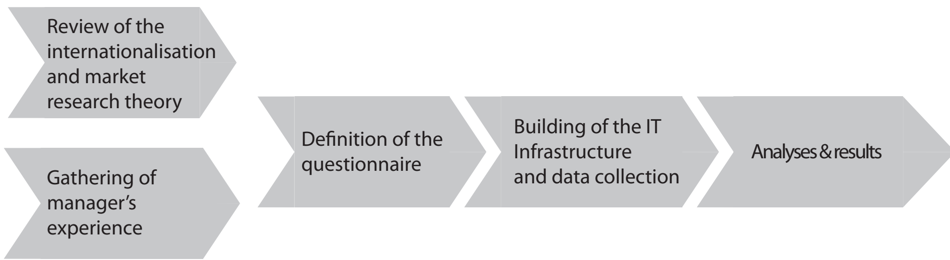
1.2 Process of the survey and methodology

Following step have been followed to define the questionnaire and get to the results (see Fig 0-1):

- In the first stage the underlying business theory has been reviewed (internationalization and market research theories) and inputs from experienced managers and institutions have been gathered
- This information has been used to develop two correlated questionnaires: one for decision makers based in Switzerland and one for decision makers managers based in China
- The supporting IT infrastructure has been built after the definition of the questionnaire and the data gathered. The respondents were able to answer by accessing the questionnaire through the Internet. The questionnaire had dynamic pages where only relevant questions were showed to the user in order to reduce the input time.
- In the last step the data gathered has been descriptively analyzed by using statistical software tools

Survey chart 0 - 1

Survey process overview

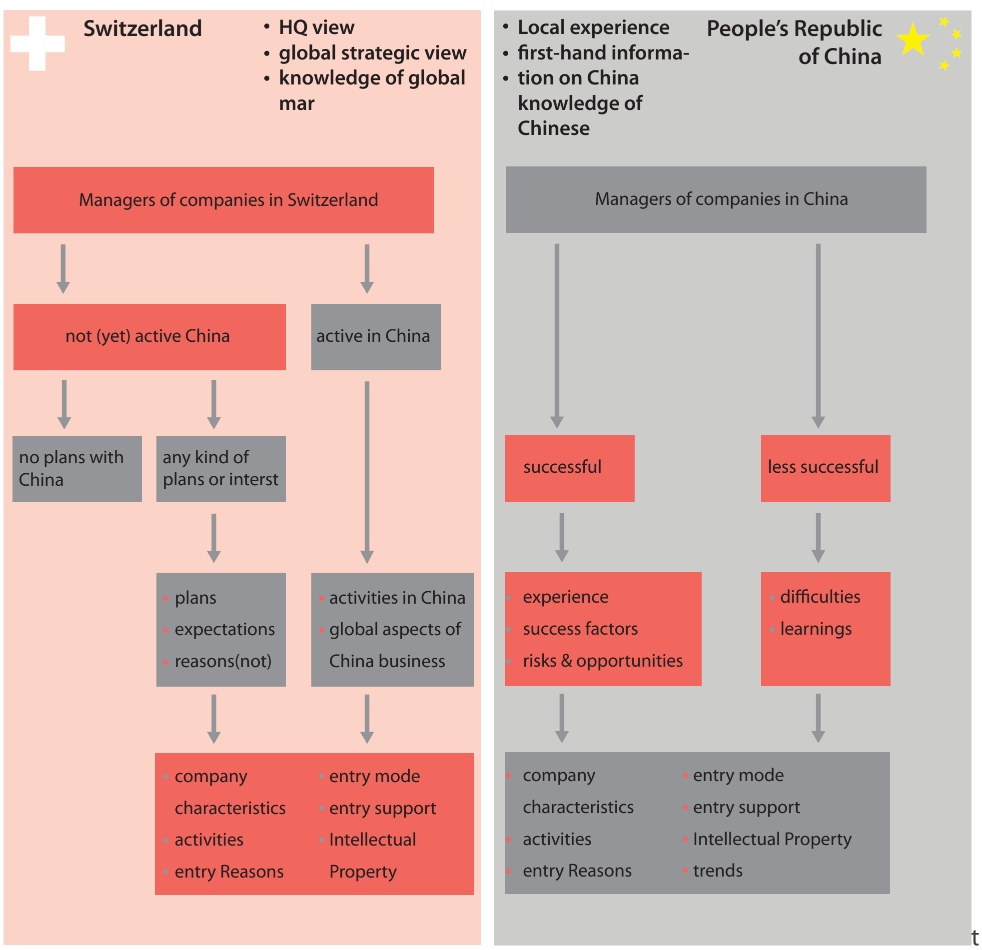


Source: Swiss China Survey, 2005

Survey chart 0-2 shows the structure of the two questionnaires and the broad set of aspects that have been considered. The results of the survey have been used directly were relevant into the different chapters of this book. The graphical results are available to the reader and can be accessed through the website: www.chinaguide.ch

Survey chart 0 - 2

Structure of the Survey



Source: Swiss China Survey, 2005

1.3 How well does the survey cover the reality of Swiss companies in China?

The Swiss Embassy in Beijing provided a list of all the registered Swiss companies in China with key data. Currently 617 Swiss subsidiaries are registered in China, representing about 270 companies. All 617 registered entities in China were offered to answer the survey and had the same chance to participate. Out of them, 111 valid answers to the Chinese questionnaire have been gathered, representing 18% of the Swiss subsidiaries registered in China.

The answers can be considered quite close to a random choice out of the population of 617 entities. However, a call center was in charge to make phone calls to remind companies in certain industries to participate, which is a possible source of bias. The analysis in the following sections 1.3.1, 1.3.2 and 1.3.3, shows that the representativeness of the sample of N=111 companies in China is fairly good across the three dimensions tested:

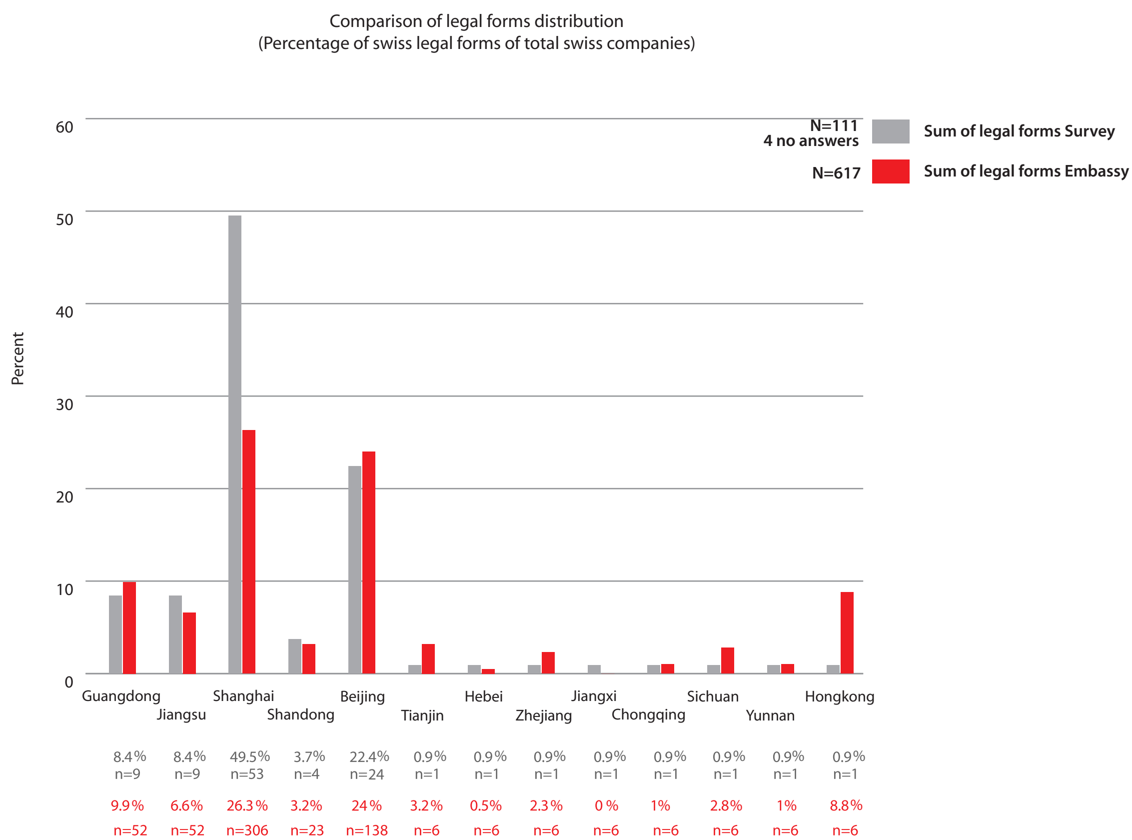
- Provinces
- Industries
- Legal forms

The number of companies to whom a chart refers to, is marked with a capital 'N' in the charts. Usually this corresponds to the number of companies to whom a question has been asked. The lower case 'n' indicates the number of answer to a specific question.

1.3.1 Geographical Representativeness

Survey chart 0 - 3

Comparison of the geographical distribution of the legal forms between official data and data from the survey



Source: Swiss China Survey, 2005

If we look at the Chinese capital of Beijing we can see that 22.4% out of the 111 companies are based in Beijing, while 24% of the 617 legal entities registered with the Embassy are in Beijing. The distribution of the legal forms looks quite similar, with a main difference in two provinces: Shanghai and Hong Kong. Shanghai is over represented in the survey (49.5% compared to 26.3%), while Hong Kong based companies are under represented (0.9% against 8.8%).

These may be the reasons for the difference in the representation:

- Since the project management is physically located in Shanghai, Yangtze Delta companies may have put more efforts in replying as they may have felt closer to the project management and persons calling than companies from other regions.
- Hong Kong companies have been reached by the invitation of the Embassy but not from the call center, possibly reducing the response rate of the Hong Kong companies.

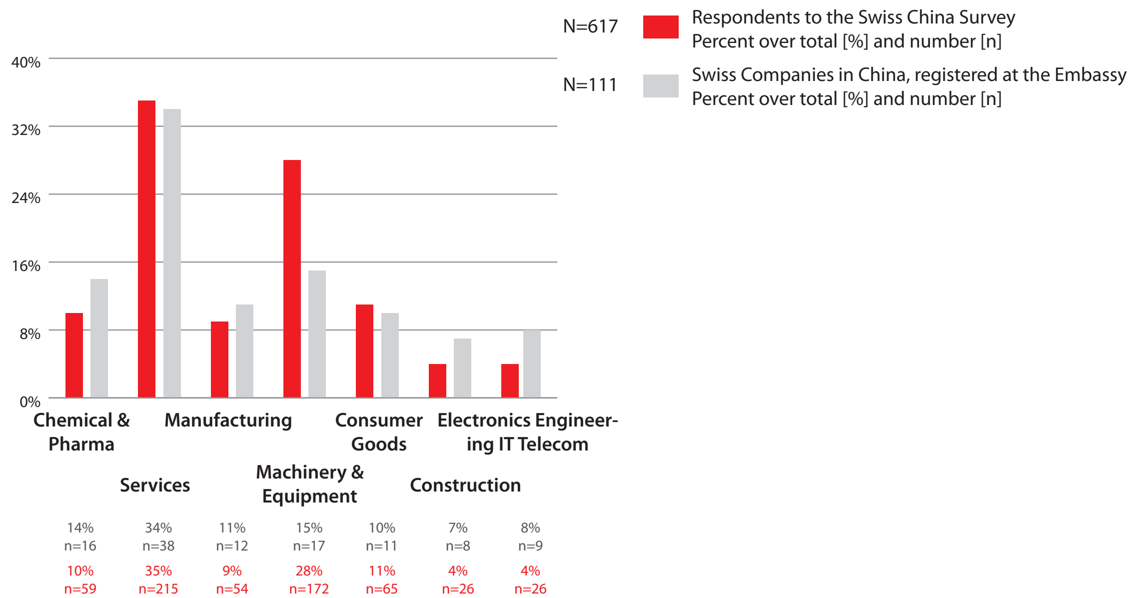
In general terms, we can reasonably believe that the survey data represents the reality of Mainland China for Swiss enterprises. The higher number of opinion of Shanghai based managers may be of particular interest since the Shanghai area currently attracts the major part of new Swiss investments.

1.3.2 Industry Representativeness

Survey chart 0 - 4 shows the distribution of industries within the survey sample and across the whole population of registered Swiss businesses in China. The list of industries in the survey and Embassy data where similar but not identical, so that both the survey sample and the official population data we grouped into similar industries to compare them. This grouping also allowed to analyze bigger samples per industry throughout the survey.

Survey chart 0 - 4

Comparison of survey respondents to embassy record by industry



Total	Chemical & Pharma	Services (Other Services; Banking & Insurance; Legal, Audit and Consulting; Media & Publishing; Logistics; Trading)	Manufacturing	Machinery & Equipment (Machinery and equipment; Medical, precision & optical instruments)	Consumer Goods (Watches; Food, Textiles & Agriculture)	Construction, civil engineering, environmental protection	Information Technology
617	59	215	54	172	65	26	26
100%	10%	35%	9%	28%	11%	4%	4%

Total	Chemical & Pharma	Services	Manufacturing	Machinery & Equipment	Consumer Goods (Consumer Goods; textiles)	Construction	Electronics Engineering IT Telecom
111	16	38	12	17	11	8	9
100%	14%	34%	11%	15%	10%	7%	8%

Source: Swiss China Survey, 2005

The 'Machinery and Equipment' category is overrepresented in the survey while the Electronics, Engineering, IT and Telecom sector is underrepresented (and the construction category to a certain extent). Would these two categories be combined in the traditional Swiss machinery and electronics category, industrial representativeness would be close to excellent.

On the other hand, the machinery and equipment sector exports most to China, second to watches and jewelry only when including Hong-Kong (also see 'China - Opportunity or Threat', the first contribution to this guidebook). As a result, equipment suppliers are certainly a group of companies that will increase their local presence in China faster than most others in the coming years. For this reason these two sectors have not been combined within the survey analysis.

The amount of answers available are few in certain industries. Any consideration made on an industry should be taken as an indication with the necessary caution about statistical errors due to low numbers. Nevertheless, we believe that even if only few companies are responding for an industry, their opinions still delivers valuable information to other managers, particularly if their experience is a successful one. Therefore factors of success and a number of other elements have been analyzed from answers of companies which have achieved a minimum level of success (also see section 2).

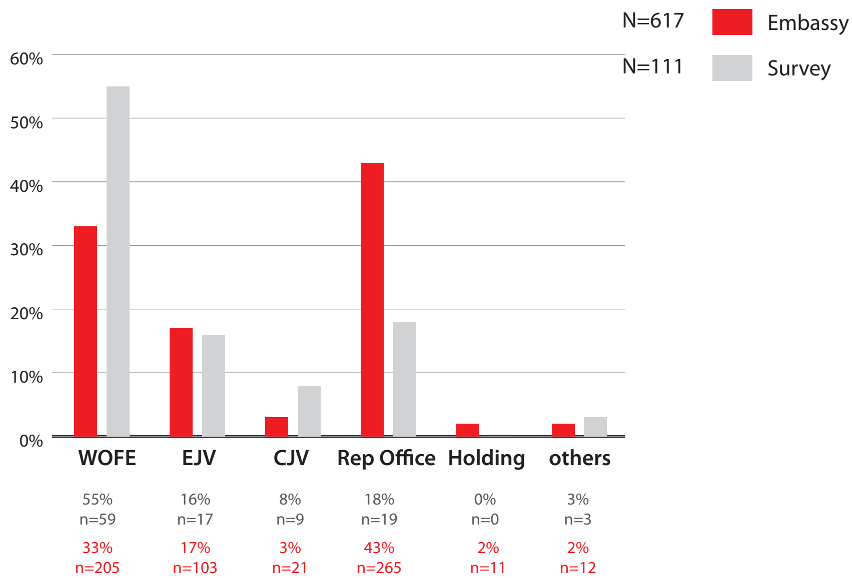
1.3.3 Representativeness of legal forms

Proportions of legal forms within the survey sample and the whole population are visible in the Survey chart 0-5. Representative offices are clearly underrepresented at the benefit of the Wholly Owned Foreign Enterprises (WOFE).

There is a trend in favor of WOFEs registration in China due to the limitations imposed by the government on Representative Offices and the more recent possibility for foreign enterprises to register wholly owned trading companies. A migration of Swiss companies from Representative Offices towards WOFEs has also been observed (see Chapter I, General Environment & Trends', 'Trends', 'Change in legal form').

Survey chart 0 - 5

Proportion of legal forms survey respondents and Embassy record



Source: Swiss China Survey, 2005

Although the representativeness of the survey sample is not perfect, we believe that the set of opinions and information given is of considerable practical value to other managers.

2 Success in China

2.1 Definition of success

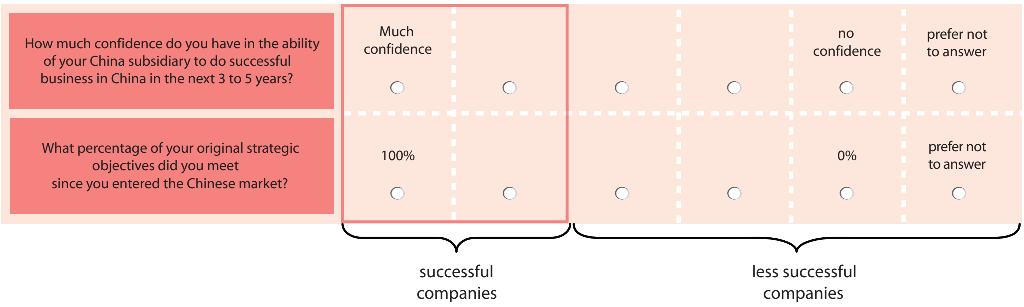
To best understand how companies perform in China, a way to measure past and future success was needed. Measurements of hard facts like Return on Investment (ROI), return on sales, profitability and turnover are possible ways to measure success. but they are focused on the past, they are difficult to obtain (companies often prefer not to disclose data of this kind), the accounting standards differ across companies (they may be profit centers or cost centers or production centers) and financial indicators, like total capital profitability cannot be directly compared across industries. Additionally, such indicators make it difficult to compare success among different industries and sectors.

Consequently, we use a different way to measure success: a subjective evaluation made by the manager about the number of strategic objectives met since operating in China and the confidence to operate successfully within the next 3 to 5 years. In so doing, we establish a comparable measure of success taking into consideration the past and the expected future success.

This measure gives more weight to subsidiaries longer in China: they naturally have more chances to achieve their objectives with more time. Yet, this also ensures that the weight of companies with little experience is less.

Survey chart 0 - 6

Selection of successful companies



Source: Swiss China Survey, 2005.

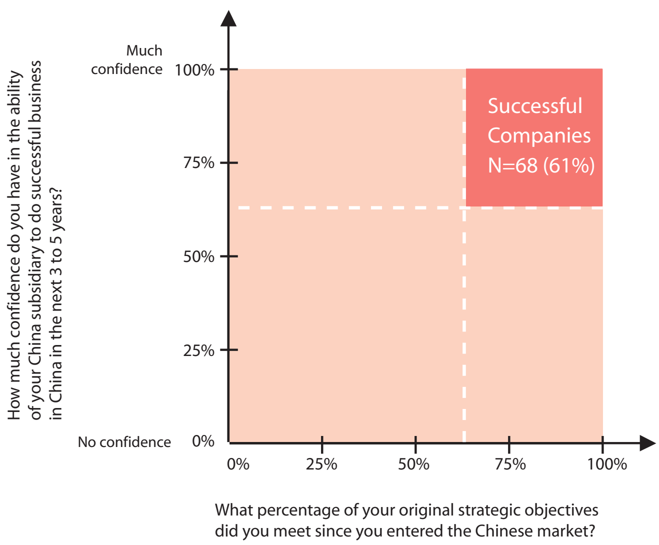
A successful company, as defined here, meets both of the following two criteria:

- For the question on the percentage of strategic objectives met since market entry: the selection of the two most left points over five of the Likert scale (meaning at least around of 75% of objectives met)
- For the question on the confidence to do successfully business in the next three to five years: the selection of the two most left points over five of the Likert scale (meaning a confidence of at least around 75%)

Survey chart 0 - 7

Definition of successful companies.

61% of the total responding companies in China are considered successful.



Source: Swiss China Survey, 2005

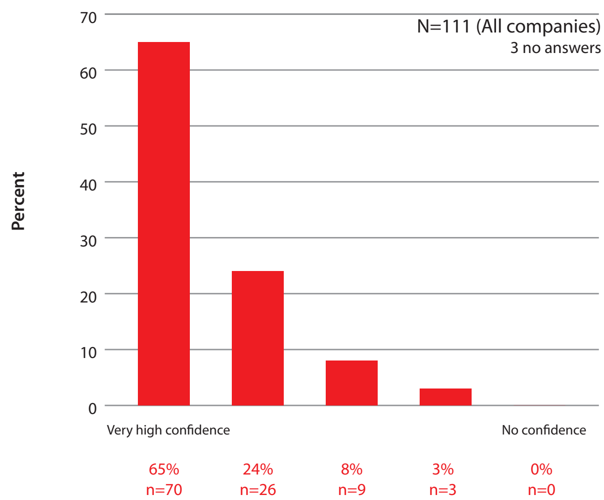
The representation in the Survey chart 0-7 uses a continuous scale to represent the discreet nature of the five points Likert scale that has been used to collect answers: theoretically respondents that reached slightly more than 62.5% of objectives should have selected 75% as an answer.

Through this success measure, we identified a group of N=68 successful companies out of a total of N=111 companies. These figures give an idea of the difficulty of operating in China: only 61% of companies are successful, according to our definition. For comparison of successful and less successful companies, we have identified a group of N=31 less successful companies: those answering the two success questions below the success standard. The remaining 12 companies are those that could not be classified, because respondents did not answer either to one or both of the success questions (12=111-68-31).

The Survey chart 0-8 and 0-9 provides the answers to the success questions.

Survey chart 0 - 8

Confidence to operate successful for the next 3 to 5 years

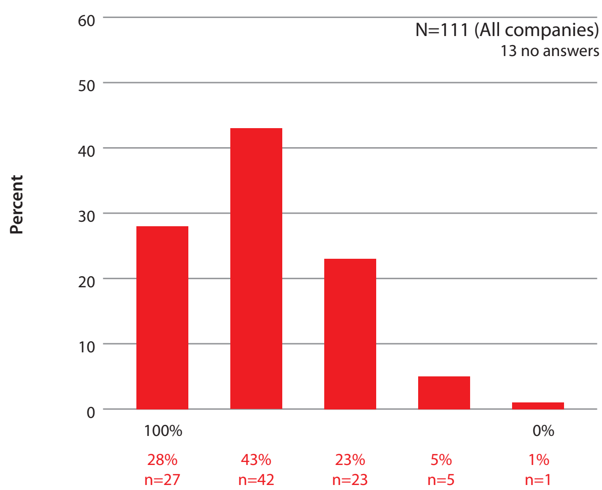


How much confidence do you have in the ability of your China subsidiary to do successful business in China in the next 3 to 5 years?

Source: Swiss China Survey, 2005

Survey chart 0 - 9

Amount of strategic objectives met



What percentage of your original strategic objectives did you meet since you entered the Chinese market?

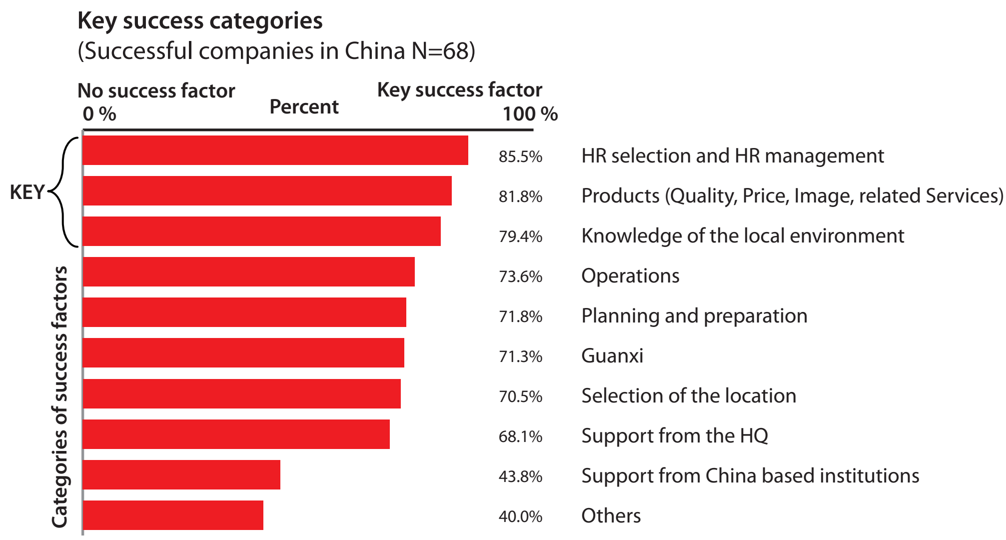
Source: Swiss China Survey, 2005.

2.2 Success factors and categories

Successful companies, as identified in the previous section, have been asked to rate a list of 47 factors of success in China. These 47 factors have been consolidated into 10 categories of success to identify the key general categories for success. These are listed in the Survey chart 0-10, while the 47 individual factors are listed in the Survey chart 0-11.

Survey chart 0 - 10

Key categories of success factors



Source: Swiss China Survey, 2005

It is important to note that not every success factor has been showed to every respondents of the online questionnaire in order to reduce input time and to avoid asking irrelevant questions. For instance, success factors related to production have only been asked to companies that produce.

Additionally, respondents may chose not to answer certain questions or choose to skip them. As a consequence the number of answers (n) for the different success factors can be different for each of them. However, we believe that this filtering and indirect weighing provides a more useful picture than if all respondents provide answers that are not directly related to their experience.

2.2.1 Key success categories

When taking answers from successful companies (N=68), we see that the factors that are related to human resources (i.e. people and management) are most relevant to be successful in China. This is an indication that the complexity of the environment requires people particularly capable to deal efficiently with it, which makes the selection and retention of good employees a key management task.

Yet, human resources alone are not enough to be successful; the right product, image and distribution for the market is needed too. As an aggregate category of success factors, product related factors are rated second, confirming the competitiveness of the market.

Rated third is the 'knowledge of the local environment' category of factors, which expresses the difficulty of dealing with Chinese circumstances.

Given the importance of environment, people and product suitability to the market, four chapters of this book are fully dedicated to these three elements:
Chapter I, General Environment & Trends and Chapter II, Legal, Tax and Finance (to describe the environment)
Chapter V, Market Types & Logistics (for an understanding of markets and product related elements)
Chapter IX, Human Resources Selection and Management.

2.2.2 Individual success factors

The relative importance of all individual success factors as rated by the N=68 successful respondents to the survey is detailed in the Survey chart 0-11. This rating is worth considering as an average of the opinion of successful managers of Swiss subsidiaries in China.

Although a lot of remarks could be made we shall just mention one striking result: support from the Chinese government comes in 34th out of 47 positions while knowledge of the Chinese language appears in 38th position. It indicates that, though human resources are key to success, the aspects of relationship with the government and the understanding of the language that often goes with it are not anymore as important as they used to be.

It is however important to realize that different industries or companies focusing on specific activities (producing , for example) will rate different factors differently.

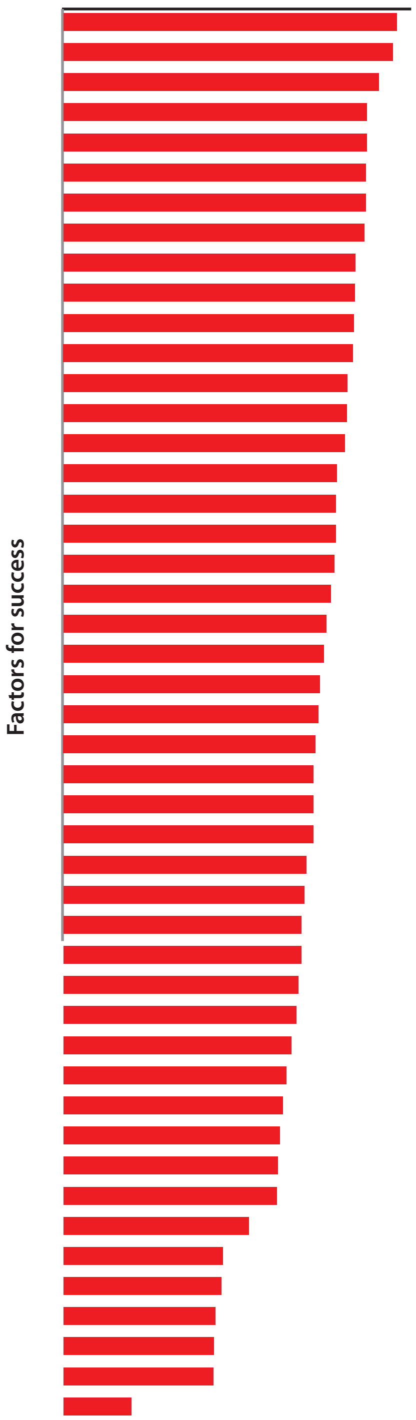
A breakdown of factors by industry is provided in individual sections of Chapter V, Market Types and by activity in the Chapters dealing with producing and exporting to China. There were not a sufficient number of companies that only purchased in China to provide a comprehensive picture of the success factors for the group 'purchasing only'.

Geographical elements are analyzed in the next Chapter (General Environment & Trends), in the 'Geographical Areas' section.
Survey chart 0 - 11

Detailed individual success factors

not important — of decisive importance

0 % — 100 % N=68 Successful companies



95.1%	Quality and qualification of the management team
94.0%	Comprehensive understanding of the local business ways
90.0%	Quality control and management
86.5%	Building of a strong brand
86.5%	Competitiveness of your product/service in the market (product/technology/service over price ratio)
86.3%	Human Resources Management (selecting, training, retaining employees)
86.2%	Strategy and concepts
85.8%	Action plans
83.3%	Unique know-how advantages (patented or unpatented)
83.1%	Comprehensive understanding of the local Chinese culture
82.8%	Choice of initial employees
82.6%	Superior organizational efficiency (e.g. quality and cost efficient operations)
81.0%	Discussing openly, carefully and thoroughly all issues with agents, partners and/or other stakeholders (Government, clients, suppliers, etc)
80.8%	Company reputation in China
80.2%	Comprehensive understanding of the relevant laws and regulations
78.0%	Review of relevant laws and regulations applying to your China subsidiary business
77.7%	Localization of management (hiring local management)
77.7%	Location of your China subsidiary
77.3%	After sales services
76.2%	Own network of contacts (private and business)
75.0%	Technical support from the parent company
74.3%	Carefully prepared and enforceable contracts and agreements
73.1%	Presence of local infrastructure (utilities, telecom networks, production, transportation infrastructure, etc)
72.7%	Choice of initial partners (agents, licensees, franchisees)
71.9%	Localization of materials and components (purchasing locally)
71.2%	Choice of customers and market segment
71.2%	Market research and evaluation
71.2%	Quality of distribution channels
69.2%	Adaptation of marketing instruments to the local market
68.7%	Timing of your China market entry
67.8%	Strong cash reserves
67.8%	Other sales services
67.0%	Strictly following legal requirements
66.4%	Local support from the Chinese Government
65.0%	Choice of suppliers
63.5%	Competitors research and evaluation
62.5%	Supplier research and evaluation
61.7%	Knowledge of the Chinese language
61.1%	Sales/marketing support from the parent company
60.8%	Presence of local services (banks, agencies, media/PR, accounting/auditing, lawyers, consultants, etc)
52.8%	Local R&D or engineering
45.5%	Support from consultants based in China
45.0%	Suppliers training and management
43.3%	Support from the Swiss Embassy/Consulates and Government
42.9%	Financial support to customers or suppliers
42.7%	Support from the Swiss Chinese Chamber of Commerce
19.3%	Support from consultants based in Switzerland

How important are the following factors to be successful in China?

Source: Swiss China Survey, 2005

3 Most frequently asked questions by managers in Switzerland

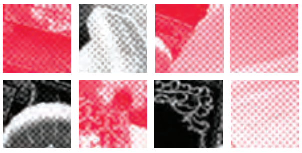
A different questionnaire has been provided to participants of the survey in Switzerland, with a section dedicated to the concerns and need for information perceived by leaders of operations based in Switzerland. In order to identify what elements are of most interest to enterprises in Switzerland interested in China, we have established a list of frequently asked questions for rating. The questionnaire for Swiss based managers was answered by 107 companies.

Throughout this guidebook, results of the Swiss China Survey refer to answers received from China based managers, with the exception of this section and when specific mention is made that respondents are Swiss based managers.

Respondents in Switzerland are mostly concerned about the presence of a market for their specific product and ensuring payment as well as contract execution. The high ratings of the following questions 'is the traffic of payments granted', 'can I enforce contracts and legal agreements' and 'how can I protect my intellectual property and know-how' show that Chinese legal circumstances and business ethics are their biggest worry.

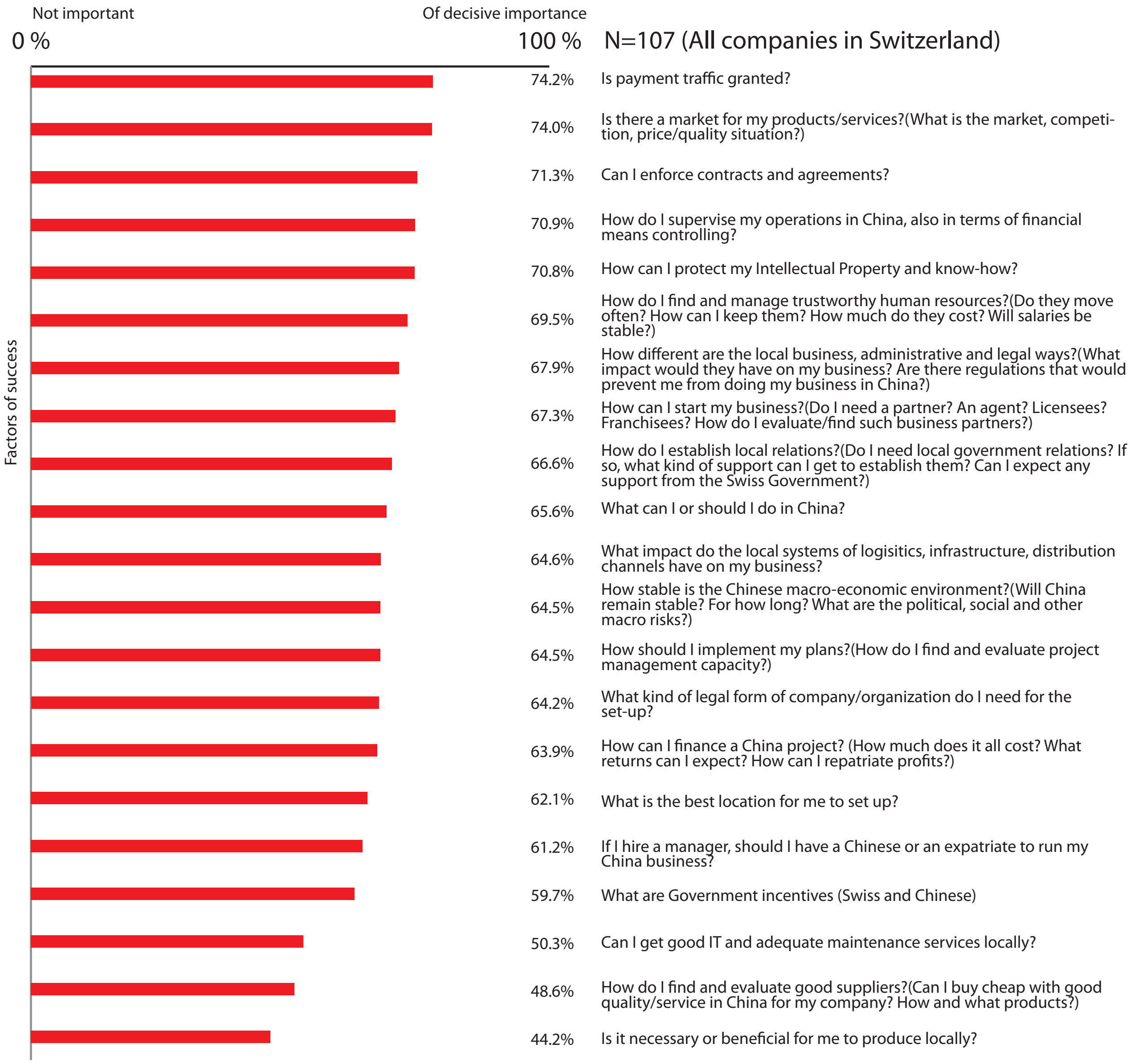
Managers in Switzerland are also concerned about operational issues (highly rated) like:

- supervision ('how do I supervise my operation in China, also in terms of financial means controlling'),
- finding business partners ('how can I start my business, do I need a partner an agent/licensee/franchisee? How do I find and evaluate such partner agent/licensee/franchisee?')
- the selection and management of human resources (see Survey chart 0 - 12).



Survey chart 0 -12

FAQ Chart



How important are/were the following questions for your particular situation to decide on a China entry?

Source: Swiss China Survey, 2005

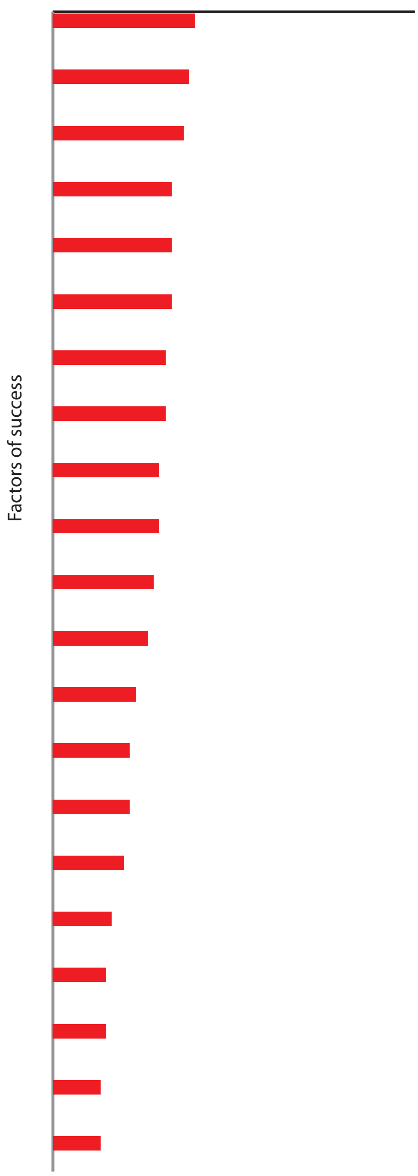
The Survey chart 0-13 indicates which are the questions whose answers are rated to be more difficult to find. The questions of most concern, are those whose answers are also more difficult to evaluate, especially questions about the level of rule of law. This indicates an opportunity for consulting companies or institutions to support enterprises planing to enter the Chinese market.

Survey chart 0 - 13

Difficulty to find answer to frequently asked questions

It is not difficult 100% = It is difficult

0 % 50 % N=107 (All companiesin Switzerland)



22.4%	What are Government incentives (Swiss and Chinese)
21.5%	How different are the local business, administrative and legal ways?(What impact would they have on my business? Are there regulations that would prevent me from doing my business in China?)
20.6%	What kind of legal form of company/organization do I need for the set-up?
18.7%	How can I start my business?(Do I need a partner? An agent? Licensees? Franchisees? How do I evaluate/find such business partners?)
18.7%	How do I find and manage trustworthy human resources?(Do they move often? How can I keep them? How much do they cost? Will salaries be stable?)
18.7%	What can I or should I do in China?
17.8%	How do I establish local relations?(Do I need local government relations? If so, what kind of support can I get to establish them? Can I expect any support from the Swiss Government?)
17.8%	What impact do the local systems of logisitics, infrastructure, distribution channels have on my business?
16.8%	How can I finance a China project? (How much does it all cost? What returns can I expect? How can I repatriate profits?)
16.8%	How stable is the Chinese macro-economic environment?(Will China remain stable? For how long? What are the political, social and other macro risks?)
15.9%	How can I protect my Intellectual Property and know-how?
15.0%	Is there a market for my products/services?(What is the market, competition, price/quality situation?)
13.1%	Can I enforce contracts and agreements?
12.1%	How should I implement my plans?(How do I find and evaluate project management capacity?)
12.1%	What is the best location for me to set up?
11.2%	Is payment traffic granted?
9.3%	If I hire a manager, should I have a Chinese or an expatriate to run my China business?
8.4%	Can I get good IT and adequate maintenance services locally?
8.4%	How do I supervise my operations in China, also in terms of financial means controlling?
7.5%	How do I find and evaluate good suppliers?(Can I buy cheap with good quality/service in China for my company? How and what products?)
7.5%	Is it necessary or beneficial for me to produce locally?

Is it difficult for my company to find answers to above topic without external support?

Source: Swiss China Survey, 2005

4 Definition of this guide's content

The main elements of content of this book have been defined based on the most frequently asked questions list and key success factors identified from the managers in China. Difficulties experienced in by managers in China are also put to use to define what content is of most value to readers.

The market types analyzed in Chapter V have been determined according to the importance of the different sectors for Swiss business. This importance is based on trade figures, the number of Swiss companies active in China in different industries and opportunities identified by the Editorial Board where little Swiss activity is currently taking place (education and health services, for example).

5 Data Protection

Data has been collected online, anonymously. Respondents were however requested to provide an e-mail address if they wished to get a copy of the results. Respondents were also asked to provide their contact details as an option. The data is stored in a database to which only researchers receive access and all data is made anonymous as soon as it is extracted from the database.

To generate participation to the survey, the call center used the addresses of the Swiss Chinese Directory, exclusively.

I

General Environment & Trends

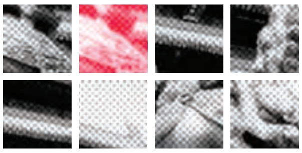
Understanding the local business ways, laws and regulations and the Chinese culture are success factors are rated consistently high by the managers of Swiss companies in China. As a result, the category 'Knowledge of the local environment', composed of environment related factors is a top three, key category of success factors.

To support enterprises in their dealing with the Chinese environment and business ways, this chapter (and the next Chapter II Legal, Tax & Finance) go deep into the aspects of China's business environment that are quite different from what a Swiss manager is used to.

The impact of Chinese culture is an important underlying basis to understand Chinese business ways. Therefore, one section attempts to explain the cultural traits and paradoxes of Chinese culture that are unfamiliar to the West.

The Chinese who form the emerging middle class are also described, through contributions about brands and their values; indeed these Chinese are the most important group to most Swiss businesses in China, as consumers or key employees.

A description of China's key economic regions as well as details and trends of Swiss business activities in China uncovered by the survey are provided for additional insights and interesting benchmarking.

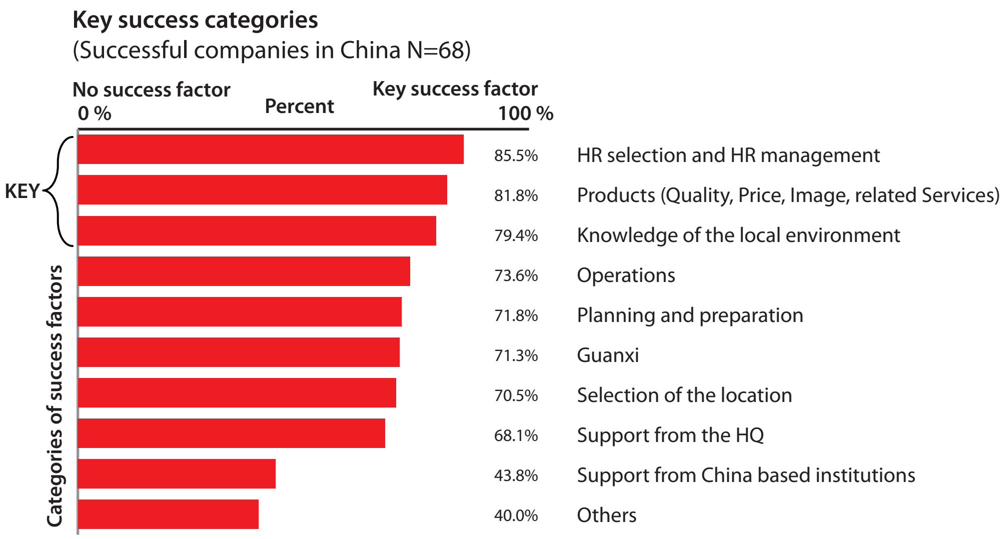


1 Knowledge of the local environment, key for success

'Knowledge of the local environment' is one of the 3 key categories of factors of success identified by the Swiss China Survey. Its position relative to the other categories is presented in the chart below.

Survey chart I - 1

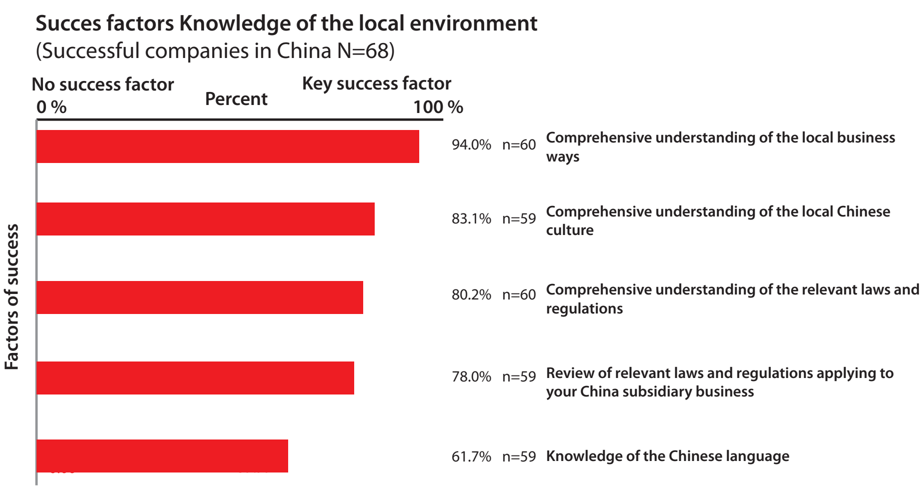
Success Categories of Successful Swiss Companies in China



Source: Swiss China Survey, 2005

When going into details (see chart below), 'comprehensive understanding of the local business ways' is the determining success factor of the category and a determining factor overall since it comes in second position (at 94%) within the 47 success factors rated by the successful survey respondents. (See Initial Chapter, Swiss China Survey, 'Success in China' for the complete list of factors.)

Survey chart I - 2



Source: Swiss China Survey, 2005

'comprehensive understanding of the local Chinese culture', in 10th position (83.1%) is rated higher than 'comprehensive understanding of the relevant laws and regulations' (15th, 80.2%).
Yet Chinese language skills are not relevant to successful managers of Swiss companies in China: 'knowledge of the Chinese language' ranks 38 only out of 47, on the chart of individual success factors. (Also see Initial Chapter, Swiss China Survey, 'Success in China' for the complete list of factors).

2 Culture, history and consumer psychology

2.1 Chinese history, business culture and psychology

by Nicolas Musy, Vice Chairman SwissCham China, Managing Partner CH-ina

Volumes are already dedicated to this subject without covering it adequately: the only ambition of this introduction is to provide a basic understanding of Chinese culture and psychology for Swiss managers to understand their business counterparts.

In order to be concise whilst remaining practical, we focus our description on those Chinese that a Swiss manager will deal with: essentially the main stakeholders of a business (employees, clients, suppliers, authorities). They will most likely have a formal education, be young (though officials may be older), live in or near major developed cities and have a degree of understanding of foreign businesses in China.

2.1.1 Cultural diversity

As one deals directly and practically with people, one soon notices that, once again, **China is not a homogenous environment, even in matters of the everlasting and unifying Chinese culture.**

There are important and expected differences between regions North and South, East and West. Mentalities may be very parochial: inhabitants from the next city (or even village) are strangers, often speaking another dialect. Yet (and not unlike the Swiss), the Chinese will immediately recognize themselves as part of the same big and united family, as soon as they find themselves in a bigger context. As an example, it would be unacceptable for a very large majority of the Chinese that Taiwan would cut its blood ties and formally declare independence from the motherland.

There are also major differences between inhabitants of large cities and the rural population. These communities are often literally worlds apart: **a Chinese army colonel who had never traveled abroad confided to the editor that he experienced real culture shock visiting relatives 300 Km inland from Shanghai; yet he felt totally at ease on his first trip to Switzerland**.

Additionally, a few families kept old traditions alive throughout the Cultural Revolution whilst for others, traditional cultural elements were erased, providing a quasi-blank cultural slate for their children to grow on.

2.1.2 There are no "cultural genes"

Chinese (like other peoples) are influenced by their culture and not by belonging to a genetic group: adopted children completely assimilate the culture they grow up in rather than that of their biological parents; a Swiss raised in China from infancy would certainly behave exactly like a Chinese!

Thus, Asians are not fundamentally different from Europeans. They just share different beliefs and habits; different sets of values and different ways to handle situations and issues that appear alike. Actually, the issues and situations one has to deal with in China always incorporate an amount of difference, inherent to the different circumstances. As a result, the Chinese way of handling a problem in China may often (though not always!) be more appropriate than a typically Swiss solution.

The characteristics of China's culture certainly arose from geographical and population circumstances, the way initial civilizations developed and the selection of the historical paths that the local people made throughout the times. Some history is therefore very useful to understand the fundamental elements of Chinese culture.

2.1.3 Two Millennia of Cultural Identity

2.1.3.1 The beginnings in a protected geography

China has been well protected from external influences by its geography: inhospitable deserts and steppes in the North, sea to the East and formidable mountain ranges to the West and South. Only in part of the North East (towards Manchuria and Eastern Siberia) and South West (towards Vietnam, Laos and Burma) are relatively easily passable areas.

These **natural barriers have protected the formation of one of the longest living cultures on earth**. Historians usually trace it to the early Shang (1700 BC) and Chou dynasties, followed then by the Warring States period (403-221 BC). This period was closed by the first unification of China under the Qin dynasty, more than 2'200 years ago. ("Qin" is pronounced Chin: it is the phonetic origin of "China".)

Among others, the Qin unified the writing throughout the first empire, providing one of the key elements of the nation's cultural identity.

2.1.3.2 The succession of imperial dynasties

Dynasties succeeded each other, bringing innovations but generally keeping intact the administrative systems that ran the empire (historians generally agree that the bureaucracy matured in the 7th century [1]).

Under the Tang dynasty (618-907) China was the center of booming trade and cultural and technological exchange, permanently hosting over 100'000 foreign merchants, craftsmen and intermediaries. By comparison, there were about 150'000 foreign residents – Taiwanese and Hong-Kongese excluded - registered in China in 2001!

The outward-looking Tang empire was by far the most technologically advanced, dynamic and wealthiest civilization of the time. Agricultural yields were up to four times the global norm. Two million people lived in Xian, the capital, when large centers in Europe counted their inhabitants in the tens of thousands [2].

This period, recognized as China's first opening to the outside world, ended when natural disasters, rising corruption and a weak central power contributed to increased inequality and higher prices. Xenophobic sentiment grew, leading to the massacre of foreigners. Historians argue that the times of tolerance and critical philosophy that ended with the Tang Dynasty were matched only by Descartes' 17th century and have not been approached again to this day in China [3].

Barbarians regularly invaded from the Northern steppes; the most famous of them, Genghis Khan and his descendants, conquered China and most of the known world of the time in the 13th century, making Beijing the capital of the largest empire that the world has ever seen. In the early decades of its reign, the Mongol Dynasty (the Yuan 1279-1368) stretched its rule from Moscow to Korea and from Baghdad to Vietnam.

Conquerors, however, invariably made the Chinese culture their own and found the existing bureaucratic systems handy and difficult to replace; they simply installed leaders of their own stock in key positions instead.

(The last dynasty - the Manchu Qing – a symbol of traditional China for the Europeans, came from a North-Eastern non-Chinese ethnic group speaking a Siberian language.)

The Ming (1368-1644), successors to the Mongols, started a global trade system based on an ocean-going navy that could carry 30'000 fully- equipped soldiers, their horses, equipment, water and food. The fleet (including commercial vessels) consisted of 1'500 teak ships (up to 150 meters long) and regularly plied sea routes from Indonesia to Africa.

This era marked the second time that China looked resolutely outwards. While the Ming could have become the first empire to control world sea routes, 300 years before Britain, the third emperor grounded the fleet in the early 1420s and ordered the destruction of all maps and other fleet records. This brought China back into autarky and isolation, after her second attempt at embracing the world.

The last dynasty, the Qing (1644-1911), pursued their predecessors' policy of isolation into the 20th century, resting their legitimacy on the Mandate of Heaven and on the fallacy that their Kingdom was still the Center of the World. Reality caught up in the early 20th Century and brought about a revolution, a short-lived republic, civil wars and the dominance of the Communist Party since 1949.

2.1.3.3 Trade with the West and Recent History

Exchanges between Europe and China go back to classical times, when Roman ladies acquired a taste for the comfort and seduction of wearing transparent silk. It arrived via the famed Silk Road and by sea, traded and transported by Central Asian, Indian and Persian merchants. By the end of the 4th century, silk was a universal accoutrement in civilized society throughout the Roman Empire.

Europeans started trading directly with China in the early 16th century, when the Portuguese received permission to establish themselves in Macao (in 1516).

Western purchases grew considerably up to the 19th century. At the same time, the Chinese found European goods generally unnecessary and consumed their own, often superior, products.

In 1820, China was the biggest economic power of its time, accounting for about 33% of world GDP, while Europe generated around 28% (and the USA only 2%; these proportions between the USA and China are inverted today).

The trade imbalance reached the point where the one-way flow of gold and silver into China (the world currencies of the time) became unbearable for Western economies.

The British finally devised a solution to this economic problem by growing opium in India and selling it to China. The new business boomed up to the second half of the 19th century, reversing the trade balance, yet causing alarm at the human depravation that resulted. As a result, the Chinese imperial government ordered confiscation and destruction of European stocks of opium. This triggered the "opium wars" of the second half of the 19th century, launched by the Western powers to open China economically by force.

For the first time in its long history China was defeated and partially settled by powers that did not share or subsequently adopt her culture; yet the territory that was conquered (up to 15 port cities) did not amount to much and **China remains the largest territory - and one of the very few nations worldwide, including Japan - unconquered by Western powers**.

The imperial times formally ended in 1911 with the setting up of the Republic of China. Yet the rule of warlords, the invasion of Manchuria by the Japanese and the civil war between the Communists and Nationalists mark the first half of the 20th century.

The founding of the People's Republic of China in 1949 by the Communist Party (and the subsequent occupation of Tibet) brought most of Imperial China again under the same rule, with the exception of Hong Kong and Macao. Taiwan - at time under Dutch, pirate or Japanese control - became the refuge of the Nationalists and the seat of the Republic of China that had been founded in 1911.

By defeating the Japanese and re-asserting control over the cities previously under European control, the Communist Government returned to the Chinese their national identity and face to the country (see section 2.1.4.3 for the concept of face).

However, the economic policies that were launched by Mao Zedong (after land was confiscated from landlords and distributed to peasants) brought China one of her worst disasters. The Great Leap Forward (an effort to modernize China rapidly, 1958-1960) is estimated to have cost a staggering 30 to 50 million lives.

The failure of his economic policies reduced Mao's credibility and undermined his authority. In order to regain absolute power over the Communist Party and the nation, he launched the Cultural Revolution (1966-1976). **While achieving its aim of ensuring Mao's single rule, it destroyed an important part of the Chinese cultural heritage and the perpetuation of many traditions**.

Though being at the source of China's worst cultural destruction, Mao found his political and government inspiration in the official history of the imperial dynasties. **Many argue that the establishment of the Chinese communist state and bureaucracy did not amount to a real break with the imperial times** and some even speak of the "Communist Dynasty", and of Mao and Deng as the "Red Emperors". Neither Jiang Zemin nor Hu Jintao, who succeeded them, would qualify for such a title. Yet the ruling Communist Party continues to claim absolute authority over all aspects of government and politics (it has abandoned the micro-management of its citizen's private lives, though).

As a result the current regime lacks the basic checks and balances that Western societies have established as a guarantee for good governance, and perpetuates many of the Confucian principles of government, notably the rule of man rather than the rule of law.

The new private freedoms also imply that communist morals are not upheld any more, leaving a morality vacuum that has not been refilled by traditional Confucian ethics.

Yet, **the ongoing "Open Door Policy" started by Deng Xiao Ping in 1978 amounts to the third outward-looking attempt by China in its more than two millennia of uninterrupted history as a nation**. Should this opening be finally sustained, the consequences for the rest of the world (and particularly for the culturally dominant West) will certainly be as important as the rise of the USA in the 20th Century. (Also see the article above, 'The Emergence of China, Consequences for Swiss Economy and Strategies for Enterprises')

2.1.3.4 Pointers for Today's Society

From the long and very rich ancient past of the Middle Kingdom, two elements help us to understand today's China:

- Society was segregated between commoners (mostly farmers) and a landowning ruling elite, whose prerogatives included access to gods and ancestors through cults and rituals. Yet, from the golden times of Chinese culture, anyone able to pass the official examination was entitled to become a Mandarin and to join the civil service, thus the ruling elite.
- The dynasty in power was considered to be the temporary recipient of the "Mandate of Heaven". The passing of dynasties amounted essentially to a transfer of the Mandate, handed over by an abstract and most important spiritual power. Culture and bureaucracy were China's very powerful and unifying factors, those that absorbed

and digested all incursions by foreign cultures [4].

In recent Chinese history, we single out two events as having a particular impact on the last 25 years of development:

- The defeat of China by Western powers in the 19th century and the Japanese invasion of the early 20th century. These events have woken the Chinese up from their isolation by making them realize that they are no longer at the Center of the World's power, despite the enormous size of their nation. As a result, China has been launched on a drive to modernize and re-establish her pride and national unity. This movement will not be completed until "the province of Taiwan has returned to the motherland" - in the current government's own terms. An unusually strong nationalist feeling is present in all layers of the Mainland's society, including the brightest and best educated (many in foreign universities) of the young Chinese.
- The Cultural Revolution has had a considerable impact on Chinese society by initiating an unmistakable break with its traditional past. Very few are the educated Chinese of today who have an understanding of - or even an interest in - their old tradition and imperial history. This break with the traditional beliefs (and the inherent pragmatism of the Chinese, also see below) has certainly accelerated the development of modern, materialistic and practical thinking in Chinese society in the last 30 years.

Overall, the very long cultural and administrative history of China has been mostly marked by an inward focus to meet constant and unpredictable challenges to unity and stability: internal strife, disasters or invaders. **The cultural and administrative continuity of their state has probably marked the Chinese as much as the potential, unpredictable chaos that is always waiting to befall them**. Yet, in periods of stability, the Middle Kingdom has unveiled its potential and experienced extraordinary periods of global reach, far ahead of its time.

2.1.4 Social Density and Shortages: a Cultural Driver

Marco Polo is supposed to have mentioned the enormous number of people as the most striking feature of China. Genghis Khan, finding his new conquest crowded beyond any reasonable measure, is known to have planned the execution of 9 out of 10 Chinese (he was dissuaded by a Chinese minister, who argued that the tax revenue was however excellent).

As early as the 9th century, Tang China counted more than two dozen cities of 500'000 inhabitants. In the 14th century, China's biggest city (Hangzhou, six million) was home to more than 30 times the number of inhabitants of Venice, the most populated European city (160'000 souls).

The greater the population density, the higher are the risks that food and other resources are only just sufficient. Small disruptions may then result in big catastrophes. Since the beginning of its existence, China's population (in absolute numbers and density) and the regular disasters and shortages it had to endure, are probably the most important factors that have marked its culture.

2.1.4.1 Scarcity of Resources, Family- and Self-Centrism

Natural and man-made disasters (floods and wars among the most frequent) combined with the population density to generate regular and widespread famines. **Throughout Chinese history, resources in general have been too scarce to meet the needs of the common people, the huge majority of the population**. This scarcity meant that being slow, not resourceful enough, or too decent in a crisis, could mean death for oneself, or one's children.

When famines struck, faced with the certain knowledge that a portion of the community would die, mothers and fathers naturally used all of their means to protect their own. Scarcity made the family the focus of all the attention of its members and, as a result, all the resources that were not due to rulers were totally devoted to the familial inner circle. This family-centrism naturally meant that there was little attention left for those outside of the circle.

Indeed, in everyday dealings with strangers (usually anyone but close family and friends), the average Chinese pay little attention to others and behave in ways that are consistently self-centric and impolite - often incomprehensibly so to Westerners.

Most Chinese (for example) almost invariably break the queues to board a train; they also try to enter an elevator before the exiting passengers have had time to exit. And in both cases, they do so even if there is obviously enough space available for all, or even if seats are numbered and reserved.

In the process they will push and shove inconsiderately, oblivious to others' condition and without care for age or physical ability. Empty seats in a city bus will be occupied by the first persons scrambling in: very rare are the cases when an old or disabled person will be offered the chance to take the place of a younger or fitter one.

One of the drawbacks of this self-centrism is the resulting low ability of Chinese to work in teams. As the proverb has it: "one Chinese is a dragon, three Chinese are but a collection of insects". This is in stark contrast to the naturally disciplined Japanese who are known to be very efficient in groups but perform poorly as individuals.

The race for resources has been a part of China's environment since time immemorial: it will take at least one more generation for behavioral habits to adjust to an environment that has just started to provide basic resources for all. Only recently have Chinese stopped scrambling when boarding airplanes in Shanghai and Beijing airports .

2.1.4.2 Hierarchy and Respect for Authority, Collectivism

With large numbers of mostly uneducated citizens to govern, and frequent crises, social organization in China has always been crucial. An authoritarian, strict and highly hierarchical system has been the answer of the times to protect against the regular collapses of Chinese society that are remembered to have brought the worst of times .[5]

However, the authority that has been wielded by the Chinese state and the resulting lack of personal freedoms has in principle been conferred for the good of all: rulers were expected to manage society to provide in return for stability, safety and possibly, harmony. In so doing they were providing the opportunity for the large majority to live an acceptable (and if ever possible, better) life.

The Chinese culture is a collective one as it supports authority and a reduction of individual freedoms and creative thoughts for the good of the large numbers. **Yet disciplined behavior is guaranteed only as long as an authority enforces rules: left alone, Chinese become fierce individualists, as illustrated in the paragraphs above.**

The millennia of living under authoritarian rule have made respect for authority at every level a constant feature of Chinese life. Respect for parents and family elders is another expression of the respect for authority that is a prerequisite for social harmony in Chinese culture. Like the ruler's authority, wishes of family leaders are not to be challenged, yet parents should provide affection, sustenance and self-sacrifice to their children in return.

Today, mostly out of respect for authority, average Chinese employees will avoid contradicting their foreign bosses, even when they disagree or the instructions they receive do not make much sense.

With the culture of not wanting to disappoint, bad news may not be communicated and meanwhile, lies may be constructed to cover up. Westerners have difficulty in reading between the lines in such situations and therefore are limited in their ability to manage appropriately. Openness, humility and friendship with at least some of the employees is necessary to get to the bottom of issues.

2.1.4.3 Face

The concept of "face" is closely linked to the respect that one is due according to one's position and authority in society. Face applies to everyone, within the family and in professional circles - in government or in an enterprise.

Loss of face occurs when inadequate treatment is dealt or due respect is not paid. Conversely, face is given to a superior or an official by acknowledging her or his power, through obedience, favors or gifts, for example. The concept extends to peers, family and friends, whose dignity needs to be preserved through one's favorable actions. Everyone needs face in China, both to be socially integrated and to function effectively at work. In this respect face remains a pragmatic need: without it there is neither respect nor authority, so little maybe achieved.

Westerners may see face as a need of people in positions of power to feed their egos. This desire is not any different from what we experience in our societies and it is certainly a feature of Chinese psychology as well. Yet it is not the culturally specific component of Chinese face.

Northern Chinese, for example are known to care much about their egos. They are known to refuse to deal with anyone that has offended them, even at the expense of some potentially lucrative business. In the more business-minded South, winning a good deal will actually gain face for the negotiator in his organization, even if offense has been sustained. (And certainly so, if such offense was unintentionally committed by a culturally unaware partner). It may also happen that in order to show his power to other members of his organization, a negotiator may refuse proposals even if they are reasonable.

2.1.4.4 Human Rights Conception and Social Volatility

To deal with large masses of uneducated citizens (to this day over 60% of the population is rural and only just literate), China's rulers devised simple and strict systems. Neither time nor attention was devolved to cater to minority cases. (Today's business legal environment remains general or non-specific, without any attention for special cases, often considerably frustrating foreign business people.)

Despite Confucian ideals of humaneness (see below), treatment of the peasants often followed practical consideration of the management of their large numbers and the need to maintain social stability. Methods were not very different from those applied to cattle, and commoners' lives had little more value than that of their animals.

Today, the death penalty is still widely applied and China's handling of prisoners is considered inhumane in Western countries (the PRC executes more people than the rest of the world combined [6]). The conception of Human Rights in China remains subordinated to the management of society and to ensure social stability at virtually any cost.

Animals are still viewed as edible things, little more than objects that are given the care needed so that they remain fit for consumption.

The nearest experience we may refer ourselves to for an understanding of this aspect of China's social organization is the military service. Indeed, and **well into the 80s, Communist China gave the impression of being a very large boot camp**. Train passengers were parked in large waiting rooms and lead through megaphones to the platforms. Students, for another example, had no other choice but to wake up at 06:00, to the sound of military marches blaring from loudspeakers all over campuses.

As long as Chinese society and its self-centric individuals are contained by harsh rule, it also remains naturally a volatile one: once the administration loses its grip, social explosion easily ensues.

The best recent example is the Beijing Spring of 1989. Justified initial demands made by students to rein in corruption were met with the sympathy and support of the general population in all functions. Though they are part of the government apparatus, train controllers were allowing whoever presented a student card to ride for free to Beijing. As a result, the protest was over a million strong within weeks.

2.1.4.5 Interpersonal Skills and Political Sense

Living in such a dense society, Chinese have been in permanent interaction with their compatriots. Until recently an average urban resident would not spend a single moment alone, from birth to death. Residential space was not enough to allow individuals to live in their own apartment or room; at work, single offices are reserved for the very few and, needless to say, public space is generally crowded.

Without the possibility to isolate oneself or to have any privacy as an individual, maintaining good relationships and acquiring the skills to deal with others has considerable value. Conflicts are naturally avoided so that, among peers, every aspect of daily life is subject to discussion and persuasion, both in private and at work. As a result, negotiating skills and political sense are practically innate to Chinese.

Unsurprisingly, the social intelligence and interpersonal skills that Chinese demonstrate are considerably higher than those that our Western societies breed. This possibly makes Chinese the best of business negotiators: among other advantages, they usually manage to achieve better conditions than any other nationalities when purchasing internationally.

2.1.4.6 Delegation of Authority and Corruption

To deal with difficult communications across a vast territory and its diversity, the administration has been delegating authority to a large degree and granting large powers to local governments.

Therefore, diversity and local autonomy has been a major fact of Chinese administration and life. It has been further promoted by the Confucian belief that the rule of man is preferable to the rule of law (also see Confucianism below).

This has been so well into the 90s; as an example, a single city (Suzhou, in Jiangsu Province) was paying more taxes to the central government in 1993 than the whole of Guangzhou, the richest and fastest developing province in China at the time. Though centralization is rising, de facto local autonomy is still considerable in China, even more so than in Switzerland. As a result, the power to interpret and enforce central laws and edicts has been devolved locally and depends highly, to this day, on the officials in charge.

This obviously creates major opportunities for corruption, particularly when the checks and balances are not in place to supervise local officials. (Ensuring a corruption-free administration will most probably prove to be a key factor for the success of the current administration. See also chapter XX Key Issues for Operation Success, guanxi, culture, corruption)

2.1.4.7 “Guanxi” and Loyalty

Faced with the rule of man rather than the rule of law, Chinese naturally tend to establish personal relationships – particularly with people in positions of power - on which they can rely to have a degree of security and control over their lives. These relationships are defined by reciprocity, trust and mutual obligation. They are actual friendships maintained by the continual exchange of favors.

“Guanxi”, the term that is used to describe the set of relationships that a person can action when needed, literally means “door into a hierarchy or group”. In China, it is also described as “a tool to achieve the impossible” ; indeed, when the implementation of rules relies on those in charge, every rule can be bent. As a result nothing is actually impossible for the well-connected, even though formalities are recognized to be much more complicated in China than in Western systems.

Conversely, the prevalence of relationships and the unchallengeable authority of people in power naturally reduces the value that Chinese put in formal agreements. They may become difficult to fulfill due to unpredictable events. Or, predictable situations may not have been accounted and planned for, rendering the agreement awkward. In either case, it is usual for Chinese partners to expect the re-discussion of contracts. In extreme cases, Chinese partners may have no moral problem in reversing agreements just because it suits them to do so.

In such an environment, most admit that without a network of relationships, nothing of importance can be achieved efficiently in China. Such a network may however be built via support organizations (chambers of commerce and consultants, for example); to be successful, a foreign company does not necessarily need to cultivate central government or even provincial leaders, depending on the size of the business.

Besides, relying on relationships as a major means of getting results is risky: people in government positions change often and once they are replaced a personal relationship with a new official needs time to be established. During the transition much can happen.

Guanxi also provides an understanding of where Chinese loyalties lie. Relationships are always personal and directly linked to persons, not to the organizations to which they belong. The feelings of trust and loyalty that are created in relationships formed in China are therefore completely associated with the persons involved. Employees, as a result, will usually be loyal to the bosses they trust, much more than to their company.

2.1.4.8 Pragmatism, Resourcefulness and "Adhocracy"

Confined by strict systems and eking a living out of scarcity, there was little alternative for the Chinese common people but to work hard, day after day.

Having to deal with shortages, thriftiness was another necessity. Maintenance and good care of tools and belongings was also very important. Yet, poverty and disasters waiting to happen, also meant that no resources should be provided for the benefit of others: the need for them would come sooner or later. This feature is most clearly illustrated by the different ways in which Chinese treat public and private property. The apartments owned by private people are kept as impeccably as those of the most demanding Swiss. Yet, very little efforts are volunteered by citizens to preserve or maintain public property, so that littering, for example, is endemic.

Unsurprisingly, **China boasts the highest savings rate in the world**.

Faced with shortages, unpredictable potential disasters and inescapable administrative constraints, the large mass of Chinese lived from day to day, concerned first and foremost by practical issues. Naturally, they devised very pragmatic ways of life. As a long as a solution worked, it was a good one. Chinese communism has perpetuated this approach: in his early years in power, Mao exhorted the Communist Party to "seek truth from the facts". **In the 60s, Deng Xiaoping maintained that "The color of a cat does not matter, as long as it catches mice …**" And as soon as the Cultural Revolution was over, very pragmatic policies were enacted again, allowing the economic development that we witness today.

When living through a disaster, however, rules and bureaucracy would often prove ineffective or inadequate. The ones who dealt best with the crises were pragmatic, but also particularly agile and resourceful; ready to disregard rules and regulations.

A good example in agility while dealing with inadequate systems is gained when observing traffic – motorized and pedestrian - in a large Chinese city: the only rule is to break the rules! Traffic regulations simply cannot be followed if a degree of fluidity is to be maintained. It goes to the extent that seeing a cyclist driving against the flow on a freeway is not unusual (Italians demonstrate a similar ability in dealing with their own traffic and other regulations: in this aspect the two nations are very close and Italy provides a good reference for what to expect from China). As a result, **Chinese are always ready to ignore prevailing rules or theories and to solve situations in an ad-hoc way**. This "adhocracy" is actually so prominent that it is part of state policy, as illustrated by the description of the social system that the government advocates: "market socialism with Chinese characteristics".

2.1.5 The Ruler and the Ruled: Parallel Cultures

The many paradoxes apparent in Chinese culture probably stem from the parallel existence of two cultures, the one alive within the masses of common people (described in the section above) and the different (though related) values by which the ruling elite is expected to behave to manage social order.

As an example, the collective aspect of Chinese society described above depends on rule and enforcement, therefore on government efforts to maintain order. Without such a framework, Chinese behave in ways that border on the extremes of individualism, and a first-time visitor watching the fierce competition of Chinese daily life (the scramble onto public transportation, for example) is hard pressed to understand the collective nature of Chinese behavior.

2.1.5.1 Education: the Ladder of a Permeable Society

Traditionally, Chinese place enormous importance on getting a good education: it is viewed as the best chance to secure a good social position (also see Chapter III, Market Types, Education).

For more than a millennium, knowledge to pass the civil service entrance examination was the only requirement to join the imperial administration and become an official. Acquiring knowledge and skills was – and still is – the preferred way for Chinese to secure better lives for themselves and their families.

The current economic development of China is offering new opportunities towards wealth. They are more than ever available to all with the ability and courage to grab them. Consequently, parents do are prepared to make every sacrifice and push their children very hard to get them into the best schools. Indeed, hundreds of thousands of Chinese are studying abroad at high cost, and many, now, return to make good on the opportunities their country offers.

The value placed on education also explains the considerable respect given to their mentors by Chinese students. Indeed, teachers provide guidance and support to climb the ladders into better lives, so that they are as respected as leaders and family elders.

As just described, though elitist, **China's social system has always been permeable** [i]. As a result, **most have a chance; at least the chance to offer their children the right opportunity.** The children, in return, will improve their parents' condition, becoming their proxy into a better life.

This minimal chance keeps everyone working hard and ensures that important talent does not go wasted.

2.1.5.2 Strategy and Innovation

Historically faced with the necessity to deal with often unpredictable hardship one day at a time and pushed to fit the common mold by the administrative system, common Chinese have had little understanding for the value of planning; or for thinking out of a framework that they cannot leave anyway. They are however extremely nimble and adept at reacting to events as they immediately affect them. In other words they maybe described as excellent tacticians but poor strategists.

On the other hand, Chinese history abounds with famous strategists bred by the ruling elite. Sun Zi (who wrote his "Art of War" 2'500 years ago) is still revered as one of the greatest strategists of all time. As well, Mao Zedong and the Communist Party, possessing a fraction of the resources of their adversaries, have shown a consummate strategic art in defeating both the Japanese and the Nationalists, then in pushing back the USA in Korea and Vietnam while, in the same period, going to the brink of war with the Soviet Union.

Though aware of the value of creative thinking, the Chinese elite has generally stifled the freedom to think "out of the box" for the sake of stability and easier government (except during times of opening, to some extent). As a result, creativity of thought has remained the privilege of a few individuals that have the social position and interest to innovate.

Today's Chinese education system still fosters the discipline of learning by heart at the expense of free thought and media censorship on socio-political issues is steadily enforced by the government, thus average Chinese do not generally develop skills in creative thinking.

However, and though no Chinese received a Nobel Prize for work done in China (still, there are 6 ethnic Chinese Nobel Prize winners, most mainland born[ii]), **the Middle Kingdom was the world technological leader until the early 17th century**. Most interesting is that the Europeans actually obtained the critical technologies of modernization from the Chinese between the 11th and 14th centuries. These included printing; gun powder; advanced hydraulics; blast furnaces for the complete liquefaction and casting of iron; the compass; designs for multi-masted ships with fixed rudder; the clock escapement - essential for measuring time and therefore for determining longitude in oceanic navigation.[8]

Freedom of original thought in social sciences may not be expected at the moment; yet innovative thinking in hard sciences improves considerably with the fast development of the laboratory and scientific environment that happens along with economic development. The trend in Chinese academic publications bears witness to it: the citation of China's scientific and technological papers is growing at a rate of 30% to 40% per year, indicating an important improvement in the quality of China's research. (China comes fifth worldwide in the number of such papers published.)[9]

Therefore, **China will certainly develop in its own ways its own impressive knowledge production in the coming decades** (as Japan did in the previous ones).

2.1.5.3 Complexity and Holistic Approaches

The density of Chinese society, the web of relationships that underlies it and the long civilization it draws traditions from have made it a very complex one from very early on by European historical standards. It is attested by the fact that such consummate thinkers as Confucius and Sun Zi lived over 2'500 years ago.

Breaking down such complexity in components and analyzing them - the favored approach developed by European scientific thought - would certainly not have yielded practical results; particularly so when fast reactions in times of crisis are necessary.

(It is anyway questionable whereas the complexity of socio-economic situations can be understood through analytical reductions and be of use. In the economic world, for example, the last 25 years of research have failed to establish a link between the formal strategic planning of multinational corporations and their financial performance [10].)

Instead the **Chinese (and Asians in general) consider the issues they are faced with in their full complexity and deal at the same time with all the actors and factors of a problem**. They get a gut feeling for them, take the incremental actions they are confident with, observe the results and decide on a new action. Going through cycles of incremental decision making and actions, they also experiment and get a growing understanding of their environment and circumstances [11].

Rather than understanding analytically the complex situation they are in, good Chinese managers obtain a feeling for what actions will bring what results. The process appears messy, yet such a holistic approach ensures that reasonably suitable solutions are quickly reached and acceptable by all. The best example of such a process is the way the Communist government brought China to her current level of development, lead by individuals with no academic basis in any socio-economic field, building the economy on incremental reforms and experiments.

Though the analytical thinking developed in the simpler European environment is the source of today's science and the very successful achievements of our modern civilization, the ability to handle situations holistically may well translate into a cultural competitive advantage. Indeed, as complexity grows in a globalizing environment, analytical approaches may fail to yield usable results as fast as holistic ones. Should it be the case, **Chinese definitely have more experience and know-how in synthetic thinking than Westerners**.

2.1.5.4 Confucianism: a Pragmatic Code of Ethics for a Harmonious Society

Confucius taught that everyone should cultivate virtue, be faithful to her or his social obligations and respect the proper hierarchy of relationships. This, then, enabled well-educated rulers of good morals to ensure the harmonious development of society.

Confucius believed in the inherent good nature of man. He thought that **the rule of an excellent man would promote the moral growth of society rather than the laws and legalist systems** debated in his times. Indeed, laws would be followed as long as enforced and promote discipline but would not develop moral consciousness.

He praised kings who handed over their lands to the most able candidate rather than to their eldest son and took students from any social class of the times, actually creating the concept of meritocracy.

Moral virtue is therefore a key concept and requirement of Confucianism. Following this philosophy, and despite the need to respect authority, a ruler without the proper moral qualities actually need not be obeyed since he is at risk of losing the Mandate of Heaven.

The Confucian moral principles include the Golden Rule of "do not do to others what you do not want done to yourself", human-heartedness, kindness, loyalty, honesty, humbleness, filial piety, following the right etiquette (or rituals) in dealing with others and respect for the rightful authority. In the hierarchy of relationships, respect is due first to the ruler, then to parents, spouse, elder and friends.

This code of ethics allows a practical management of society. By establishing authority, hierarchy and etiquette under an enlightened rule, discipline and social order ensues. Confucius left very little influence to gods in social organization: "Show respect to the spirits and deities, then keep away from them" is one of his precepts. The ruler that follows Confucian principles should thus be of a benevolent kind. He should be an extended parent to his subjects, the father of the big family-nation.

Though Confucius was not retained as a Prime Minister as he wished during his lifetime, Confucianism established itself as the official state philosophy - and the base of the imperial examination system - for all of China's ancient history. Naturally, the key virtues that this moral philosophy promotes are still part of the ideal ethics of most Chinese today.

2.1.6 The Young Chinese Urban Society

Through the economic development of the last 25 years, China has seen the appearance of a new class of young educated urban white-collar workers, technicians and managers, earning a better living than the early actors of the Communist society: the farmers, workers and bureaucrats.
Though it would certainly be of interest to describe the other constituents of Chinese society, **the young urban**

Chinese are those that a foreign company is most likely to deal with. They fill the ranks of the management positions and are also the main driver in the consumption of quality products. Additionally, more and more join the government as it offers interesting positions in its efforts to attract new talent.

This new middle class is estimated to be about 100 million-strong across China, earning between USD10,000 and USD35,000 a year.

Most of them are between 22 and 35 years old. They have not experienced the oppression, injustice and the forced political correctness of the Cultural Revolution that has eroded much of the old tradition. As a result, they usually have little knowledge of and no real interest in their history and traditions.

They usually earn a multiple of their parents' combined income and contribute importantly to increase their fathers' and mothers' income (they often purchase housing for them). While they maintain filial respect, their parents are actually indebted to them and in no position to impose their will.

Working in the new market economy, they develop their entrepreneurial spirit and independence of character. With the Government abandoning control of private lives and beliefs, independence in moral judgment and private behavior naturally follows.

Indeed, in a twist of modern history, personal independence and the lighter weight of tradition has unburdened the young Chinese middle class to such an extent that today they feel less moral pressure than Swiss youth.

Social competition and peer pressure are far heavier on the Chinese, though.

Though individual personalities prevail - as everywhere else, the young urban Chinese can be generally characterized to be:

- friendly, spontaneous and adept at establishing new relationships
- open, curious and very eager to learn from the modern world
- informal, uncomplicated, not necessarily well-mannered
- pragmatic, generally risk-adverse and focused mainly on their personal material improvement while enjoying life as possible.
- (Material preoccupations and social status dominate as long as they do not own an apartment, a car and substantial savings. Overall quality of life may then become pre-eminent.)
- quality- and image-conscious: they will tend to purchase the best they can afford (or rather what they perceive as such).
- proud of being Chinese and of being part of the time that is bringing their country back to a world leadership position

A large majority would support an invasion of Taiwan if the island declared independence.

Young educated Chinese with additional personal qualities (honesty, intelligence, straight forwardness, assertiveness, consideration for others) are often fantastic people to be associated with, for work or friendship. Should one respect basic principles of politeness, respect, equality, fairness and humaneness; dealing with such Chinese is no more difficult than with Europeans.

As much as dealing with bureaucratic systems can be one of the biggest frustrations of one's life, interaction with good Chinese people makes a China experience definitely worth its while and extraordinarily enriching.

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Notes

i India's castes culture, by comparison, defines an Indian's social status for life.

ii Yang Zhenning and Li Zhengdao were the first Chinese to win the Nobel Prize in 1957 (at the early age of 35 for Yang). They obtained it jointly for work on particle physics. Both were educated in the Mainland and immigrated to the USA in 1946 where they conducted their PhD and groundbreaking work.

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2.2 China, brands and consumer psychology

By Angie Eagan, Vice President China, Young & Rubicam Brands

The following is based on research effected by Y&R in China and the rest of the world. It is developed based on Y&R BrandAsset® Valuator (BAV) model to measure the value of brands in consumers' eyes. Here are a few headlines of the results of the survey conducted in China:

- China's leadership brands are fueled by devotion to quality, increasing popularity and being progressive
- Brand Building in China is more like Western developed economies. and not like developing economies around the planet
- In China, as in the USA and Europe, brands are struggling to avoid commoditization and gain pricing power

What follows is an overview of the framework and the research findings that led Young & Rubicam Brands China to the above conclusions.

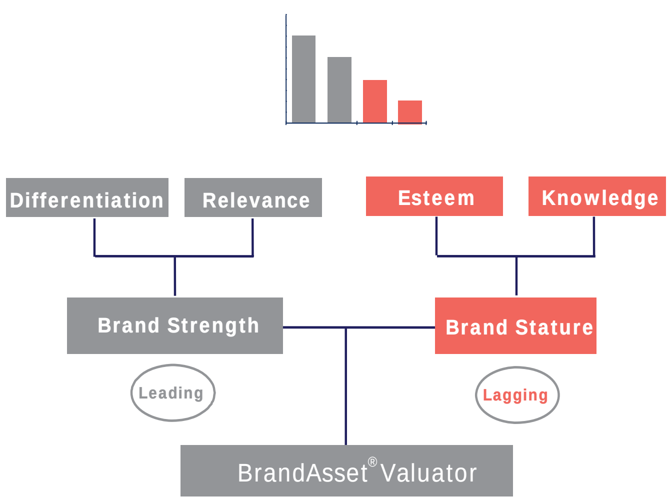
2.2.1 The Brand Asset Valuator Framework

The BAV model relies on a characterization of brands in **Brand Strength** and **Brand Stature**:

- Brand Strength is further characterized by its **Relevance** to a consumer and the **Differentiation** that this brand achieves towards others.
- Brand Stature is defined by the **Esteem** a consumer has for it (or how much she or he likes the brand) and the **Knowledge** the consumer has of it.

Taken together, Differentiation, Relevance, Esteem and Knowledge are the pillars that are measured through consumer surveys to define the value of a brand. When all four are strong, a brand is in a leadership position and command a premium in pricing. When differentiation fades a brand becomes a commodity. The model is symbolized on Fig I - 1 below:

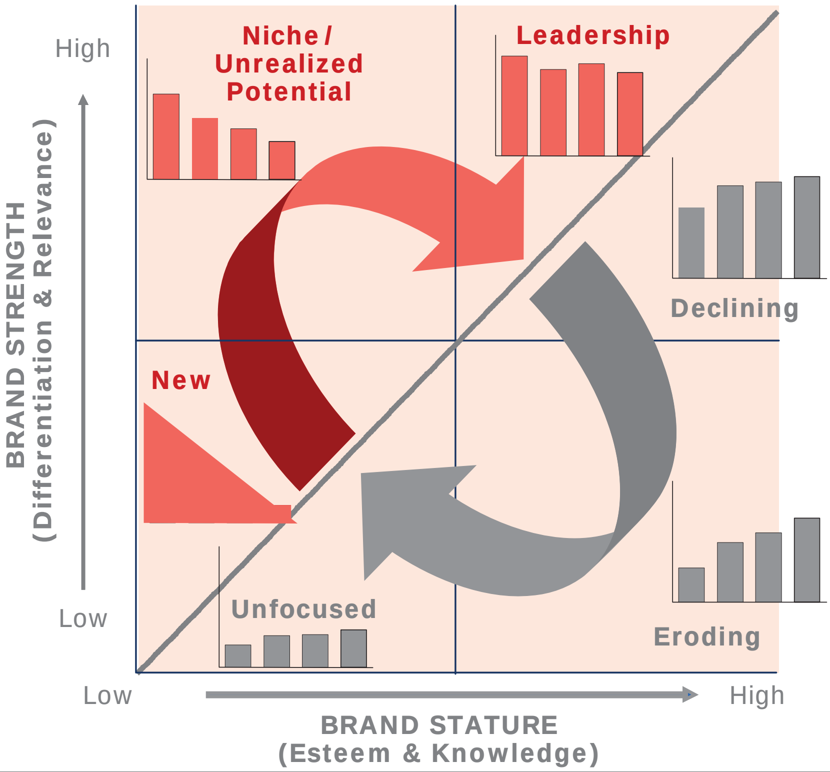
Fig I - 1
The Relationships Among the 4 Pillars Are Key



In addition to providing a relative positioning of different brands, the Strength and Stature model defines brands positions in their life cycle, as is illustrated in Fig I - 2 below

Fig I - 2

The Power Grid: Model for Brand Diagnosis

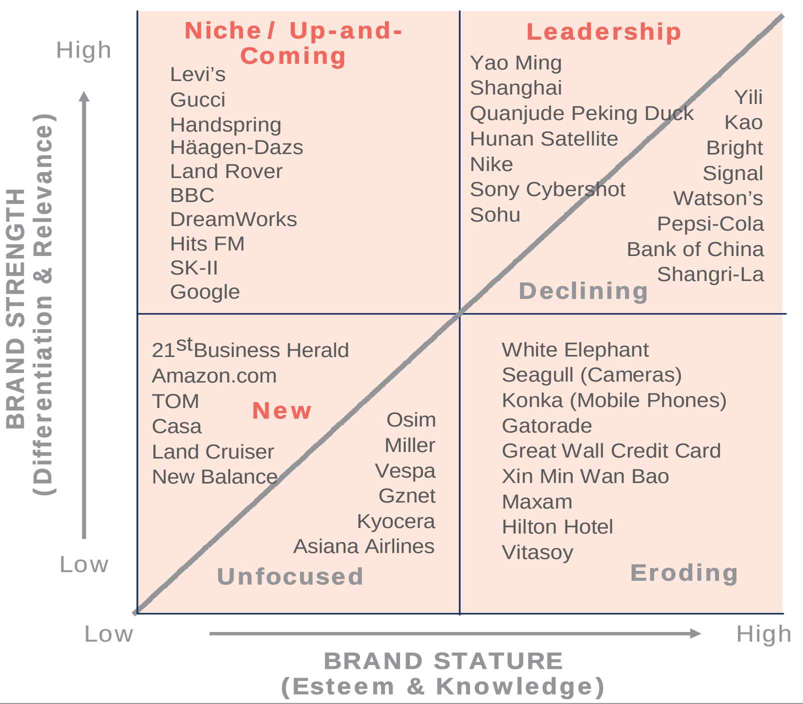


Base: PRC Total Adults, 2004

Examples of Chinese brands positioning and of top brands in China can be found in Fig I - 3, 4, and 5 below:

Fig I - 3

Examples of Chinese Brand Development Landscape



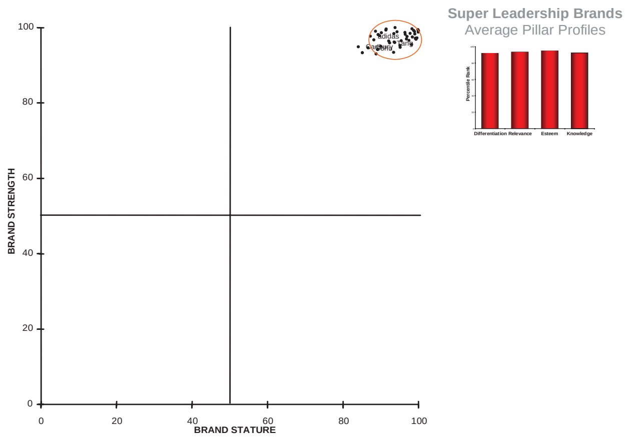
Base: PRC Total Adults, 2004

Fig I - 4

Super Leadership Brands in China are both Global and Local

EXAMPLES

Michael Jordan
Real Madrid
Jackie Chan
Shanghai
Phoenix TV
World Cup Soccer
Pizza Hut
Nike
McDonald's
Hunan Satellite
Coca-Cola
Samsung
Hong Kong
KFC
Head & Shoulders
Mentholatum
Vidal Sassoon
Dong Fang Shi Kong
CCCTV Movie
Beijing
Sony Ericsson
Yao Ming
Panasonic

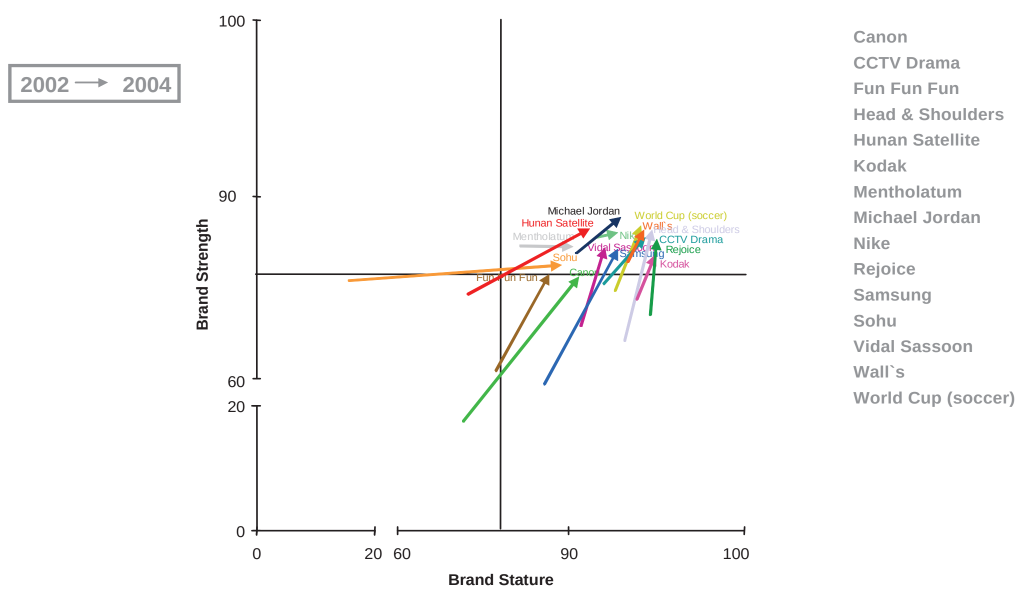


*Super leader = each of the 4 pillars >80

Base: PRC Total Adults, 2004

Fig I - 5

The Recent arrivals to super leadership...2002-2004



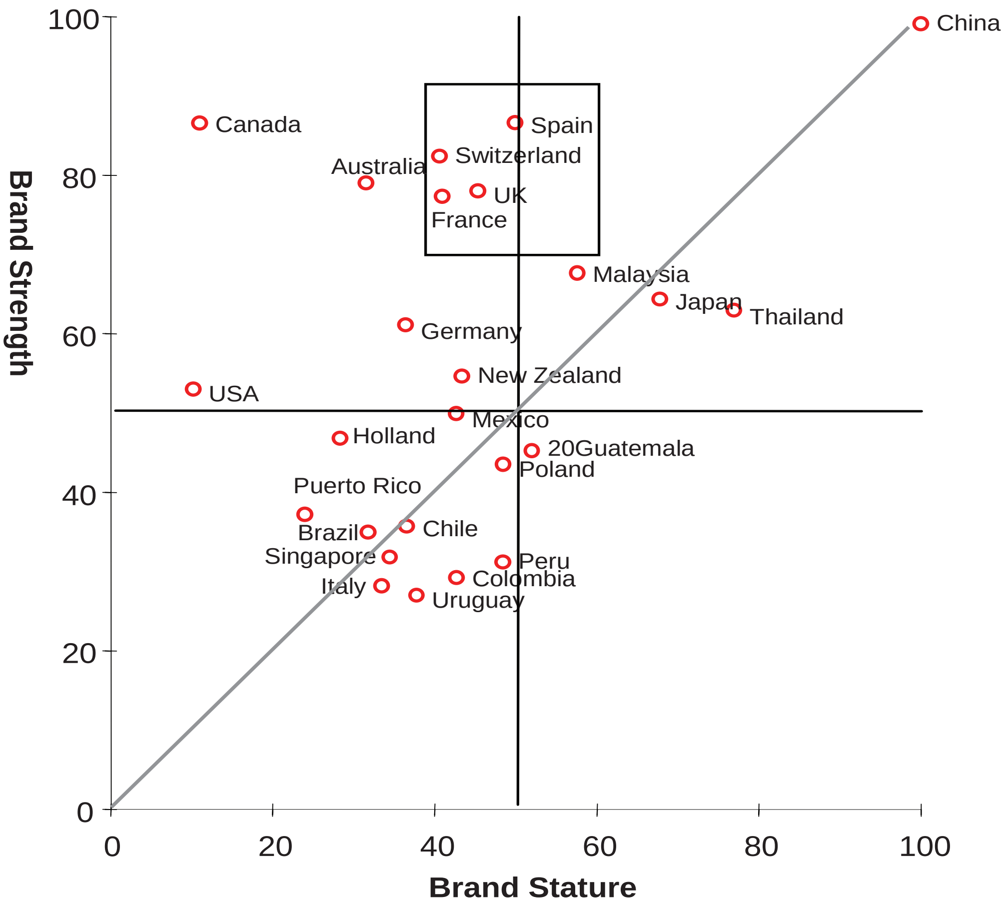
Base: PRC Total Adults, 2002-2004

2.2.2 The rest of the World, viewed by the Chinese

Using the BAV methodology, China is perceived as a superleader by the Chinese themselves.
(This provides an indication of the strong nationalist sentiment prevailing among consumers.)

European countries are perceived as stronger brands than the other countries. Switzerland is doing well, but could do better ...

Fig I - 6
A global perspective from Chinese eyes:



Base: BAV Total Adults, 2000-2004

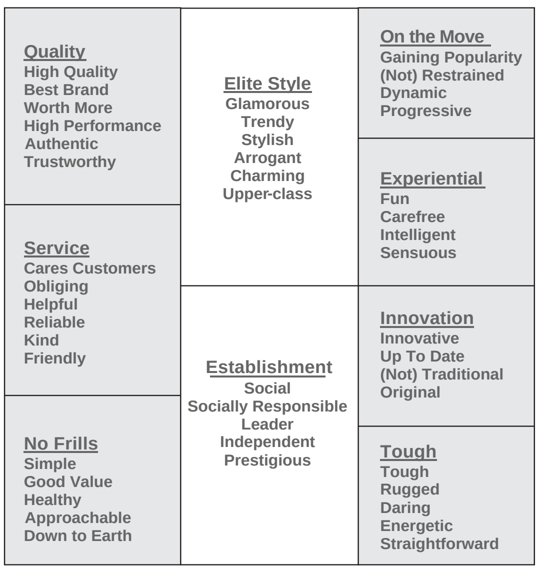
2.2.3 Dimensions that Characterize Brands for Chinese Consumers

Y&R's research identified the following dimensions and attributes to best define Chinese consumers' perceptions of brands:

Fig I - 7

Nine Image Dimensions Describe the Chinese Market

Chinese Market Dimensions



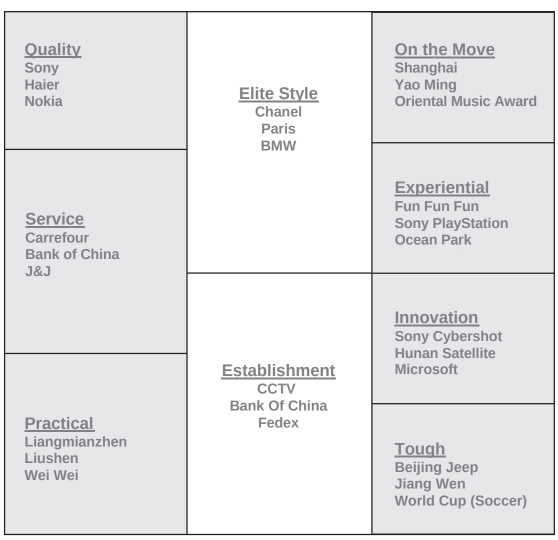
Base: BAV China 2004 All Adult - 73% Total Variance Explained

These dimensions can be illustrated by the following brands:

Fig I - 8

Nine Image Dimensions Examples

Chinese Market Dimensions

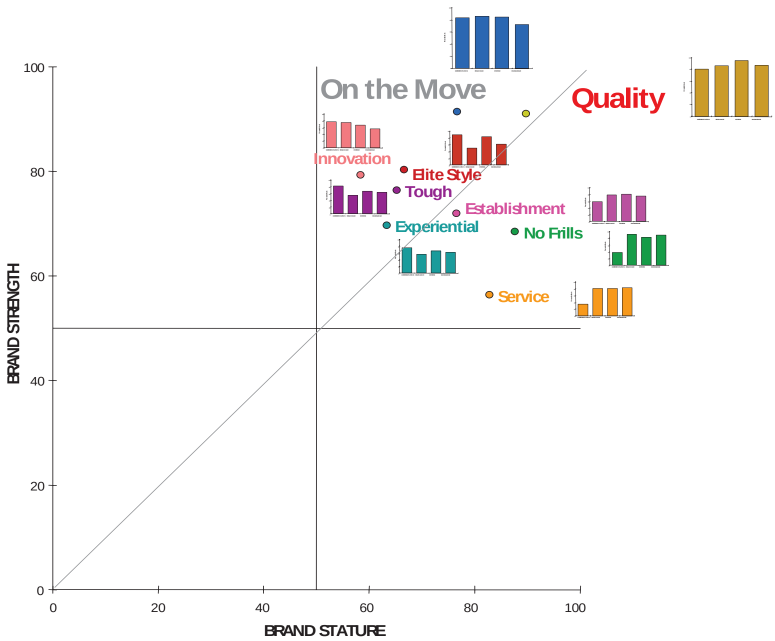


Base: BAV China 2004 All Adult - 73% Total Variance Explained

An analysis of China's 30 leading brands show the following positioning of market dimensions established above:

Fig I - 9

The Strongest brands are about Momentum ('On the Move') and 'Quality' attributes



Top Brands for Each Imagery Dimension
(Average Based on Top 30 Brands)

Base: PRC Total Adults, 2004

2.2.4 China's New Affluent: Household Income of RMB 5'000 and over (HHI 5000+)

2.2.4.1 Evolution over time of Chinese household incomes brackets:

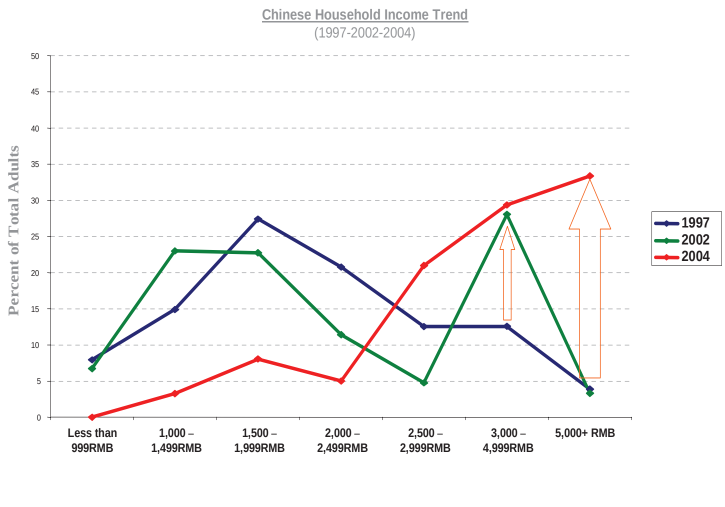
The emergence of a more affluent class of Chinese household is evidenced by the household income bracket that gathers around 30% of adults polled in the Young & Rubicam surveys:

1997: RMB 1'500 to 1'999	28%
2002: RMB 3'000 to 4'999	29%
2004: RMB 5'000+	34%

Even more striking is the evolution of the RMB 5000+ class from less than 5% in 1997 and 2002 to 34% in 2004. (See chart below.)

Fig I - 10

A clear surge of a higher household income segment



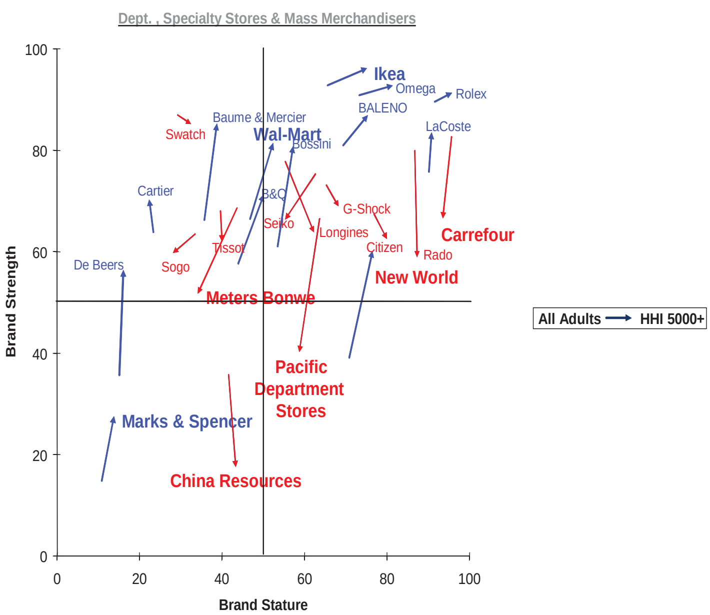
Base: PRC Total Adults, 1997-2002-2004

2.2.4.2 Example of difference of perception of affluent Chinese:

The chart below shows how affluent Chinese perceive different retail brands by comparison to all Chinese consumers. (Arrows link the position of the perception of all consumers to the affluent ones.)

Fig I - 11

Swiss watches and other brands in the retail sectors, perceived by all adults and +5000 income



Base: PRC Total Adults, HHI 5000+, 2004

Contributed by Young & Rubicam Brands

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Phone: +86 21 3651 8588, Fax: +86 21 6350 1109, e-mail: angie_eagan@sh.yr.com, website: www.yr.comh

2.3 Why China is not Europe - and what this means for your brand

by Doris Ho, Director of Sprout Brands

2.3.1 "East is east, west is west, never the two shall meet." – Rudyard Kipling

Kipling's longstanding wisdom on the vast differences between the cultures of the East and West still holds true. However, China's burgeoning economy and the lure of its potentially immense market has been challenging businesses from Europe and the US to find ways of reconciling these polarized cultures and business practices for a piece of the action.

Analysts and businesses all paint rosy prospects for China. Nokia predicts that a quarter of all new mobile phone subscribers over the next five years will be Chinese, and by then, China will probably have overtaken the US as the Finnish firm's biggest market. Martin Coles, president of international operations for Starbucks says that: "long-term, we see China as potentially our second largest market after the US" General Motors expects China to overtake Japan as the world's second biggest car market next year.

It almost seems like one can't afford not to be in China, but what do European brands need to know to successfully enter and survive in the Chinese market?

2.3.2 One huge market, or many distinct ones?

In market terms, China is a lot closer to Europe than one may think. To the outsider, China may look like one big market that is waiting to be tapped; however, **like Europe, it is made up of many distinct markets, each with its own set of language, culture and consumers, and varying potential for different industries**.

During the early economic boom, the modern shopping malls, flashy apartments and ostentatious lifestyles symbolic of New China were restricted to pockets of the **nouveaux riche in first-tier cities**; Beijing, Shanghai and Guangzhou, and special industrial zones, such as Shenzhen. However, **cities in their hinterland, such as Chongqing, Wuhan and Chengdu, are fast becoming distinct new target markets**, with needs and demands of their own. To meet these burgeoning needs, French retailer Carrefour opened its third hypermarket in Chongqing in April 2005, and Wal-Mart followed with its first store in July. Giorgio Armani opened stores in Wenzhou and Dalian in 2004, while Louis Vuitton has also moved inland, with new shops in Xi'an and Xiamen.

With each advancement, international brands have learnt that **what sells in first-tier cities may not have the same appeal in second- and third-tier cities. So in effect, what is required is a multi-, and not single-market, entry strategy**. Having a multi-market strategy can help brands find a niche in the increasingly competitive Chinese market and enhance its appeal to a more diverse audience.

2.3.3 A Different Ball Game Altogether

The low level of exposure of the average Chinese consumer to international brands, coupled with the flood of brands into China in the last few years, has led to a rise in competitive anomalies.

In China, for example, the brand Playboy, whose well-known rabbit symbol in the USA and Europe is associated with erotic magazines has licensed its brand in China for apparel, pens and other high end goods and directly competes with big fashion labels like Giorgio Armani [ii].
Lesser-known brands have also taken the opportunity to re-position or revitalize themselves in this market.
"Anyone can be a (...) brand in China if they market the right image - there's no difference: it's a big hot spot and the brands all pile in. They can't expect the consumers to be educated." [iii]

When entering the Chinese market, brands can expect to find familiar competitors, as well as surprising new

ones. It is therefore important to re-evaluate the distinctiveness of its brand promise as it relates to the Chinese competitive landscape; to enhance differences or to capture new opportunities.

2.3.4 Playing to a Tough Audience

Chinese consumers are spending, and will be spending even more in the future. **China's aspirational middle class is the target for most brands entering China. A 2003 study by Mastercard and Fudan Management School numbered that group at 60 million as of 2002, and said it is likely to grow to 160 million by 2010**.

However, as these consumers are still developing their tastes and sophistication, the motivations behind their purchases are still superficial.

Whereas people in the West are buying more discreetly branded luxury goods identifiable only by those 'in the know', the Chinese favor prominent logos that shout, "Look, I'm rich", says Claire Kent, an analyst at Morgan Stanley.

Not a brand-loyal lot, **Chinese consumers are also fickle and trend conscious, seeking choice and constant excitement**. In the mobile phone industry, for instance, consumers in big cities like Shanghai sometimes replace their phones every three months—compared with the global average of about 18 months—forcing the major phone makers to pump out new models as quickly as they can. **Samsung offers an average of one new model per week in China**.

To create excitement and brand loyalty in China, brands need to have relevance and appeal. This comes from a strong understanding of what target consumers in China want, and also the ability to inspire them through brand messages, products and activities. Nike, for example, has stood out in introducing sports-related hip hop culture into China, while at the same time appealing to China's nationalistic pride and culture through made-for-China events and campaigns.

2.3.5 Rapid Change Cycles

The only constant in China seems to be change itself. Until recently, 80% of luxury spenders were male. However, this has changed, with new brands and services emerging to cater to the changing demographics, such as Evian Spa in Shanghai.

Trends, consumer profiles and behavior in China have to be reviewed in much shorter cycles to account for the rapid changes. **This in turn impacts how brands connect and communicate with their target audiences**.

In addition, this in turns affects brand responsiveness. Flexibility, sensitivity and intuition can help build a strong foundation for stronger brand relationships in the future.

2.3.6 Some advice for brands entering China

2.3.6.1 Beware of over-generalizations and over-expectations

It is tempting to believe forecasts that read, "If eight percent of the population eventually end up as luxury consumers, that's 100 million consumers"; almost equal to the entire population of Japan. That may be too simplistic, given the complex nature of the market and its consumers; a good understanding of the industry, consumers and market structure should be part of the planning for your brand in China.

2.3.6.2 Prepare and protect

Look to ensure that the appropriate signals and messages that you send out in China are distinctive, relevant and in the right language. These will help explain your brand quickly and effectively to your customers, giving them greater access to your brand and its promise. Concurrently, protecting your trademarks, local website address and tagline in both English and Mandarin is also advisable.

2.3.6.3 Review your brand strategy

The differences between the East and West are more than just culture. The competitive landscape, target segments and communications channels may all differ. As such, it may not be enough to look at adapting your current brand name and tagline to be successful in China; it's necessary to review the strategic implications of whom your brand plans to target, how it will engage them and what sort of promise would be relevant to them.

2.3.6.4 Tap local knowledge and experience

With the rapid and frequent cycles of change in the Chinese market, having local managers, consultants and research could increase brand responsiveness.

Entering the Chinese market is much more than a market entry strategy; it's a real brand building exercise. **Brand managers may need to re-evaluate key components of their brand strategy to face the needs of the market and stand up to competition**. This requires both time and investment; however, for those who endure, the right moves today will sustain success for tomorrow. "China is a proving ground for international companies," says Colin Giles, a senior vice president at Nokia in Beijing. "Only the strong will survive." (Time Asia, 9 May 2005)

Contributed by SPROUT
SPROUT is a brand development and extension consultancy.

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3 Geographical Areas

China's diversity is legendary in many aspects. In geographical terms, China is more a continent than a country, very much like Europe or India.
Dialects, customs, food, habits, attitudes all vary considerably, in ways that are actually not so unfamiliar to the Swiss and their local particularities.

Yet, differences in China are magnified by the low education levels and the lack of exposure to the rest of the world (or even to Chinese metropolises) that characterizes rural inhabitants. From the cities of the Coast promising many opportunities to the barren Tibetan high plateau, Taklamakan desert and Mongolian steppes, the very uneven degree of economic development affects mentalities to the points that cousins living in different areas find that they have very little to talk about when they meet at Chinese New Year time for the traditional family reunions.

To provide an idea of this variety, a very general description of various regions and their economic figures are provided as well as key elements based on opinions of the respondents of the Swiss China Survey in different regions.

3.1 Survey results breakdown in key regions

There are practically no Swiss companies in Chinese provinces away from the coast. Besides, in most of the cases, it is not advisable (at least from SMEs) to combine the difficulties of China's general environment with the additional problems that one meets in areas of little economic development.
Such caution should even be exerted when venturing in 3rd or even 2nd tier cities in coastal regions. (Also see Chapter III, Preparing for China, ' Location Selection' for more details.)

In order to obtain a picture of trends, respondents to the survey have been grouped in 4 regions for which a reasonable number of answers is available:

- Beijing 26 respondents
- Shandong & Jiangsu 13 respondents
- Shanghai 53 respondents
- Guangdong & Jiangxi 10 respondents

These regions, however, cover well the reasonable alternatives for the set-up of a new operation in China.

This breakdown provides an insight into the 3 main economic areas (North, East and South) and 2nd tier cities of the Shandong and Jiangsu provinces.

3.2 Costs trends

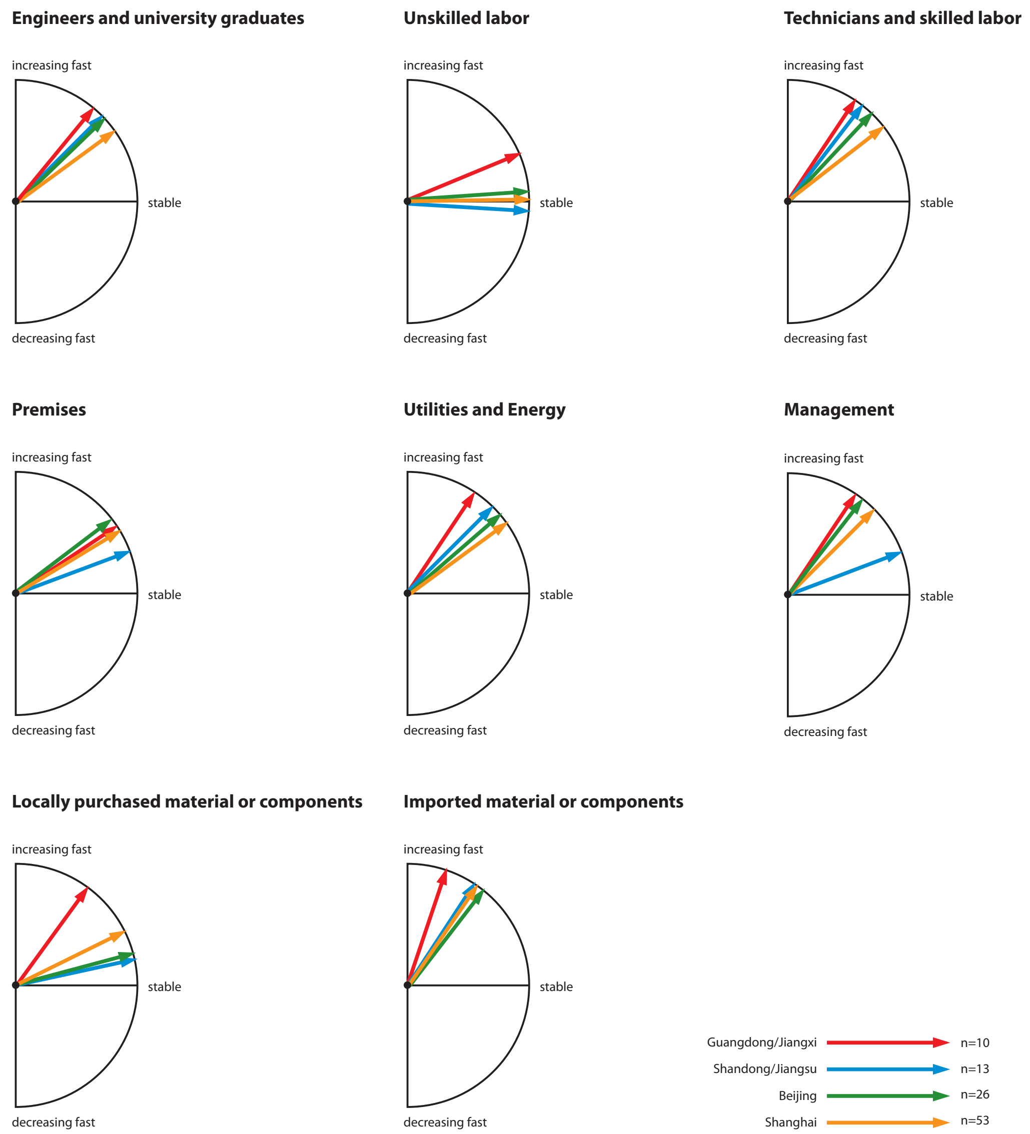
Costs are the main reason for foreign companies to consider less developed areas, when they are not influenced by the location of a stakeholder (major client or potential partner).

Below are the trends on 8 main cost groups, as subjectively answered by the respondents to the survey.

Survey chart I - 3

In your industry and field of activity how do you expect following costs to evolve?

N=111 (All companies in China)
9 no answers



Source: Swiss China Survey chart, 2005

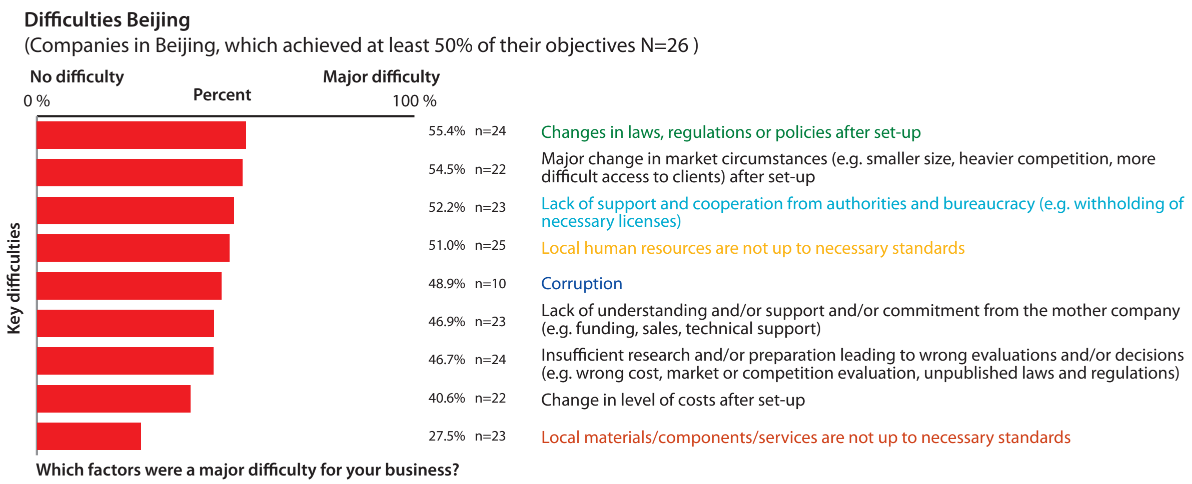
While it is difficult to differentiate between the eastern and northern regions, the South is clearly in the lead in terms of cost increases.

(Also see Chapter IX Human Resources Selection and Management, for a more detailed analysis of the HR costs trends in the regions as well as the ' Trends' section below for analysis of costs other than HR related. Also see Chapter V, Market Types and Logistics for a breakdown of costs by industries.)

3.3 Different difficulties met across the regions

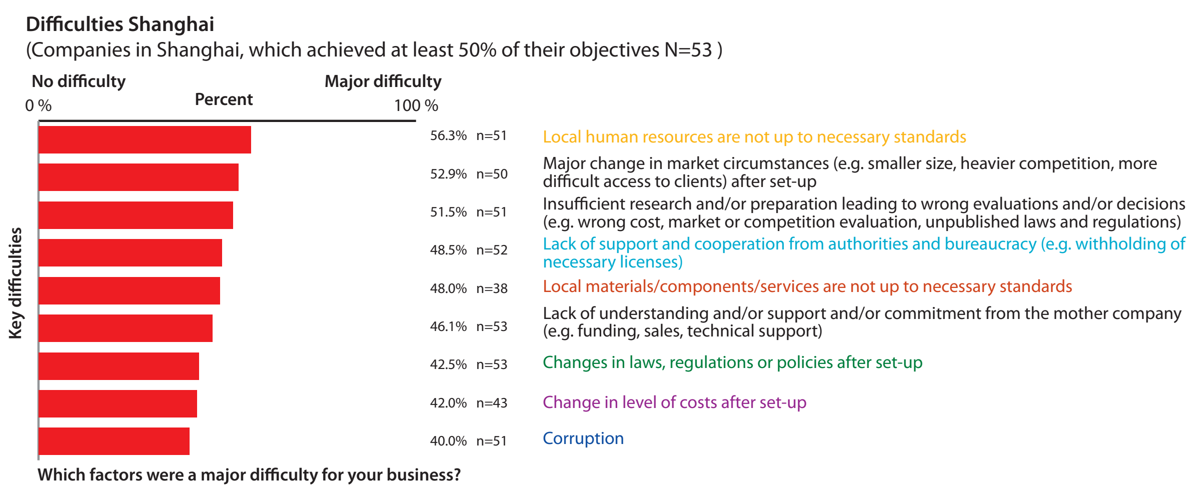
Analysis of the rating of difficulties given by respondents from specific regions shows that companies in different areas cope with very different sets of problems. The four charts below illustrates best the considerable variations of business environment that managers face in China.

Survey chart I - 4



Source: Swiss China Survey chart, 2005

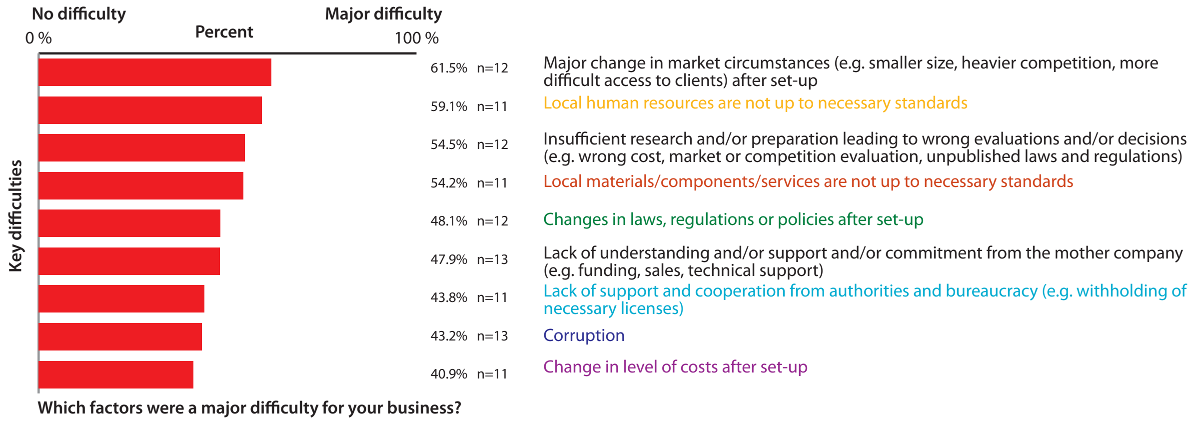
Survey chart I - 5



Source: Swiss China Survey chart, 2005

Survey chart I - 6

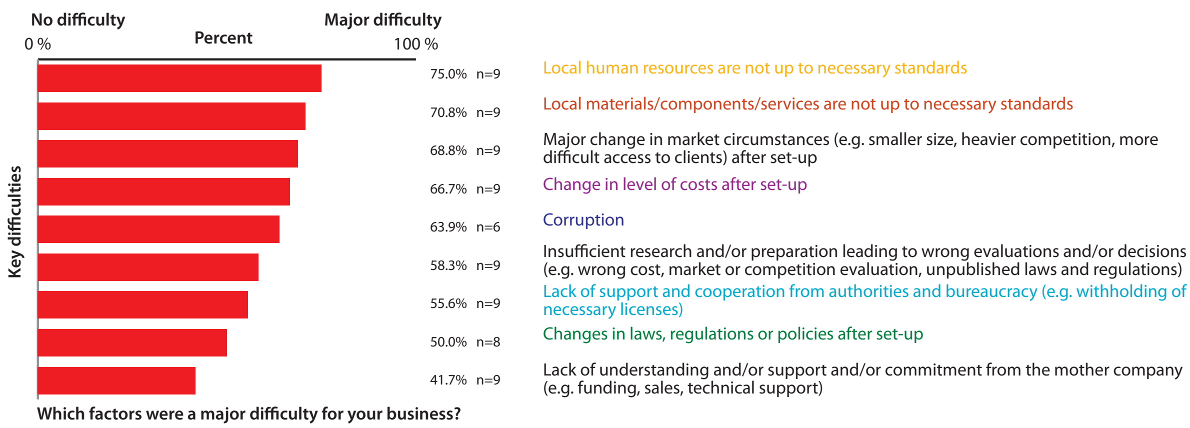
Difficulties Shandong / Jiangsu
(Companies in Shandong / Jiangsu, which achieved at least 50% of their objectives N=13)



Source: Swiss China Survey chart, 2005

Survey chart I - 7

Difficulties Guangdong / Jiangxi
(Companies in Guangdong / Jiangxi, which achieved at least 50% of their objectives N=10)



Source: Swiss China Survey chart, 2005

One issue, only, is consistently rated in a similar position in the four regions, '**major change in market circumstances [...]**', indicating that unexpected market disruptions are the only problems of common importance facing all managers. (Even **'local human resources are not up to standard'** is rated in 4th position in Beijing while it is in 1st or 2nd position in the other three regions.)

The only two regions that present a similar pattern are Shanghai and the Jiangsu/Shandong regions. Difficulties are rated in a reasonably similar order, while the level of difficulty is generally rated slightly higher in Jiangsu/Shandong than in Shanghai. (This is consistent with the next sections findings, showing that slightly more efforts are needed in Jiangsu/Shandong to achieve objectives than in Shanghai.)

The only differences between these two eastern regions are:

- **'changes in laws, regulations or policies after setup'**: this element comes in 7th (out of 9) position in Shanghai, whereas it is in 5th (middle) position in Jiangsu/Shandong
- **'lack of support from authorities and bureaucracy'** comes 4th in Shanghai but 7th in Jiangsu/Shandong

(the two elements being of a same nature, taken together, they actually tend to make the legal environment equivalent in both regions.)

As for the other three regions, the North (Beijing) and the South (Guangdong/Jiangxi) could well be two different countries while the East (Shanghai, Jiangsu/Shandong) is somewhat in the middle, yet also showing major differences with the other two:

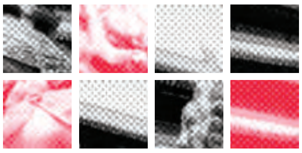
- The South and Beijing see '**changes in laws, regulations or policies after set-up**' at two extremes (Beijing considers it the No 1 difficulty and the South as the one but last).
- The same applies to '**local materials/components/services are not up to necessary standards**' (the South considers it the No 2 difficulty while Beijing sees it last)
- While the East and the South agree on '**local human resources are not up to necessary standards**' as the top issue, Beijing differs and sees it in 4th position.
- Similarly '**change in level of costs after setup**' is of no concern for the East and Beijing (last) while it is an issue in the South (4th position).

The perception of '**corruption**' is a subject of particular interest for many business people. There the East sees of last concern, while it comes in the middle in both Beijing and the South. as a , given the perceived as quite important in the North and the South (middle position), Shanghai sees it last.

'**lack of support and cooperation from authorities and bureaucracy […]'** is of low concern in the South and Jiangsu/Shandong (7th) but in 3rd and 4th position in Beijing and Shanghai respectively. (Big city governments tend to be less helpful.)

This (and the rating as top difficulty in Beijing of **'changes in laws, regulations or policies after set-up'**) presents the North as the most unattractive region in terms of rule of law for Swiss businesses.

The South, on the other hand, has a consistently higher rating of all difficulties, consistent with the higher degree of effort to achieve objectives that respondents from the South mention when compared with answers from Beijing or Shanghai.

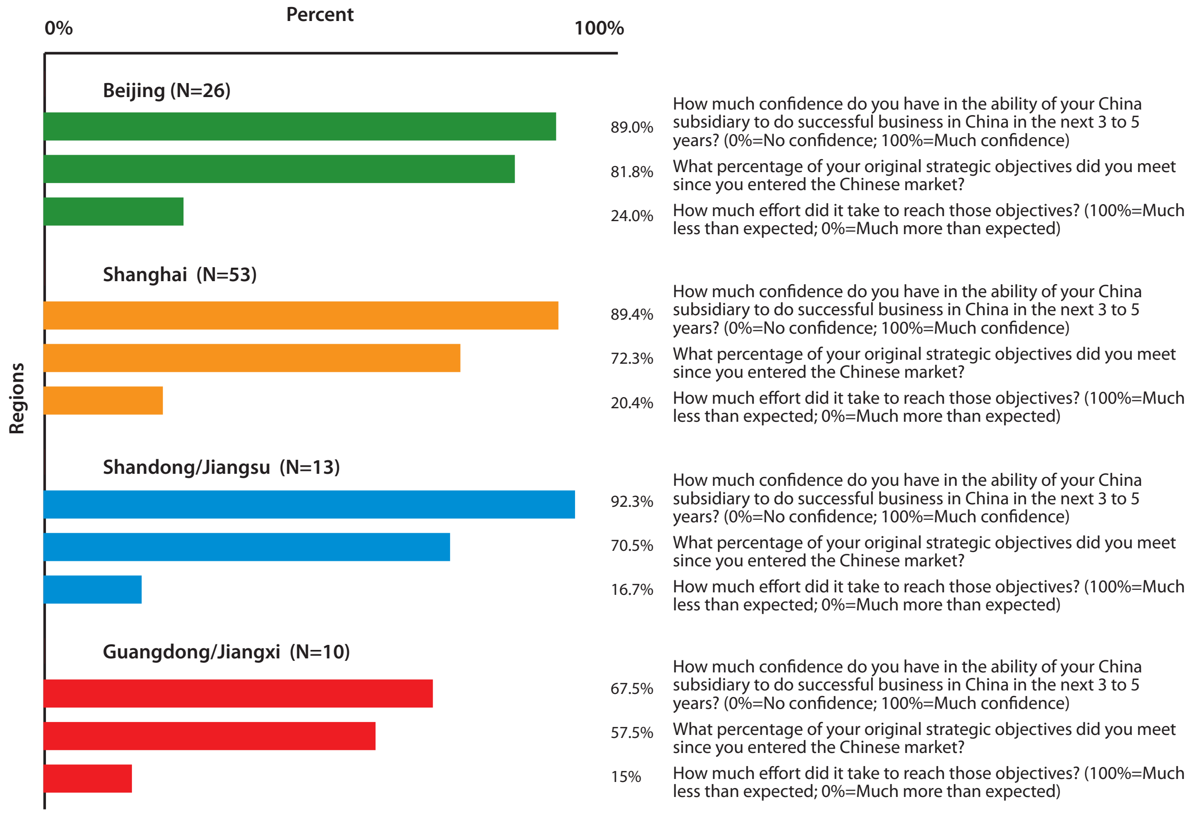


3.4 Level of success

To provide one more important insight, the questions that have been devised to evaluate the level of success of respondents to the survey are also broken down by regions below.

Survey chart I - 8

Level of success and effort by regions
(All companies in China) N=111
9 no answer



Source: Swiss China Survey chart, 2005

Again, the South (Guangdong/Jiangxi) presents a less favorable picture. The level of success is lower than the other regions (less objectives met and less confidence to operate successfully in the future) while at the same time indicating more difficulties to operate than in the other regions analyzed (more efforts than expected are reported, when compared to Shanghai, Beijing or Shandong/Jiangsu).

Shandong/Jiangsu seem to present a lower level of success, while also giving some more difficulties, while Beijing comes on top in terms of meeting objectives. Meanwhile, It is useful to keep in mind that the number of objectives reached is higher with time and that Swiss companies often started with subsidiaries in Beijing, than in Shanghai and later only in 2nd tier cities.

An important note of caution

It is important to emphasize, that the above is based on subjective and relative opinions of managers without extensive experience of each other's regions, so that it does not provide more than an indication on how these managers perceive their own environment.

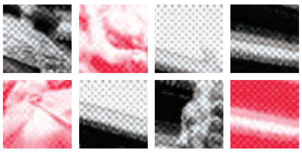
Besides, the number of answers from the South is small (10) and may happen not to represent the reality of the region. This could be the case if those respondents who participated in the survey are less successful than the average of Swiss companies in the South. Indeed successful managers may see less interest in spending time answering the questionnaire and getting results to improve their operation. This bias, however should then be a specific one to South China, as the same bias should apply to managers in other regions.

However, the bias could indeed be emphasized in the South if managers of successful companies are more local or Hong-Kong managers, who certainly feel less linked to the Swiss community and, therefore, feel less need to participate in such a survey.

3.5 Factors of success

The number of answers from South China and the Shandong/Jiangsu area do not allow for a reasonable rating of factors of success in these regions. It may be interesting, though, to compare the variations between the metropolises of Beijing and Shanghai, for which sufficient numbers are available.

The lists are provided below and speak for themselves:



Survey chart I - 9

Success factors Beijing

(All companies in Beijing, which achieved at least 50% of their objectives N=26)

How important are the following factors to be successful in China?

Source: Swiss China Survey chart, 2005

Survey chart I - 10

Success factors Shanghai
(All companies in Shanghai, which achieved at least 50% of their objectives N=53)

Source: Swiss China Survey chart, 2005

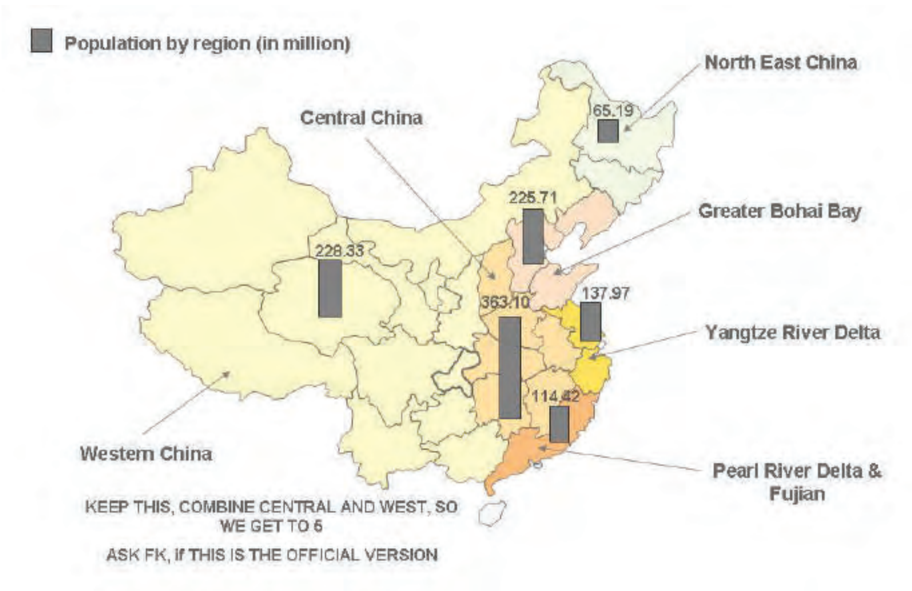
3.6 China's economic regions

by Franc Kaiser, Senior Consultant Fiducia Management Consultants

3.6.1 The six economic regions of China

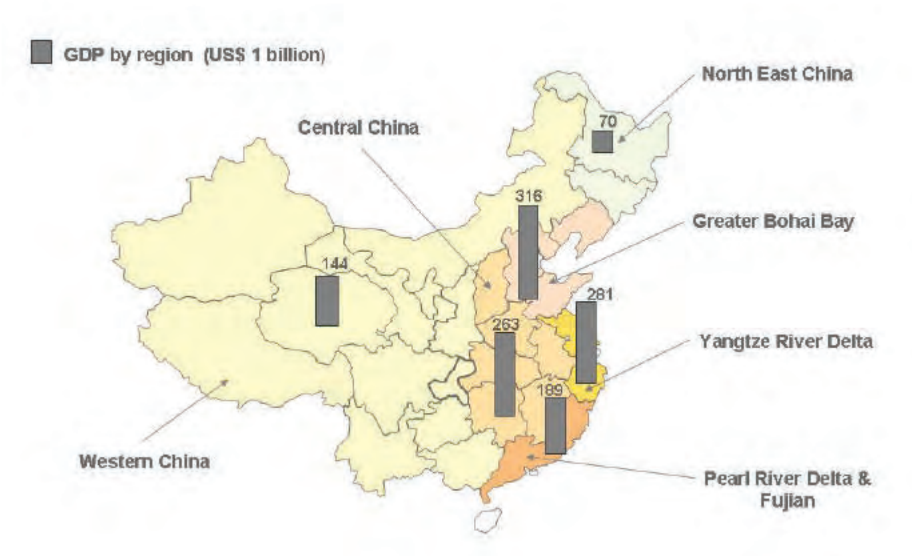
3.6.1.1 Population within the Regions

Fig I - 12



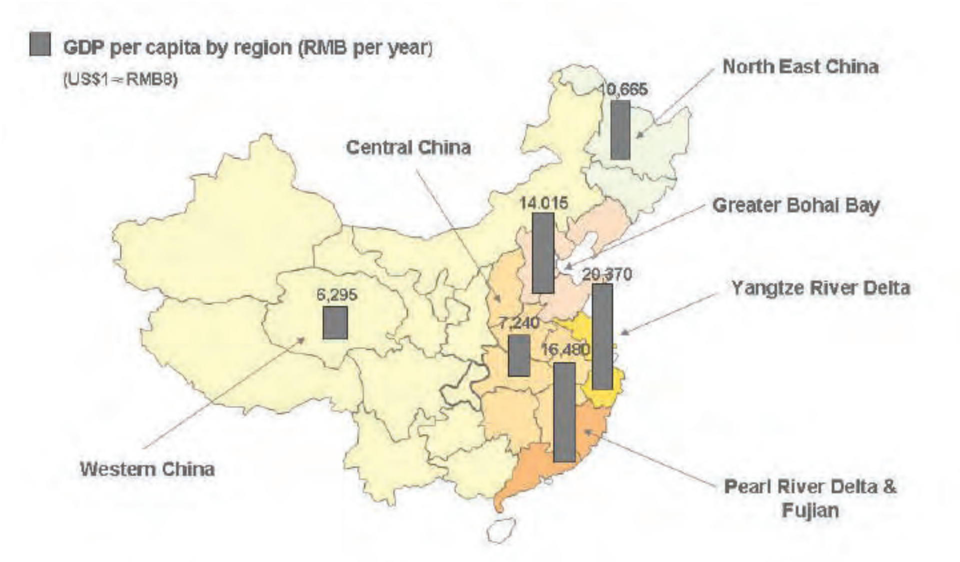
3.61.2 Gross Domestic Product According to Regions

Fig I - 13



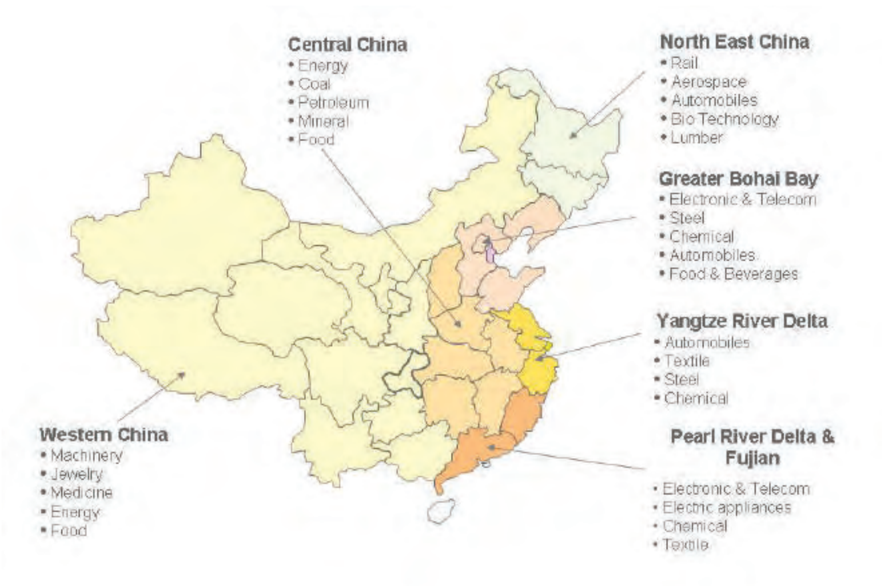
3.6.1.3 GDP per Capita According to Regions

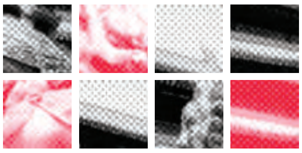
Fig I - 14



3.6.1.4 Leading Industries According to Regions

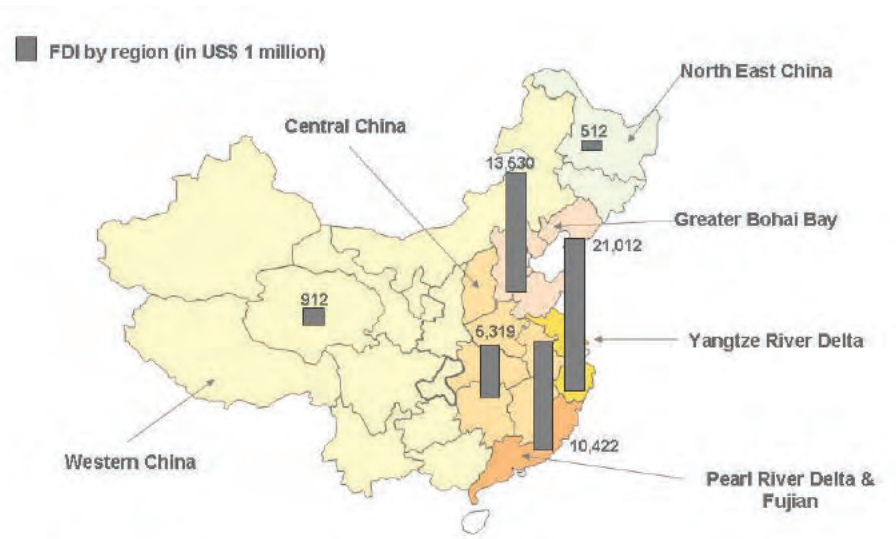
Fig I - 15





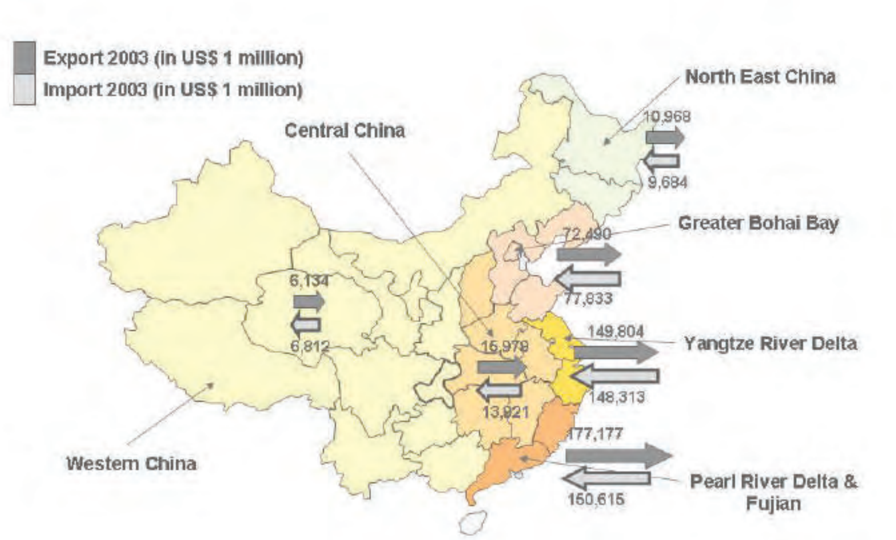
3.6.1.5 Foreign Direct Investment According to Regions

Fig I - 16



3.6.1.6 Import and Export According to Regions

Fig I - 17



3.6.2 Greater Bohai Bay Region

The Bohai Bay Region (BBR) is situated in the north east of China with an area of 521,000km^2 (6.3% of China's total area) and contributed 25.1% of China's GDP in 2003.

A definition of BBR Economic Zones can be found in the Chinese Statistics Press, 2001:

"Included are the provinces Beijing, Hebei, Liaoning, Tianjin and Shandong. The important cities within these provinces are Beijing, Shijiazhuang, Chengde, Shenyang, Dalian, Tianjin, Jinan, Qingdao and Yantai".

3.6.2.1 Economic Performance and Policy

Bohai Bay Region's economy leads the country in many aspects :

- The largest GDP among all regions, accounting for 25.1% of the national total
- The 2nd largest recipient of foreign direct investment, accounting for 26.2% of China's utilized FDI in 2003
- The 3rd largest exports value among all regions, accounting for 16.8% of the national total

Bohai Bay Region's current major economic policy focuses include:

- To further develop automotive and heavy industries
- To strengthen technological innovation
- To continue economic structural adjustment, including the development of modern logistic services and distribution
- To expand the share of the private sector economy

3.6.2.2 Industries

The Bohai Bay Region puts its focus on heavy industries such as automobile, steel, chemicals, machinery and other upstream industries, i.e. the production of raw materials, intermediate goods and capital goods including electronic parts. Furthermore, it concentrates on textiles and food, e.g. soda, salt, wines, beer, cotton yarn, cloth.

Beijing focuses on the high tech industry with its leading Haidian Digital Park. This park is China's incubator for high-tech companies and is seen as an equivalent to the Silicon Valley. Tianjin specializes more on iron, textile mills and food processing establishments. Shandong, Hebei and Liaoning mainly produce energy, chemicals, building materials and machinery.

3.6.2.3 Foreign Trade

The Bohai Bay Region is an important export base in China. In 2003, the region's exports continued to grow and reached US$72.5 billion. Major export items include machinery, electronic equipment and parts, textiles and light industrial products. Major export markets include the US, EU, Japan, Hong Kong, Russia and Korea.

Imports to the region rose to US$ 77.8 billion in 2003. As a manufacturing base, the top imports of the Bohai Bay Region include raw materials, chemical products, electrical equipment and parts and components. Major import sources include the EU, Japan, the US, Taiwan, Korea and Hong Kong.

3.6.2.4 Foreign Investment

The Bohai Bay Region is a major destination for foreign direct investment (FDI). The FDI inflow in 2003 reached US$13.5 billion, which is about 26.2% of China's total. So far, Hong Kong and Taiwan are the largest sources of FDI in the Bohai Bay Region, followed by Japan, Korea, the EU and the US. Most of the well known fortune 500 companies have invested in the region. The range of products includes cars, televisions, air-conditioners, refrigeration equipment and multimedia equipment.

There are about 40,000 foreign-invested companies in Beijing, Tianjin, Hebei, Shandong and Liaoning as of the end of 2003, with an accumulated investment of more than US$85 billion.

The utilization of foreign capital has had a far reaching impact on the economic development. It has enabled the agricultural sector to make increasing use of advanced technology. The industrial sector has benefited, particularly machine building, textiles and building materials. Last but not least, it has given birth to industries based on high technology, especially in the fields of mechatronic, information processing and bio-engineering.

3.6.3 Yangtze River Delta Region

The Yangtze River Delta (YRD) Region is situated in the central east of China with an area of 488,000km^2 (5.9% of China's total area), and contributed 22.3% of China's GDP in 2003.
A definition of YRD Economic Zones can be found in the Chinese Statistics Press, China's Yangtze River Economic Belt, 2001:

"Included are the cities of Shanghai; the Jiangsu Province with the cities of Nanjing, Zhenjiang, Yangzhou, Suzhou, Wuxi, Changzhou, Nantong, and Taizhou; and the Zhejiang Province with the cities of Hangzhou, Jianxing, Huzhou, Ningbo, Shaoxing, and Zhoushan".

3.6.3.1 Economic Performance and Policy

Yangtze River Delta Region's economy leads the country in the following aspects
:

- The 2nd largest GDP among all regions, accounting for 22,3% of the national total
- The largest recipient of foreign direct investment, accounting for 40.5% of China's utilized FDI in 2003
- The 2nd largest exports value among all regions, accounting for 34.8% of the national total

Yangtze River Delta Region's current major economic policy focuses include:

- To strengthen regional economic integration of YRD cities, mainly in six areas, including traffic network construction, unified markets, environmental protection, information sharing, financial cooperation and exchange of talent.
- To boost the regional logistics network by focusing on the overall layout of transport infrastructure, such as roads, sea-routes and ports.
- To develop the YRD Financial Zone, enabling the provision of integrated banking services and sharing of credit system information.

3.6.3.2 Industries

The YRD puts its focus on heavy industries such as machinery, chemicals and other upstream industries, i.e. the production of raw materials, intermediate goods and capital goods including electronic parts, textile and chemical fiber etc. For example, **Shanghai and Jiangsu together accounted for more than 55% of the national total output of integrated circuits**. Within the YRD region, while Jiangsu and Zhejiang are major producers of garments, textiles, chemical fibers, and machinery, Shanghai produces a relatively large share of chemicals, machinery and motor vehicles.

3.6.3.3 Foreign Trade

The YRD is one of the leading industrial bases as well as an important export base in China. In 2003, the YRD's exports continued to grow strongly and reached US$149.8 billion. Major export items include machinery, transportation equipment, electrical equipment and parts, garments, textiles and raw material products. Major export markets include the US, the EU, Japan, Hong Kong and Korea.

Imports of the YRD rose to US$148.3 billion in 2003. As a manufacturing base, top imports of the YRD include raw materials, chemical products, electrical equipment, and parts and components. Major import sources include the EU, Japan, the US, Taiwan, Korea and Hong Kong.

3.6.3.4 Foreign Investment

The YRD is a major destination for foreign direct investment and is becoming increasingly popular among foreign investors in recent years. FDI inflow rose constantly in 2003 to reach US$21billion, roughly 40% of China's total. So far, Hong Kong is the largest source of FDI in the YRD, followed by Taiwan, Japan, and the US.

There are about 85,000 foreign-invested companies in Shanghai, Zhejiang and Jiangsu as of the end of 2003, with accumulated investment of more than US$160 billion. Major foreign investors in the YRD include General Motors, Shell, Matsushita, Exxon, Siemens, Sony, Volvo, Alcatel, and LG, etc. Many of them have even set up their regional headquarters in the YRD, such as Siemens, AMD and General Electric. Among various cities in the YRD, foreign investment is concentrated in Shanghai and Suzhou, with a combined actual FDI accounting for 55% of the total. However, FDI inflow has been spreading more evenly from Shanghai and Suzhou to other YRD cities in the past few years.

Foreign investment in the YRD is mainly engaged in manufacturing activities, including the manufacture of computers, mechanical and electrical products, hardware and chemical products etc. However, foreign investment has increasingly been channeled into service industries in recent years. Given China's WTO commitment to further liberalize its services sector, an increasing share of FDI is expected to go into the services sector in the coming years.

3.6.4 Pearl River Delta Region

The well known Pearl River Delta (PRD) Region has always been quoted as "the World's Factory" due to the high concentration of foreign investment in the region.

The PRD Region is situated in Guangdong Province with an area of 178,000km^2 and Fujian Province with an area of 121,400km^2 (both accounting for 3.6% of China's area), and contributed 14.9% of China's GDP in 2003.

The official definition of the PRD Economic Zone was released by the Guangdong Provincial Government in 1994:

"Guangdong includes 14 economically important cities and counties (districts), including Guangzhou, Shenzhen, Zhuhai, Foshan, Jiangmen, Dongguan, Zhongshan, the urban district of Huizhou, Huiyang County, Huidong County, Boluo County, the urban district of Zhaoqing, Gaoyao, and Sihui. Fujian province contains Fuzhou, Xiamen, Anxi and Lianjiang".

3.6.4.1 Economic Performance and Policy

PRD's economy leads the country in many aspects:

- The 4th largest GDP among all regions, accounting for 14.9% of the national total
- The 3rd largest recipient of foreign direct investment, accounting for 20.2% of China's utilized FDI in 2003
- The largest exports value among all regions, accounting for 41% of the national total

PRD's current major economic policy focuses include:

- To further develop electronics and information technology industries
- To strengthen technological innovation
- To continue economic structural adjustments, including the development of modern logistic services and distribution
- To expand domestic demand and the share of private sector economy

3.6.4.2 Industries

The PRD's manufacturing industries have developed rapidly as a result of foreign investment. It is noteworthy that Guangdong and Fujian are major export-processing bases for foreign investors mainly from Hong Kong and Taiwan.

The PRD is strong in light industry. Output of light industries account for over half of the region's total industrial output. Major products include electrical appliances such as television sets, electrical fans and refrigerators, and other consumer products such as garments, bicycles, toys, shoes and electronics. The exports of most of these products rank highest in China.
In recent years, the PRD is moving towards new and high technology products. For example, electronics and telecommunications now account for over 20% of Guangdong and Fujian's industrial output value.

The PRD has a strong private sector. **Production by the private sector (non-state-owned and non-state-holding enterprises) accounted for 81% of the region's total industrial output. Many indigenous enterprises have also developed a strong brand name in their specialized areas and become market leaders in China**. These include Galanze, Midea, Macro, Donlim, Kangbao, Gree, Sunten and Huawei.

3.6.4.3 Foreign Trade

The PRD has the largest amount of imports and exports in China. Major export items included machinery and electric products, electrical appliances, electronics, textiles, garments, toys, plastic articles and shoes. Major export markets include Hong Kong, the US, the EU and Japan. Exports grew by an average of 12.2% for the period 1996-2003 and accounted for US$177.17 billion in 2003. Imports on the other hand grew by 12.5% over the period 1996-2003, accounting for US$150.61 billion in 2003. As a manufacturing base, major imports included raw materials, parts & components, electronics, machinery, and complete sets of equipments. Major import sources are Taiwan, Japan, ASEAN, the US and the EU.

3.6.4.4 Foreign Investment

The PRD ranked among the top three regions in attracting foreign direct investment (FDI). In 2003, the PRD attracted a total of US$10.42 billion, which accounted for 20.2% of China's total utilized FDI. Foreign investments in Guangdong are mainly engaged in manufacturing industries (68% of utilized FDI between 1979 and 2003) including mechanical and electrical products, computer accessories, computers, biological products, refined chemicals, hardware and traditional industries such as toys and garments. Foreign-invested enterprises (FIEs) are playing an important role in the PRD economy. FIEs now account for 63% of the PRDs gross industrial output and 59% of exports.

3.6.5 North-East China

North-east China covers an area of 656,000km^2 which accounts for 7.9% of China's total land area. Within this region live 65 million people. North-East China contributed 5.5% of China's GDP in 2003.

Provinces:
Heilongjiang
Jilin
* North-East China usually also includes Liaoning Province, but since this province is part of the Bohai Bay Region, it has not been included in this region

3.6.5.1 Economic Performance and Policy

North-East China's economic performance:

- The 6th largest GDP among all regions, accounting for 5.5% of the national total
- The 6rd largest recipient of FDI, accounting for 1% of China's utilized FDI in 2003
- The 6th largest exports value among all regions, accounting for 1.4% of the national total

North-East China's current major economic policy focuses include:

- Future development in petrochemicals, cars and spare parts, electronics, food stuffs and pharmaceuticals
- Strengthening technological innovation
- To continue economic structural adjustments, including the development of modern logistic services and distribution

3.6.5.2 Industries

The main industries in Heilongjiang are located in the cities Daqing, Harbin and Qiqihar. Within Jilin the economically important cities are Jilin and Changchun. Key industries include automotive, oil extraction, timber, petroleum, manufacturing of airplanes, railway wagons, large mechanical equipment and machine tools. **The electronics, cars and animal feed industries have become the region's pillar industries, along with heavy industry, timber and mining**.

3.6.5.3 Foreign Trade

North-East China is among the leading export bases for cement, cars, textiles, clothing, electronic parts, soybeans and footwear. In 2003, North-East China's exports continued to grow and reached US$6.1 billion. In terms of imports, North-East China reached US$6.8 billion in 2003. Major import goods were petrochemicals, machinery, and light industrial and textile products. Major trading partners include Russia, Germany, Taiwan, Japan, Hong Kong and Korea.

3.6.5.4 Foreign Investment

North-East China attracted US$0.51 billion of FDI in 2003. FDI inflow has risen constantly since 1995, but only accounts for 1% of China's total. So far, Hong Kong, Korea, Taiwan and the UK are the largest source of FDI. Harbin, Qiqihar and Mudanjiang, Jilin and Chungchun have attracted the bulk of this investment. To accelerate the growth of the region, the State Council has granted further tax incentives to foreign invested companies.

3.6.6 Central China

Central China covers an area of 1,028,000km^2 which accounts for 12.5% of China's total land area. Within this region live 363 million people. Central China contributed 20.8% of China's GDP in 2003.

Provinces:
Shanxi
Henan
Anhui
Hubei
Hunan
Jiangxi

3.6.6.1 Economic Performance and Policy

Central China's economic situation:

- The 3rd largest GDP among all regions, accounting for 20.8% of the national total
- The 4th largest recipient of foreign direct investment, accounting for 10.3% of China's utilized FDI in 2003
- The 4th largest exports value among all regions, accounting for 3.7% of the national total

Central China's current major economic policy focuses include:

- Further developing the agricultural and food processing industries, as well as the production of raw materials and the energy sector
- Enhancing the overall quality of industrial enterprises through technological innovation and transformation of management systems whilst striving to develop the electronics and information industries

3.6.6.2 Industries

The key provinces with the highest share of GDP contribution in Central China are Henan, Hubei and Hunan. Especially these 3 provinces have well-developed industries in coal, electricity, petroleum, metallurgy, chemicals, machinery, textiles and food. Hubei furthermore has a strong focus in the automobile industry which is the 4th biggest in China.

3.6.6.3 Foreign Trade

Central China is an export base for agricultural goods, processed foodstuffs, coal, cars, textiles, clothing, machinery and iron alloy. In 2003, Central China's exports continued to grow and reached US$15.9 billion. In terms of imports, Central China reached US$13.9 billion in 2003. Major import goods were electric parts, chemicals, timber, steel &iron, petrochemicals, machinery, light industrial and textile products. Major trading partners include Hong Kong, Russia, EU, Japan, US, Malaysia and Korea.

3.6.6.4 Foreign Investment

Central China attracted US$5.32 billion of FDI in 2003. But even though Central China is the 2nd largest of all regions, it only received 10.3% of China's total FDI inflow in 2003. Hong Kong is the biggest investor in Central China, followed by Korea, Japan, US, Taiwan and EU. **Investments were channeled into the sectors of agriculture, electronics, energy, medicine, telecommunication, chemicals, infrastructure and real estate**.

3.6.7 Western China

Western China covers an area of 5,262,000km^2 which accounts for 63.7% of China's total area. Within this region live 228 million people. Western China contributed 11.4% of China's GDP in 2003.

Provinces:
Gansu
Guizhou
Qinghai
Shaanxi
Sichuan
Guangxi
Yunnan

Special autonomous regions

Inner Mongolia
Ningxia
Tibet
Xinjiang

Municipalities:

Chongqing

Western China's economic situation:

- The 5th largest GDP among all regions, accounting for 11,4% of the national total
- The 5th largest recipient of foreign direct investment, accounting for 1.8% of China's utilized FDI in 2003
- The 5th largest exports value among all regions, accounting for 2.3% of the national total

The average annual GDP rose as high as 10% between 2000 and 2004. During the last five years approx. USD10bn of FDI has been attracted to the region. Moreover, approx. 10,000 Chinese businesses from Eastern and coastal regions have invested in Western China. By today, many of the Fortune 500 companies have entered Western China, including

Toyota, Motorola, Shell, BP, Ford and General Motors.

Contributed by Fiducia Management Consultants
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3.6.8 The 'Go-West' Strategy

In order to decrease the regional disparities, the government has initiated the "Go West" campaign as part of the five year plan (2001-2005) to develop China's interior (the Central and Western regions), investing heavily in the construction of railways, highways, telecommunication facilities, and the establishment of new agricultural and industrial bases.

By investing in infrastructure and introducing favorable policies, China's Central Government hope to spur economic growth in the regions where 45% of the nation's population lives. **Western and Central China accounts for 80% of the country's total land area, but has lagged far behind its more prosperous eastern counterparts**.

Such favorable policies, however, do come with the drawback of poorly trained human resources, often unreliable services, partially substandard infrastructure and considerable logistics difficulties.

Smaller companies with an open choice of location may consider these elements carefully and leave the pioneering work to multinationals, Hong-Kong and Taiwan Chinese or coastal Chinese companies.

4 Switzerland in China

Based on the Swiss China Survey and the data from the Swiss Embassy in Beijing, this section provide the most detailed and comprehensive overview, as yet, of the Swiss presence in China. Particularly the geographical distribution of Swiss companies in China by industry and legal form is represented info-graphically.

4.1 Sino-Swiss business ties - Sino-Swiss investment and trade

by Beat Buergi, Counsellor and Managing Director of the Swiss Business Hub China in Beijing

The origins of Sino-Swiss business collaboration can be traced back to the Qing dynasty when Swiss trading houses bought Chinese tea, silk, porcelain and agricultural products, while their Chinese counterparts imported Swiss watches, machine tools and chemicals. In the 1920s and 1930s, Swiss entrepreneurs started to open factories in China, among others for the production of machinery and aluminium. The first manufacturing joint-venture in China was also established by a Swiss company in 1980.

Since the launch of the economic opening in 1978, more remarkable achievements have been made through the efforts of the Chinese and Swiss governments, as well as business communities of both countries. At the beginning of that period, initial investments concerned the elevator industry, the production of power generating equipment and a milk powder plant were made. Soon further projects followed reflecting an increasingly prominent involvement of Switzerland's chemical, pharmaceutical, machine and instruments industries. By the end of 2004 over 270 Swiss firms have set up more than 600 branches in China with total direct investments of over CHF 5 billion (around USD 3.99 billion) [1], which makes Switzerland one of the top 15 investors in the country.

In line with the rapid expansion of the PRC economy Swiss-Sino trade saw tremendous growth during the 1990s and reached new records when China joined the World Trade Organization in late 2001. In 2004, the bilateral trade volume between those two countries amounted to CHF 5.90 billion (around USD 4.7 billion), an increase of 21.1% on a year-on-year basis.

Trade between Switzerland and China reflects the respective strengths of the two countries' economies. Switzerland is a world leader in research and technology and home to many companies providing class-leading products in their field, whereas China's greatest strength has been its processing industry. Following this pattern, Swiss exports to China are dominated by machinery, machine tools and precision instruments (over 2/3 of total exports), meanwhile more than half of Chinese exports to Switzerland are textiles, shoes, toys and other consumer goods. Due to China's entry into WTO and the subsequent opening of her markets, the rapid progress of China's industrial production in size and sophistication as well as the demands of a growing middle class, trade between Switzerland and China will become ever more important and diversified. We will see more Chinese consumer and capital goods with recognizable brands and higher value arriving in Switzerland. Meanwhile, more and more Chinese companies and individuals will join the market for Swiss quality goods and services.

Fig I - 18

Year	Exports (CHF mio)	Variation%	Imports (CHF mio)	Variation%	Trade balance
1980	233.4	-	128.6	-	104.8
1981	241.7	3.6%	153.7	19.5%	88.1
1982	263.3	8.9%	146.3	-4.8%	117.0
1983	262.6	-0.3%	157.4	7.6%	105.2
1984	291.0	10.8%	194.5	23.6%	96.6
1985	589.1	102.4%	218.0	12.1%	371.1
1986	738.3	25.3%	185.3	-15.0%	553.0
1987	613.6	-16.9%	238.7	28.8%	374.9
1988	596.7	-2.8%	297.6	24.7%	299.1
1989	629.9	5.6%	386.7	29.9%	243.2
1990	415.0	-34.1%	418.7	8.3%	-3.7
1991	471.3	13.6%	710.5	69.7%	-239
1992	620.3	31.6%	875.1	23.2%	-254.8
1993	942.6	52.0%	1083.6	23.8%	-141.0
1994	863.3	-8.4%	1144.4	5.6%	-281.1
1995	843.3	-2.3%	1075.3	-6.0%	-232.0
1996	887.7	5.3%	1204.1	12.0%	-316.4
1997	937.8	5.6%	1562.2	29.7%	-624.4
1998	809.1	-13.7%	1682.4	7.7%	-873.3
1999	990.0	22.4%	1800.0	7.0%	-810.0
2000	1402.7	41.7%	2300.5	27.8%	-897.8
2001	1668.2	19.8%	2257.7	-1.9%	-589.5
2002	2046.5	22.7%	2206.9	-2.3%	-160.4
2003	2460.0	20.2%	2413.9	9.4%	46.1
2004	3075.7	25.0%	2827.1	17.1%	248.6

Contributed by the Swiss Business Hub China
The SBH China in Beijing and Shanghai offers small and medium-sized Swiss and Liechtenstein enterprises specific services for strengthening and developing their business relations with China. The Hub also functions as a networking platform and helps fostering business relations between Swiss/Liechtenstein and Chinese companies.

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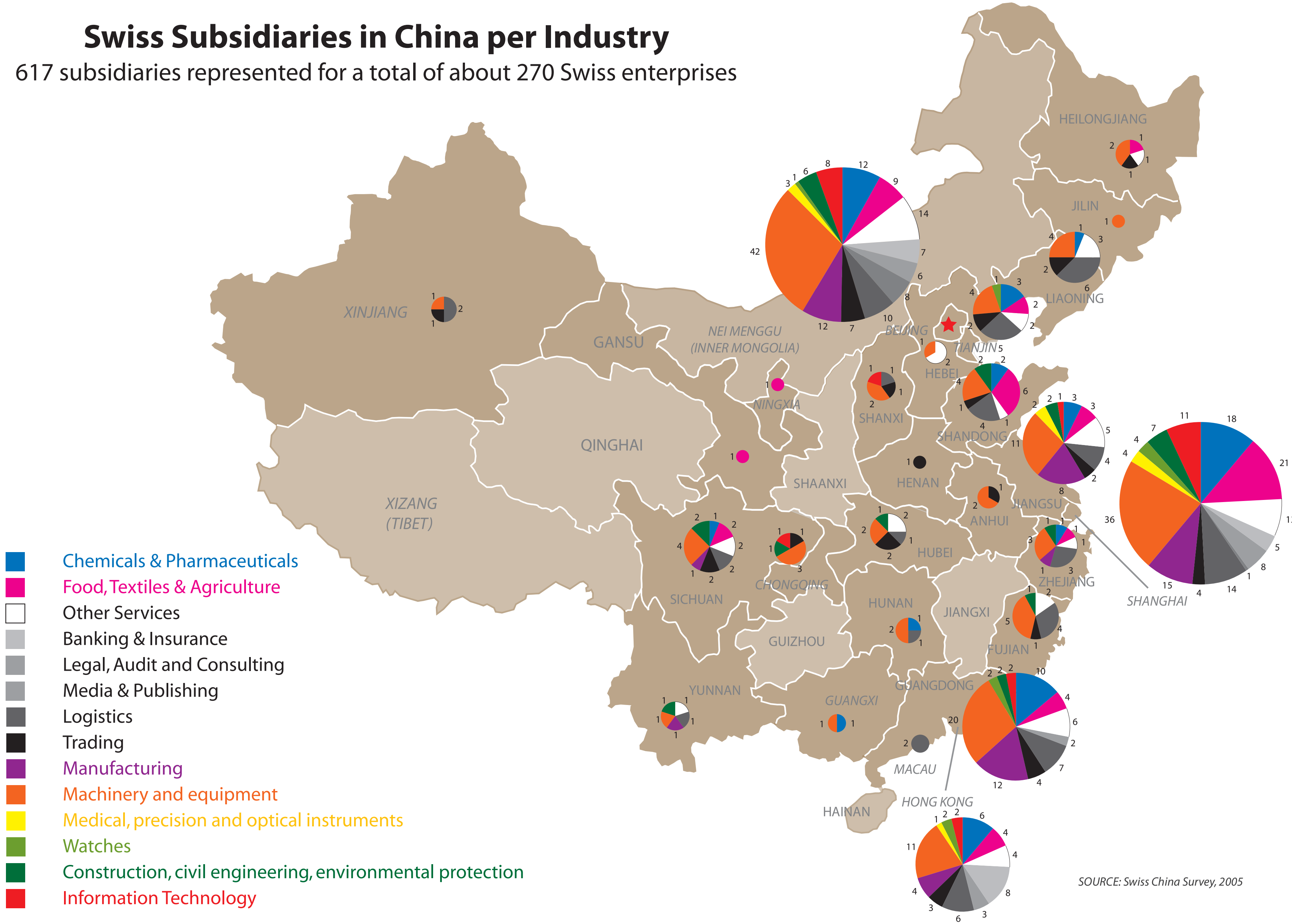
Notes

1 Exchange rate : 1 USD = 1.31 CHF, 26 December 2005

Fig I - 19

Swiss Subsidiaries in China per Industry

617 subsidiaries represented for a total of about 270 Swiss enterprises

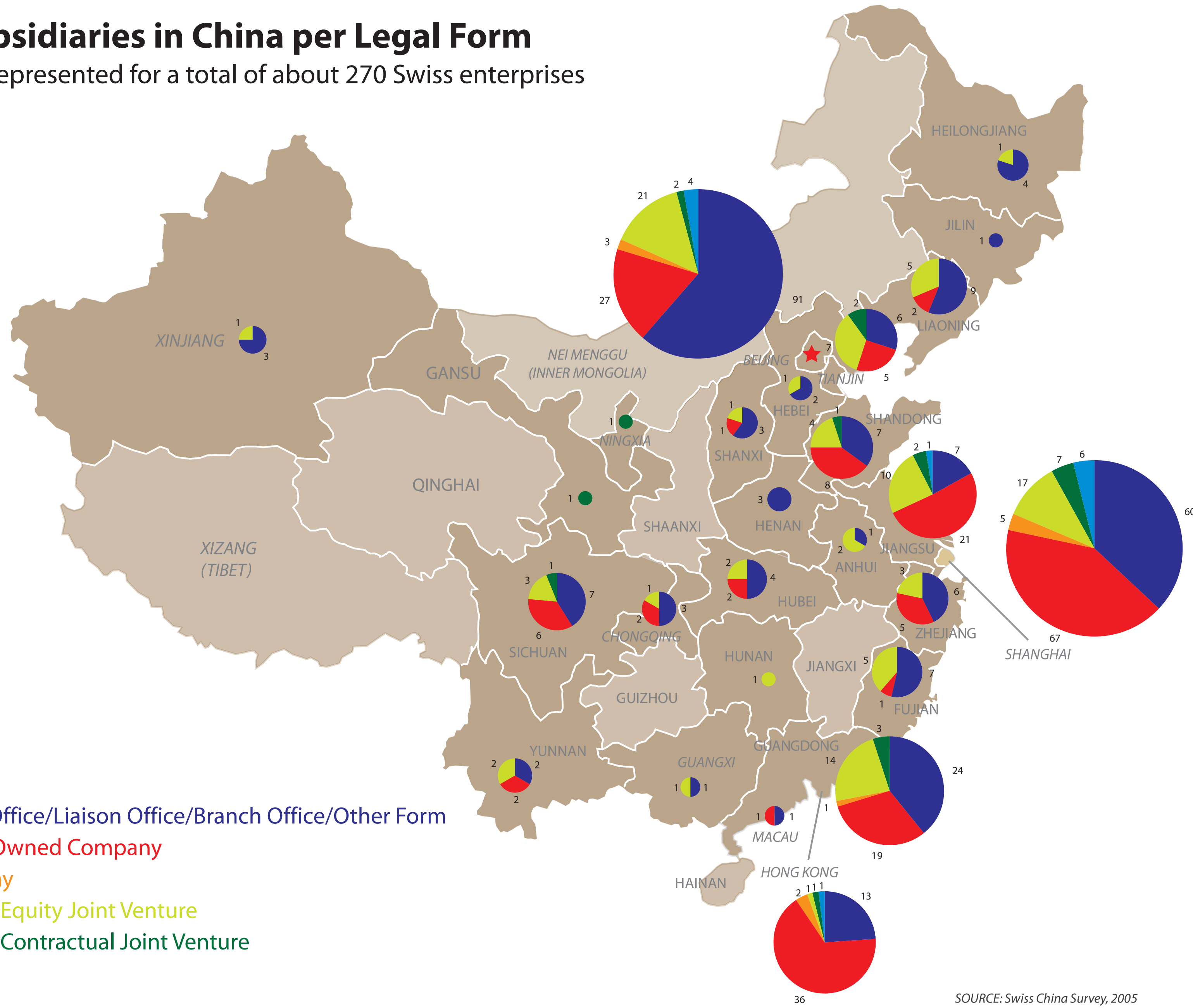


SOURCE: Swiss China Survey, 2005

Fig I - 20

Swiss Subsidiaries in China per Legal Form

617 subsidiaries represented for a total of about 270 Swiss enterprises



Representative Office/Liaison Office/Branch Office/Other Form

Wholly Foreign-Owned Company

Holding Company

Chinese-Foreign Equity Joint Venture

Chinese-Foreign Contractual Joint Venture

Others

SOURCE: Swiss China Survey, 2005

4.2 Surveyed companies characteristics

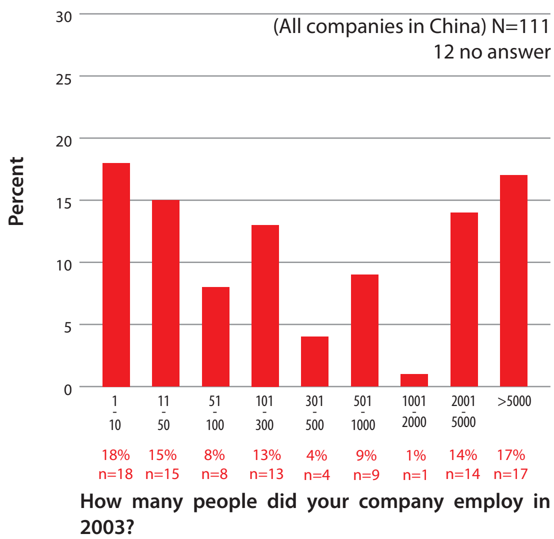
4.2.1 Companies demographics

Subsidiaries are rather big or rather small.

About one third have less than 50 employees and another third has more than 1000 employees. 54% employs less than 500 employees.

Survey chart I - 11

Swiss subsidiaries' sizes in China

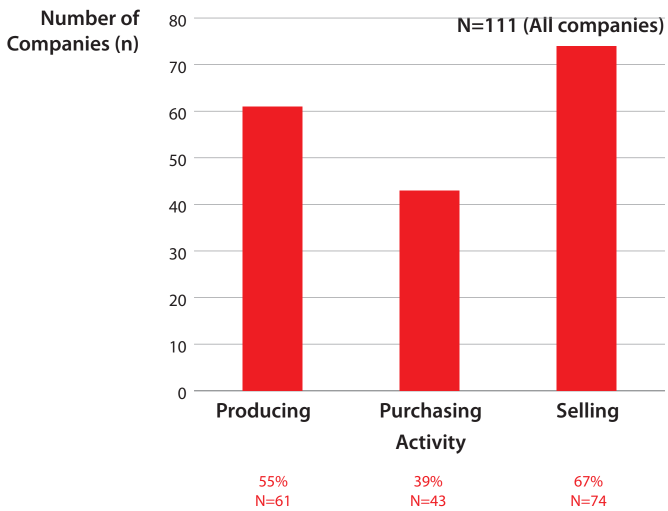


Source: Swiss China Survey, 2005

4.2.2 demographics of activities, clients

Overall, Swiss subsidiaries are focused on sales and production in China. There purchasing activity is the less represented. A few of the respondents have a pure purchasing activity and about 20% are functioning as production centers for the group, without sales responsibilities. Their product may still be sold in China via the group distribution, tough.

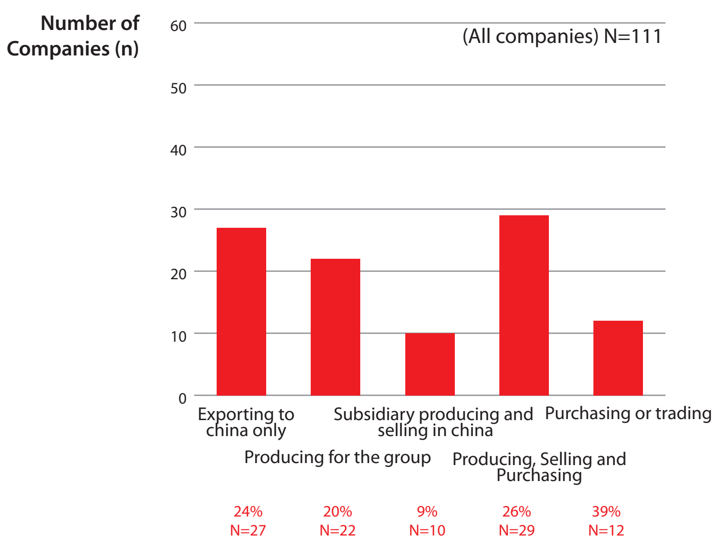
Survey chart I - 12



What is your reason to do business with China? (Mutiple selection possible)

Source: Swiss China Survey, 2005

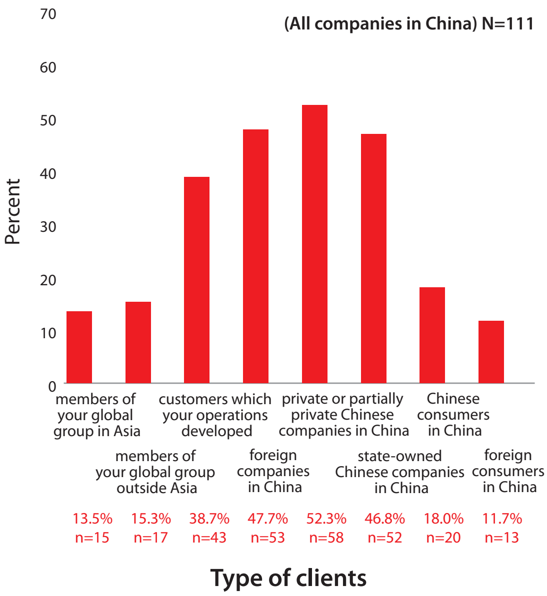
Survey chart I - 13



Mutually exclusive companies' activities profile (each company is in one category only)

Source: Swiss China Survey, 2005

Survey chart I - 14



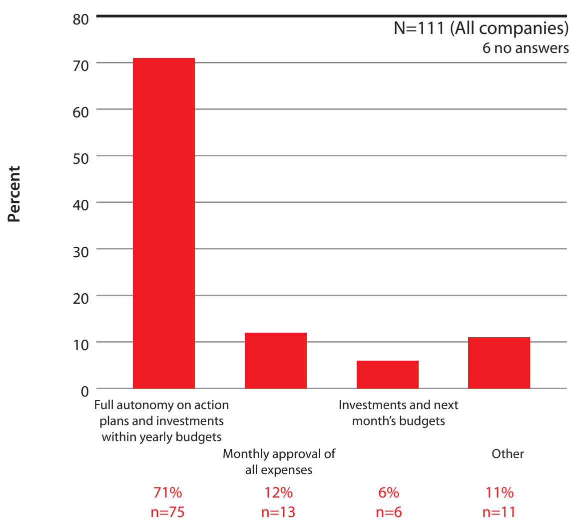
Source: Swiss China Survey, 2005

Swiss subsidiaries' customers are overwhelmingly new clients for the whole group. Indeed, only 12% of respondents states to sell for the group. Besides, two third of these clients are Chinese clients
This confirms that delocalization of production is a very minor reason for Swiss companies to be in China. On the contrary, Swiss enterprises obviously acquire new clients and markets in China.

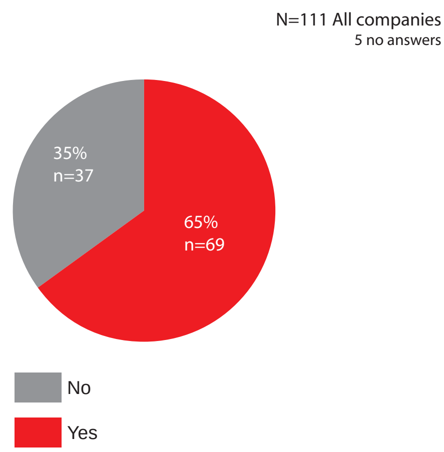
4.2.3 Management culture

Swiss subsidiaries are essentially organized as profit centers, largely autonomous from the mother company, lead by flat hierarchies.

Survey chart I - 15 and I - 16,



Source: Swiss China Survey, 2005



Does the Swiss headquarter consider the business under your responsibility as an independent profit center?

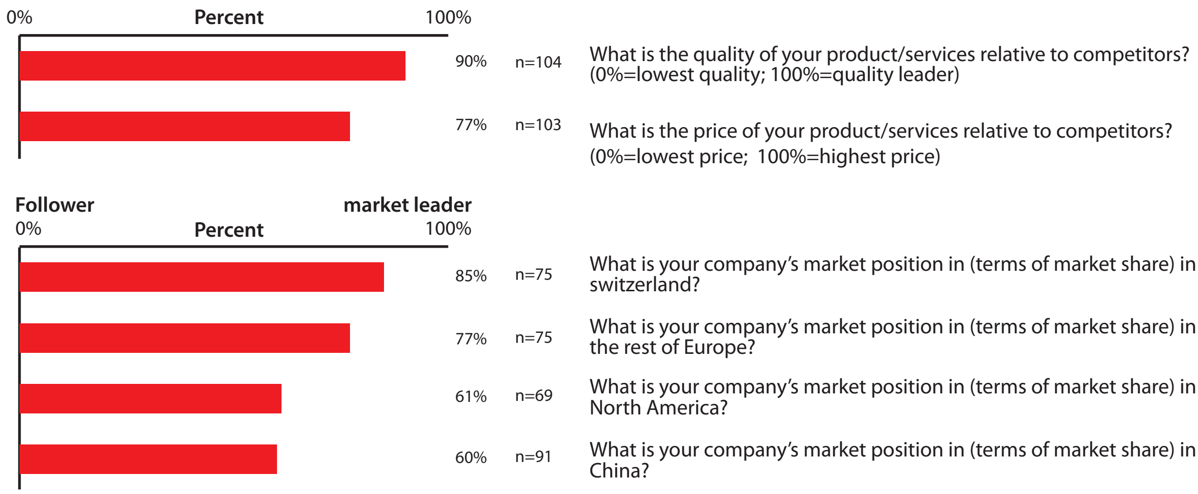
4.2.4 Market, price and quality leadership

Swiss companies are market and quality leaders, yet selling at less than highest prices.
In so doing they echo the philosophy of Sulzer, which maintains that clients want suppliers who can supply solutions to meet their whole needs, not only the top end, expensive market segment. (See case study in Chapter V, Market Types & Logistics, 'Machinery & Equipment'.)
Two third of Swiss subsidiaries in China are market leaders in Switzerland, half are in Europe and 30% in North America. 39% of these companies achieve market leadership in China.

Over 60% of subsidiaries are quality leaders, yet less than 40% charge the highest price for their goods.

Survey chart I - 17

Quality, market and price position of Swiss companies



Source: Swiss China Survey, 2005

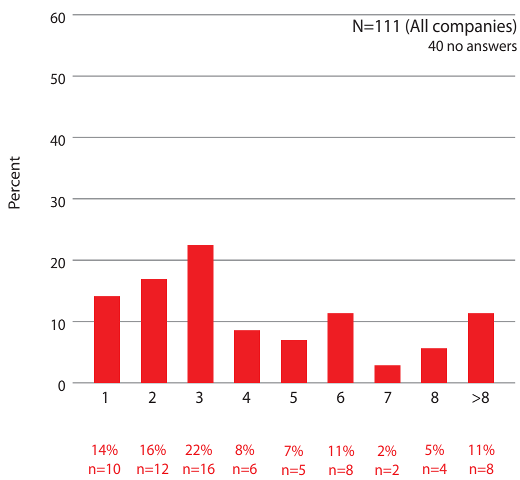
4.3 Financial returns

4.3.1 Year to payback

Over three quarters of respondents state to have paid back the amount of their investment with profits (91 out of 111 for this question).

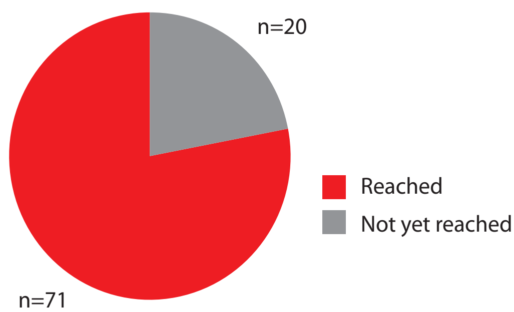
52% of respondents achieved or expect to achieve a payback of their investment in 3 years.
(71 companies out of 111 have chosen to answer the question.)

Survey chart I - 18 and I - 19



How many years will/did it take you to cover your intitial capital investment (Payback)?
(Payback = invested capital / average yearly net income)

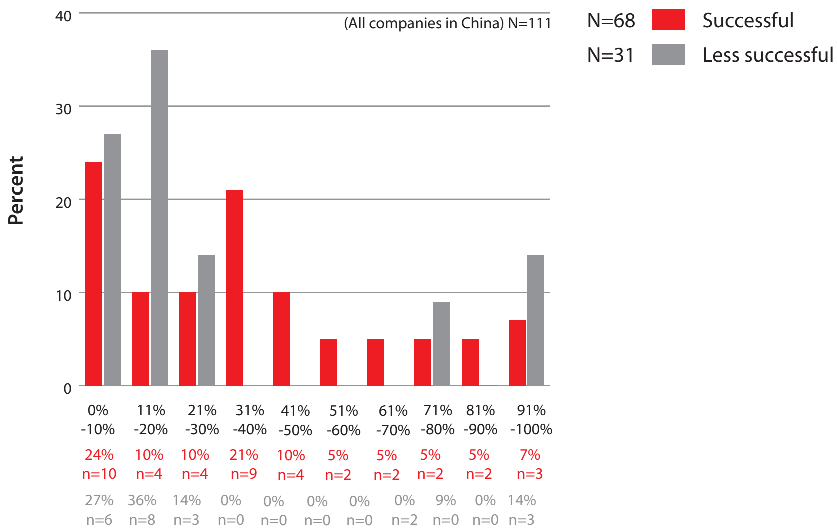
Did you cover your intitial capital investment (Payback)?
(All companies in China) N=111
20 no answers



Source: Swiss China Survey, 2005

4.3.2 Cash generation & added-value

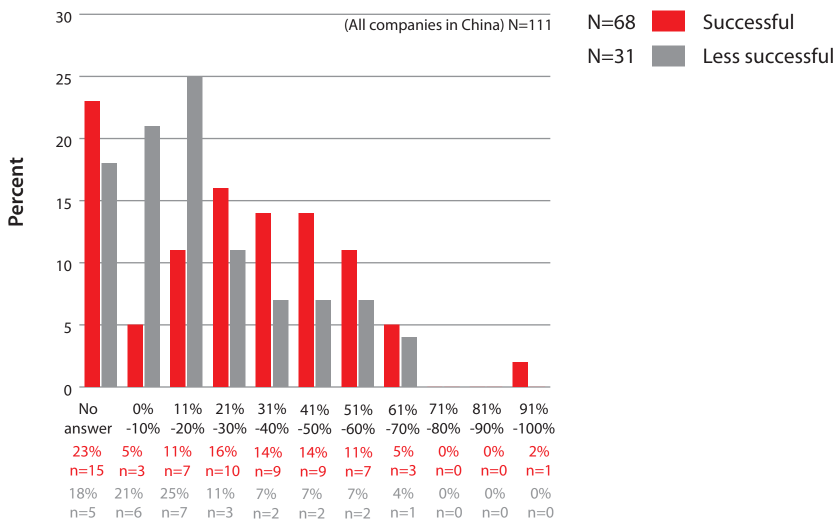
Survey chart I - 20



What is the average percentage of cash generation on turnover in 2003?

Source: Swiss China Survey, 2005

Survey chart I - 21



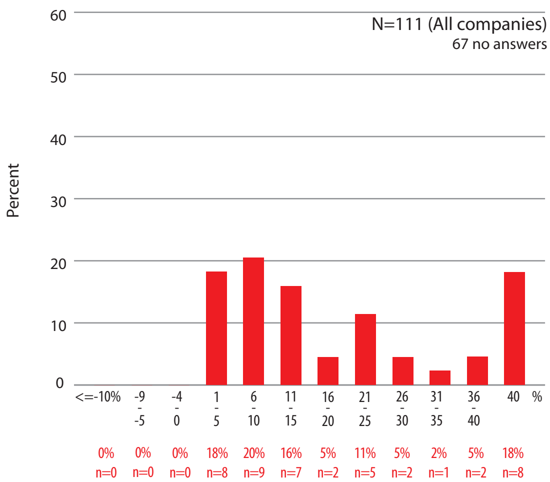
What is the average percentage of added value in your product / services in 2003?

Source: Swiss China Survey, 2005

Successful respondents, at least, state to have reasonably good margins and cash generation.

4.3.3 Expected return on investment for 2006

Survey chart I - 22



What ROI (return on total invested capital of your profit center) do you expect for the year 2006?

Source: Swiss China Survey, 2005

The 44 subsidiaries who answered the questions are rather positive: 40% of them expect 20% to 40% return on investment.

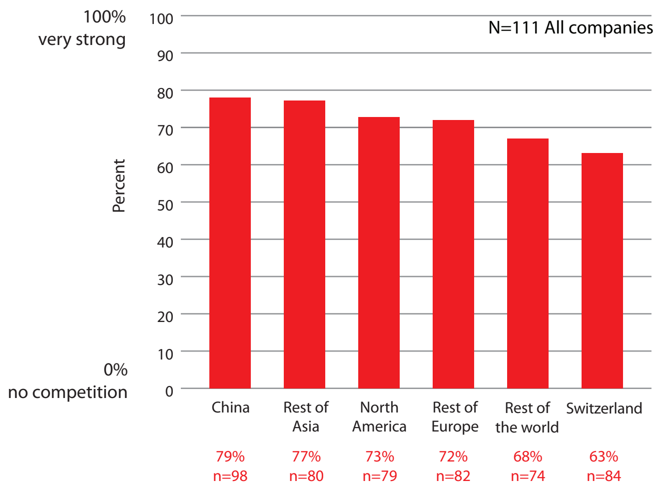
5 Trends, as seen by surveyed companies

The following charts illustrate trends for subsidiaries in China. Costs and financial returns are analyzed by industry in Chapter V, Market Types.

5.1 The world's most competitive and important region

China and Asia are the most competitive world markets ... Switzerland the least competitive, for managers of Swiss businesses in China.
The difference in the environment is felt particularly stronger for Swiss companies entering China without prior Asia experience.

Survey Chart I - 23

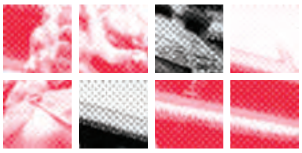


How strong is the competition in the following markets?

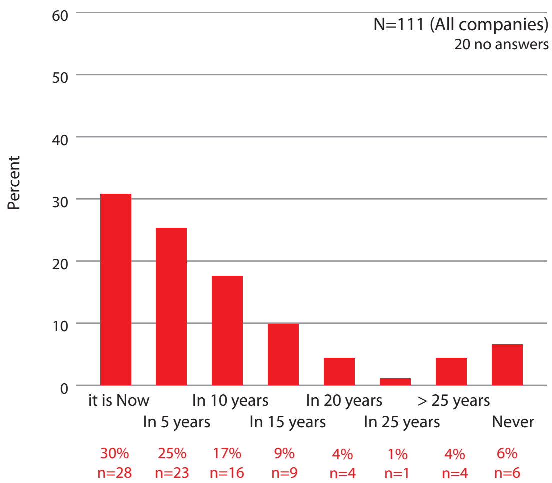
Source: Swiss China Survey, 2005

Over 55% of respondents to the survey in China expect their host country to be a more important economic region than the USA or the EU in the next 5 years.

Though this information is impressive and indicate a trend in the respondents' fields, it may not be valid for others.



Survey Chart I - 24



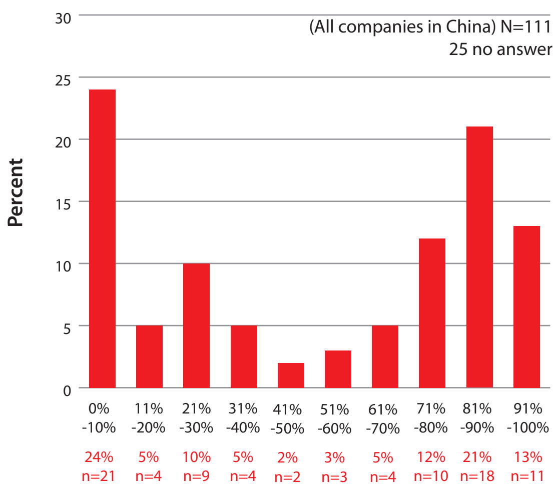
When do you expect China to be the most important economic region for your business in the world?

Source: Swiss China Survey, 2005

5.2 Localization of supply

Respondents state to achieve a good rate of local source in three years: 46% of Swiss subsidiaries will purchase 70% or more of their needs in China.

Survey chart I - 25



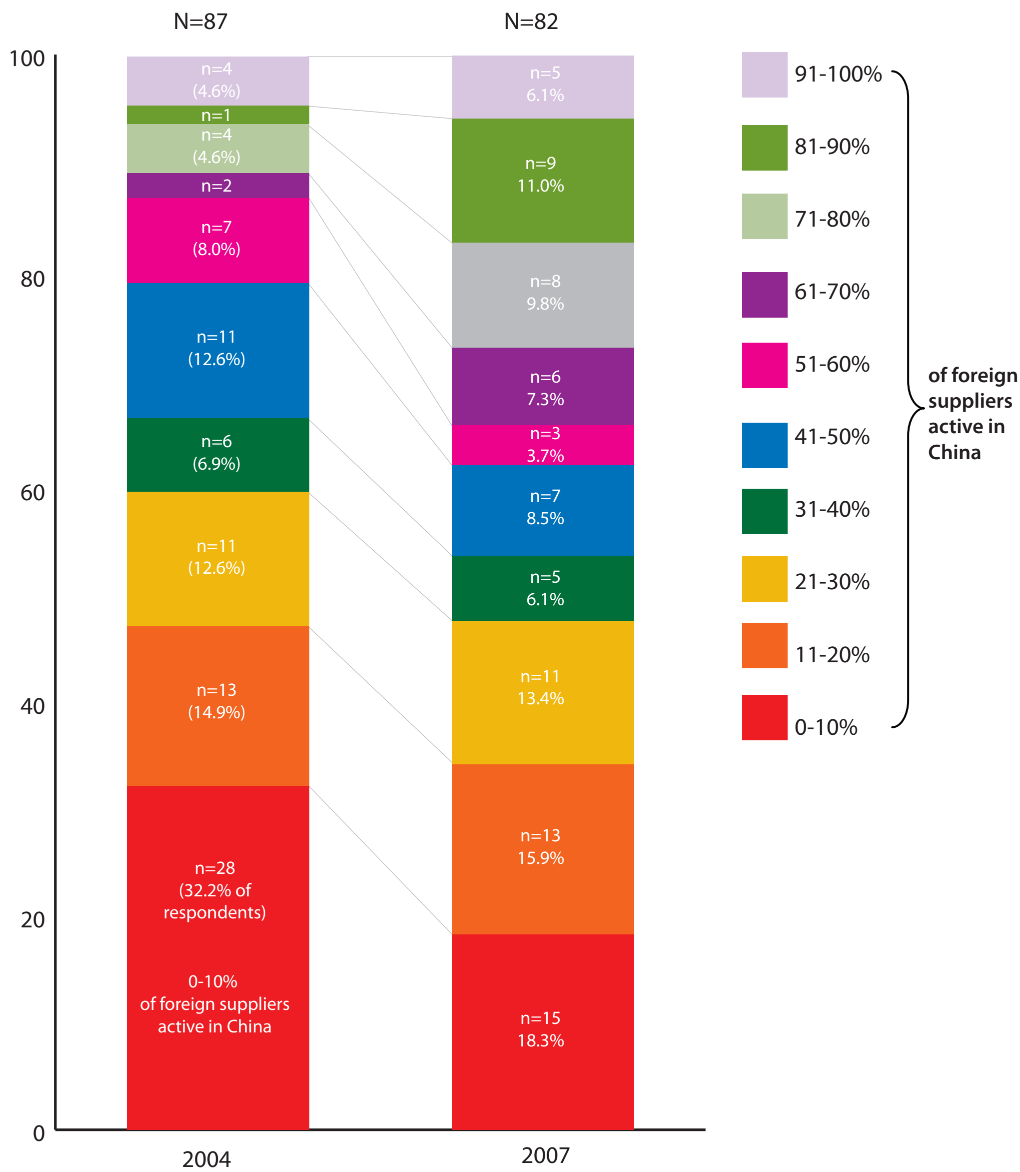
Percentage of local sourcing in 3 years

Source: Swiss China Survey, 2005

Foreign suppliers of Swiss subsidiaries are getting active in China, though not at a very fast pace. See chart below: About half of respondents expect about 30% of their foreign suppliers to be active in China in 2007. In 2004, half of respondents had 20% of their foreign suppliers active locally.

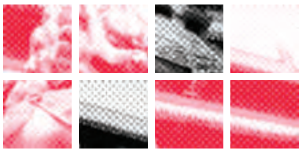
Survey chart I - 26

Localization of foreign supply



Which percentage of your foreign suppliers is active in China in 2004 and which percentage do you expect for 2007?

Source: Swiss China Survey, 2005



5.3 Costs

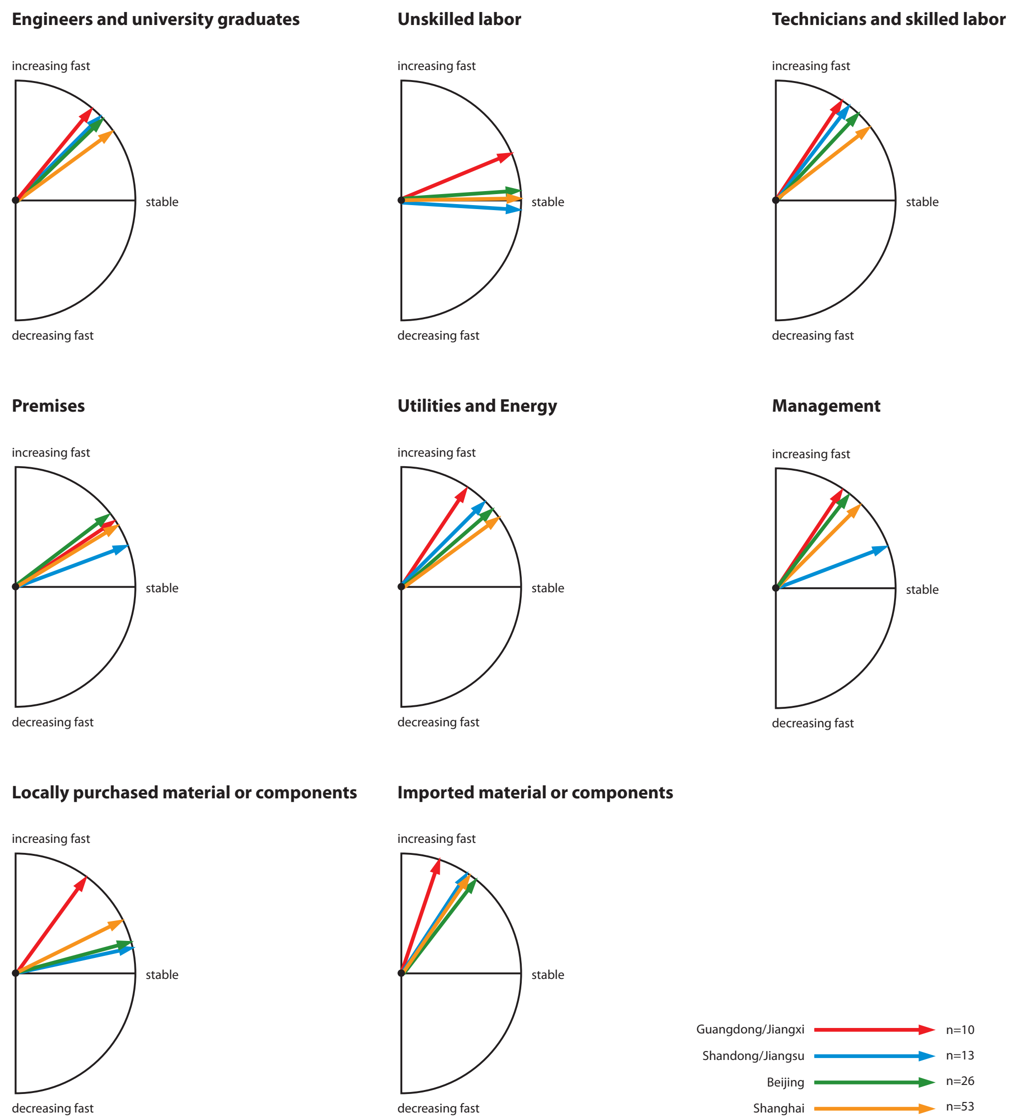
The 8 charts below provide the cost trends perceived by the N=111 surveyed managers of Swiss companies in China. Regions are identified through the different colors, costs per region are analyzed in the 'Geographical Areas' section above.
The comments on the evolution of human resources costs are made in Chapter IX, Human Resources Selection and Management, 'Human Resources costs trends'.

Cost trends are broken down by industry in Chapter V, Market Types & Logistics.

Survey chart I - 27

In your industry and field of activity how do you expect following costs to evolve?

N=111 (All companies in China)
9 no answers



Source: Swiss China Survey, 2005

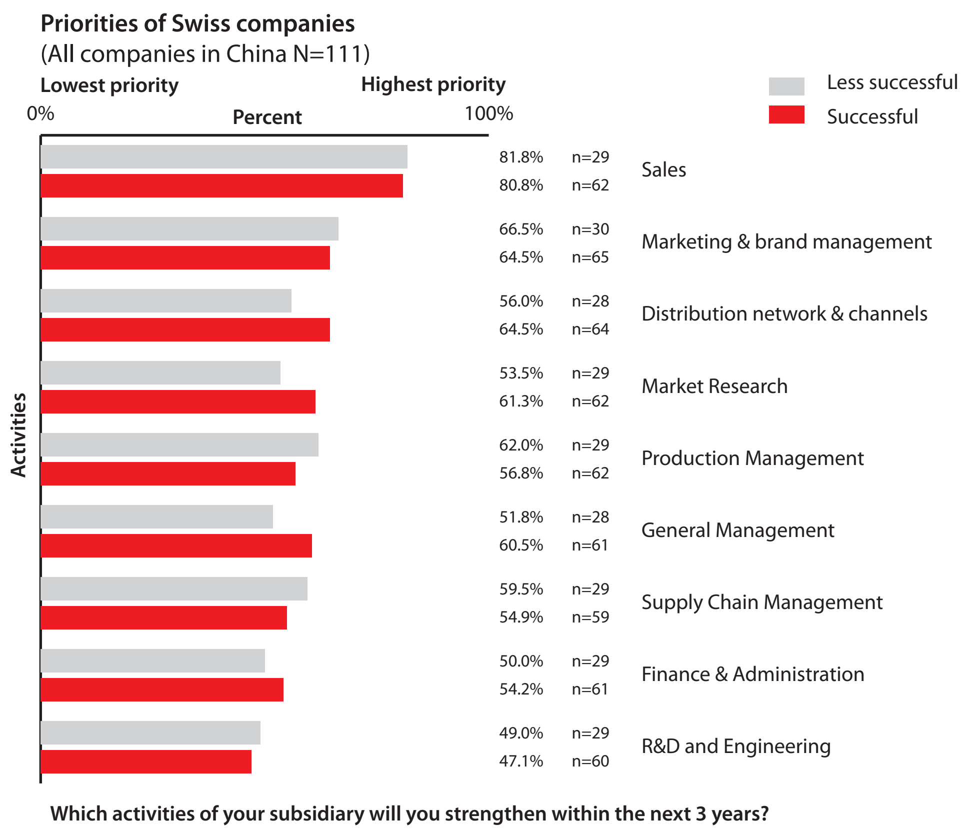
At a glance, South's China's costs are increasing faster than all other regions. At the same time, should one exclude Guangdong and Jiangxi, costs are generally stable or even partially decreasing for unskilled labor and rising slowest for locally purchased materials. Interestingly, locally purchased materials rise slower than imported materials even though customs tariffs are on a downwards trend. This indicates that compared with international markets, Chinese material costs are rising slower and unskilled labor costs are stable; at least in the eyes of Swiss managers in China.

This tends to confirm the analysis offered in Chapter VIII, Sourcing and Purchasing, 'Are China's low costs here to stay'.

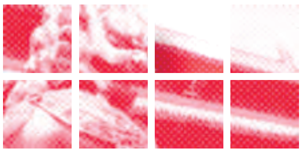
5.4 Priorities of surveyed companies

Respondents clearly intend to improve their sales performance: Sales comes on top with 'marketing & brand management' and 'distribution networks & channels' below, but at a comparative level.

Survey chart I - 28



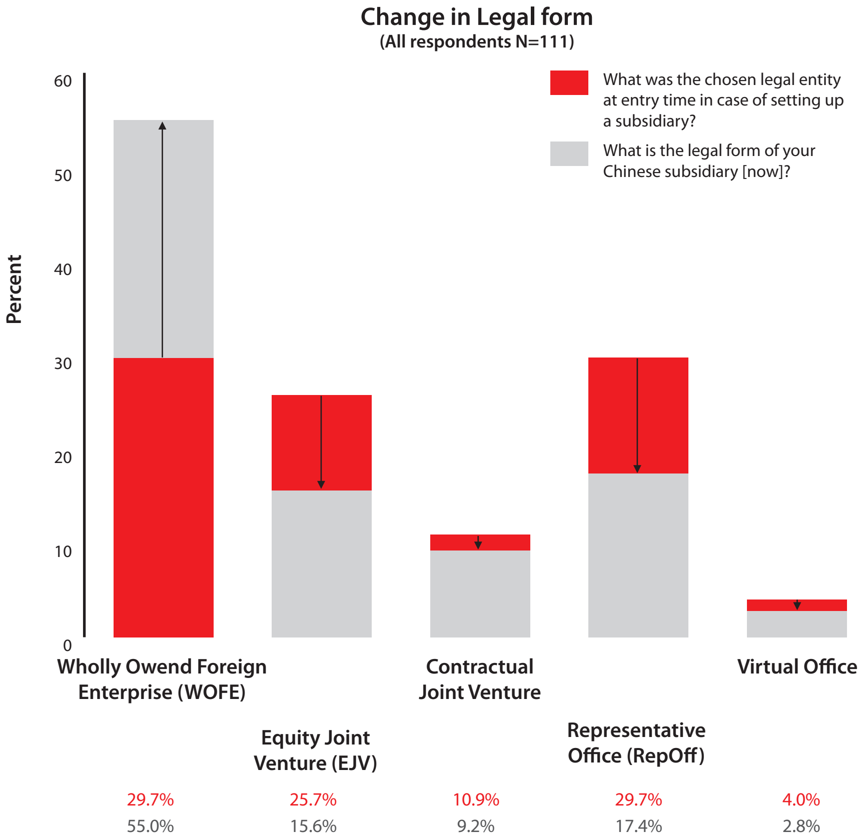
Source: Swiss China Survey, 2005



5.5 Legal forms and changes

Companies have had a strong tendency to register many more Wholly Owned Foreign Enterprises than Representative Offices and Joint Ventures (particularly equity JVs) over time. (Also see Chapter III, Preparing for China, for information on advantages and disadvantages of a Joint-Venture.)

Survey chart I - 29



Source: Swiss China Survey, 2005

II

Legal, Tax & Finance

Legal and financial aspects are a source of constant headaches for managers in China. The following contributions provide a first understanding of the differences and difficulties.

- The Chinese Government structure
- Differences of the Chinese legal system
- Dispute Resolution In China
- The Customs System and bonded areas
- Differences between the Chinese, International and Swiss Accounting Systems
- China's Banking and Currency System for Foreign Invested Enterprises
- Summary of Major PRC taxes
- Foreign Investment and Corporate Tax Rates
- The Importance of Chops
- Establishment of Trading, Distribution, Retail and Franchising Operations in China
- Transfer Pricing among Related Companies
- Mergers and Acquisitions in China
- Foreign Investments in Capital Markets

1. Legal background, banking and accounting

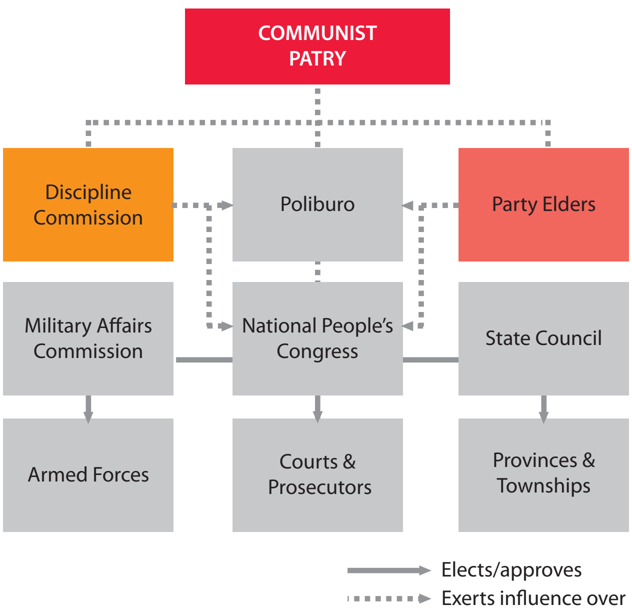
1.1 The Chinese Government structure

by Beat Buergi, Counsellor and Managing Director of the Swiss Business Hub China in Beijing

The Communist Party with both central and local organizations is the party in power in China and has ruled since 1949. **The Communist Party's 66-million membership makes it the biggest political party in the world**. The Party oversees and influences many aspects of people's lives – what they learn at school and watch on TV, their jobs and housing. The top of the pyramid is the National Party Congress, which is convened once every five years and brings together more than 2'000 delegates from Party organizations across the country. The National Party Congress' main function is to "elect" a **Party's Central Committee of 200 full members and 150 lower-ranking members, though in fact almost all of these people are approved in advance**.

The 24-member Politburo is elected by the Party's Central Committee. Every significant decision affecting China's 1.3 billion people is first discussed and approved by the handful of men sitting on the Politburo, the nexus of all power in China. But **real power lies with its nine-member Standing Committee**, which works as a kind of inner cabinet and groups together the country's most influential leaders. How **the Standing Committee operates is secret. Members of the Standing Committee also share out the posts of Party General Secretary, Premier, Chairman of the National People's Congress, and Head of the Central Discipline Inspection Commission**.

Fig II - 1
How China is ruled



Source: BBC NEWS

Under China's 1982 constitution, the most powerful organ of state is meant to be the National People's Congress (NPC), **China's parliament. The NPC is made up of nearly 3'000 delegates elected by China's provinces**, autonomous regions, municipalities and the armed forces. Delegates hold office for five years, and the full Congress is convened for one session each year. This sporadic and unwieldy nature means that real influence lies within a Standing Committee of about 150 members elected from Congress delegates, who meet every couple of months. In theory, the Congress has the powers to change the constitution and make laws. But it is not, and is not meant to be, an independent body in the Western sense of a parliament. For a start, about 70% of its delegates - and almost all its senior figures - are also Party members. Their loyalty is to the party first, the NPC second. What actually tends to happen, therefore, is that the Party drafts most new legislation and passes it to the NPC for "consideration", better described as speedy approval. The major functions of the NPC are to:

- amend the state constitution and enact laws;
- supervise the enforcement of the state constitution and the law;
- "elect" the country's highest leaders, including the state president and vice-president, the chairman and other members of the state Central Military Affairs Commission, the president of the Supreme People's Court, the procurator-general of the Supreme People's Procuratorate, and the major officials of government;
- examine and approve the national economic plan, the state budget, and the final state accounts;
- decide on questions of war and peace; and
- approve the establishment of special administrative regions and the "systems to be instituted there."

The Standing Committee of the NPC is responsible for:

- conducting the election of NPC delegates;
- interpreting the State Constitution and laws;
- supervising the work of the executive, the state Central Military Commission, and judicial organs;
- deciding on the appointment and removal of State Council members on the recommendation of the premier;
- approving and removing senior judicial and diplomatic officials;
- ruling on the ratification and abrogation of treaties; and
- deciding on the proclamation of a state of war when the NPC is not in session.

China's 2.5 million-strong People's Liberation Army (PLA) has always defended the Party as much as national borders. During the early years of Communist rule, most of the country's leaders owed their positions to their military success during the civil war, and links between them and the PLA remained very close. But as this generation has died off and reforms have been introduced to make the armed forced more professional, the relationship has shifted subtly. Party leaders know they are lost without the army's support, as became clear during crises like the 1989 Tiananmen protests. At the same time, senior military leaders realize they need the leadership's backing if far-reaching plans to modernize the armed forces are to be paid for. The Party's control over the armed forces and their nuclear arsenal is institutionalized through the Central Military Affairs Commission. **The 11-man Commission has the final say on all decisions relating to the PLA, including senior appointments, troop deployments and arms spending.** Almost all the members are senior generals, but the most important posts have always been held by the Party's most senior leaders. In theory, the Commission's chairman is elected by the National People's Congress. But in practice, the job automatically goes to the party's most powerful figure, who effectively becomes commander-in-chief.

The State Constitution of 1982 and the Organic Law of the People's Courts that went into effect on January 1, 1980, provide for a four-level court system. **At the highest level is the Supreme People's Court, the premier appellate forum of the land, which supervises the administration of justice by all subordinate "local" and "special" people's courts**. Local people's courts-the courts of the first instance-handle criminal and civil cases. These people's courts make up the remaining three levels of the court system and consist of "higher people's courts" at the level of the provinces, autonomous regions, and special municipalities; "intermediate people's courts" at the level of prefectures, autonomous prefectures, and municipalities; and "basic people's courts" at the level of autonomous counties, towns, and municipal districts. **In China, courts have limited power and authority. The NPC and its Standing Committee have the ultimate authority to interpret law and to enforce the Constitution**. As China is a civil law jurisdiction, courts have no formal power to make law in the sense that judicial decisions are not binding precedent. Similarly, courts are not empowered to interpret administrative regulations--ultimate authority over the interpretation and application of such rules rest with the issuing agency. Even with this limited authority, Chinese courts are subject to detailed supervision by the people's congresses and the procuratorate.

Court officials typically are outranked by public security and other law enforcement officials in the Party hierarchy, limiting their influence over Communist Party policy related to legal work.

The 1982 State Constitution refers to the procuratorates as the state organs for "legal supervision." **However, the procuratorates exercise both prosecutorial and watchdog functions**. In their prosecutorial roles procuratorates review cases investigated by public security officials, decide whether to approve arrests and prosecute criminal suspects, and carry out public prosecutions on behalf of the government. As the watchdogs of China's bureaucracy and legal system, however, procuratorates are also responsible for investigating cases involving official graft, corruption, and dereliction of duty; supervising criminal investigations, trials, and the execution sentences; and investigating citizen complaints against state personnel. These supervisory powers include the right to appeal verdicts if a procuratorate determines that a criminal or civil court has made errors.

The State Council is the cabinet which oversees China's vast government machine. It sits at the top of a complex bureaucracy of commissions and ministries and is responsible for making sure Party policy gets implemented from the national to the local level. In theory it answers to the National People's Congress, but more often the State Council submits legislation and measures which the NPC then approves. **The State Council's most important roles are to draft and manage the national economic plan and the state budget, giving it decision-making powers over almost every aspect of people's lives**. It is also responsible for law and order. The full Council meets once a month, but the more influential Standing Committee comes together more frequently, often twice a week. This committee is made up of the country's premier, four vice-premiers, state councilors and the secretary-general.

Through organizational changes, **the State Council has sought to improve efficiency**, combat corruption, **and advance market-oriented economic reforms**. In its March 2003 reform plan, the NPC made several important changes to the State Council that reflect China's interest in developing a "**market economy with socialist characteristics**." The merger of a number of government bodies that administer China's domestic and foreign trade regimes into a new Ministry of Commerce (MOFCOM) http://www.mofcom.gov.cn/ may prove to be the most significant of these changes. MOFCOM may simplify access to China's economy for foreign businesses and investors through greater centralization and coordination of regulatory activities. In other potentially important changes, the NPC created a new commission to supervise state-owned enterprises, with a mandate to supervise state capital, but not to participate in the management of the specific enterprises. The NPC also created a new commission to supervise the People's Bank of China http://www.pbc.gov.cn/, apparently to coordinate efforts to shore up the shaky state-owned banking sector-a risky and complex task. Please refer to the following Figure "Organs Composing the State Council".

Fig II - 2

Organs Composing the State Council			
Ministries			**Commissions**
Agriculture http://www.agri.gov.cn/	Foreign Affairs http://www.fmprc.gov.cn/	Personnel http://www.mop.gov.cn/	National Development and Reform Commission http://www.ndrc.gov.cn/default.htm/
Civil Affairs http://www.mca.gov.cn/	Health http://www.moh.gov.cn/	Public Security http://www.mop.gov.cn/	Commission of Science, Technology and Industry for National Defence http://www.costind.gov.cn/
Commerce http://www.mofcom.gov.cn/	Information Industry http://www.mii.gov.cn/	Railways http://www.chinamor.cn.net/	State Ethnic Affairs Commission http://www.seac.gov.cn/
Communications http://www.moc.gov.cn/	Justice http://www.legalinfo.gov.cn/gb/moj/node_183.htm	Science and Technology http://www.most.gov.cn/	State Population and Family Planning Commission http://www.chinapop.gov.cn/
Construction http://www.cin.gov.cn/	Labour and Social Security http://www.molss.gov.cn/	State Security Supervision http://www.mos.gov.cn/Template/home/index.jsp	State Owned Assets Supervision and Administration Commission http://www.sasac.gov.cn/
			Other
Culture http://www.ccnt.gov.cn/	Land and Resources http://www.mlr.gov.cn/	Water Resources http://www.mwr.gov.cn/	People's Bank of China http://www.pbc.gov.cn/
Education http://www.moe.edu.cn/	National Defence http://www.mnd.gov.tw/		National Audit Office http://www.audit.gov.cn/cysite/docpage/c182/200212/1231_182_486.htm
Finance http://www.mof.gov.cn/display/index.jsp			

Source: Congressional – Executive Commission on China : http://www.cecc.gov

Fig II - 3

Organs Directly Under the State Council	**Institutions Directly Under the State Council**	**Working Organs of the State Council**
General Administration of Customs http://www.customs.gov.cn/	Xinhua News Agency http://www.xinhua.org/	Overseas Chinese Affairs Office of the State Council
State Administration of Taxation http://www.chinatax.gov.cn/	Chinese Academy of Sciences http://www.cashq.ac.cn/	Hong Kong and Macao Affairs Office of the State Council
State Administration for Industry and Commerce http://www.saic.gov.cn/	Chinese Academy of Social Sciences http://www.cass.net.cn/	Legislative Affairs Office of the State Council http://www.chinalaw.gov.cn/
State Environmental Protection Administration http://www.zhb.gov.cn/	Chinese Academy of Engineering http://www.cae.ac.cn/	Economic Restructuring Office of the State Council
General Administration of the Civil Aviation of China http://www.caac.gov.cn./	Development Research Centre of the State Council http://www.drc.gov.cn/	Research Office of the State Council
State Administration of Radio, Film and Television http://www.sarft.gov.cn/	National School of Administration http://www.nsa.gov.cn/	Taiwan Affairs Office of the State Council http://www.gwytb.gov.cn/
State General Administration of Sport http://www.sport.gov.cn/	China Seismological Bureau http://www.seis.ac.cn/	Information Office of the State Council
National Bureau of Statistics http://www.stats.gov.cn/	China Meteorological Administration http://www.cma.gov.cn/	Office of the Leading Group for Western Region Development of the State Council http://www.chinawest.gov.cn/
State Forestry Administration http://www.forestry.gov.cn/	China Securities Regulatory Commission http://www.csrc.gov.cn/	
State Food & Drug Administration http://www.sda.gov.cn/	China Insurance Regulatory Commission http://www.circ.gov.cn/	
State Intellectual Property Office http://www.sipo.gov.cn/	National Council for Social Security Fund	
National Tourism Administration http://www.cnta.com/	National Natural Science Foundation of China http://www.nsfc.gov.cn/	
State Administration of Religious Affairs	State Electricity Regulatory Commission http://www.serc.gov.cn/	
Counsellors' Office of the State Council http://www.counsellor.gov.cn/	China Banking Regulatory Commission http://www.cbrc.gov.cn/	
Government Offices Administration of the State Council http://www.ggj.gov.cn/		
State General Administration for Quality Supervision and Inspection and Quarantine http://www.ciq.gov.cn/		
National Copyright Administration http://www.ncac.gov.cn/		
State Administration for Work Safety (State Administration of Coal Mine Safety) http://www.chinasafety.gov.cn/		

Source: Congressional – Executive Commission on China : http://www.cecc.gov

Fig II - 4

Administrations and Bureaus Under the Ministries and Commissions of the State Council		
State Bureau for Letters and Calls http://www.gjxfj.gov.cn/	State Bureau of Surveying and Mapping http://www.sbsm.gov.cn/	State Administration of Foreign Exchange http://www.safe.gov.cn/
State Administration of Grain http://www.grain.gov.cn/	State Post Bureau http://www.chinapost.gov.cn/	State Archives Administration http://www.saac.gov.cn/
State Tobacco Monopoly Administration http://www.tobacco.gov.cn/	State Administration of Cultural Heritage http://www.sach.gov.cn/	
State Administration of Foreign Experts Affairs http://www.safea.gov.cn/	State Administration of Traditional Chinese Medicine http://www.satcm.gov.cn/	
State Oceanic Administration http://www.nmemc.gov.cn/	China Atomic Energy Authority http://www.caea.gov.cn/	

Source: Congressional – Executive Commission on China : http://www.cecc.gov

Contributed by the SBH

The SBH China in Beijing and Shanghai offers small and medium-sized Swiss and Liechtenstein enterprises specific services for strengthening and developing their business relations with China. The Hub also functions as a networking platform and helps fostering business relations between Swiss/Liechtenstein and Chinese companies.

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Notes

BBC News : http://news.bbc.co.uk (29 September 2005)
Congressional – Executive Commission on China : http://www.cecc.gov (29 September 2005)
China Internet Information Centre : http://www.china.org.cn (29 September 2005)
Swiss Embassy/SBH, Beijing

1.2 Differences of the Chinese legal system

by Trevor Goh, Chief Representative of Blake Dawson Waldron, International Lawyers

1.2.1 Laws

1.2.1.1 Hierarchy

The Chinese legal system is essentially a Civil law system. At the top of the Chinese legal hierarchy lies the Constitution. The Constitution was adopted by and can only be amended by the National People's Congress (NPC), China's parliament. The Chinese courts do not review the constitutionality of laws or regulations.Laws adopted at sessions of the NPC and its Standing Committee are basic laws or laws regarding matters of major national importance, for example, the Civil Law, Contract Law, Taxation Law, Equity Joint Venture Law.

The State Council (China's Cabinet), the ministries and administrative agencies further refine the legislative process of the NPC or its Standing Committee. The various ministries, committees and commissions of the State Council issue a plethora of regulations (tiao li, or guiding), rules (guize), provisions or measures (banfa), decisions (jue ding), resolutions (jue yi), notices (tongzhi) and orders (mingling).

Various laws are also issued by provincial, municipal and county prefectures adding to the difficulty of interpretation and understanding. Furthermore, the use of inconsistent terminology and classifications make ranking the laws difficult. Attempts at cross-referencing among translations into various foreign languages have not alleviated these ranking difficulties. Finally, certain internal rules (nei bu) and policies, akin to "circulaires" in French administrative law, also apply.

The Communist Party of China (CPC) has utilized these nei bu in its ruling of China since 1949. It is important not to underestimate the importance of these internal policies which foreign companies will often encounter when dealing with various governmental bodies. The fact that these nei bu are not always made public can be a source of frustration when doing business.

Local People's Congresses (local parliaments) and local government authorities also adopt and formulate local regulations.

1.2.1.2 Adoption of laws

There is often a misconception as to the extent or non-existence of laws applying in China. Over the past 20 years, the NPC and State Council have passed over a thousand pieces of legislation. Many more regulations have been passed at the lower levels of government. **It is evident that in the last few years, the number of laws passed has exponentially increased demonstrating China's progress in this area**.

1.2.1.3 Characteristics

Unfortunately, Chinese laws are often plagued by the following characteristics:

- Vague and loosely drafted with a lapse in time before further implementing rules are drafted
    - Contain very broad discretions
    - Often state matters of principle rather than actual rules
    - Lack of proper definitions

1.2.1.4 Application

In operating in China, foreign companies often encounter the following frustrating aspects of the Chinese legal and administrative system.

1.2.1.5 Local laws and implementation

As noted above, local governments can legislate and issue their own regulations to complement and implement national laws. However the following can occur:

- The possibility that a particular legal issue is regulated by a main law together with implementing regulations and various notices and rules issued by different levels of government and authorities can result in difficulties in just finding all the relevant "laws".
- **Different provinces, municipalities may have different rules on similar issues**. Labor laws are one such example with different areas having different laws on minimum wages, working hours, social security. **Foreign entities operating in more than one province need to be aware of potential differences in these local laws**.
- Certain laws provide administrative bodies with wide discretions and that discretion may be applied by the same authority differently in different areas. For example, a foreign investment project may be approved by the relevant authority in Chengdu, but the same project can be rejected in Guangzhou through the exercise of discretion.
- A local government may issue local laws clearly in conflict with national laws however the Central Government may choose to "ignore" the discrepancy. For example, the national tax free threshold for wages in China is RMB800 per month. However Beijing has set its threshold at RMB1'200 per month and Guangzhou at RMB1'600 per month with no apparent reaction from the Central Government.

- There are also instances where local authorities have acted inconsistently with national laws for an extended period of time and only then have the Central Government taken action. For example, for many years since 1992 local governments have exceeded their authority in approving foreign investment in the retail sector. The State Council had to issue a stop notice in 1997 to prevent further approvals. Shanghai for many years issued local Internet Content Provider Licenses in breach of new national legislation. Those companies were forced to restructure to comply with the national laws. This is not very comforting for foreign companies who thought they had already received the appropriate license and thought they were operating legally.
- In the approval of foreign investment projects, recent regulations have been promulgated providing for verification in certain cases by the National Development and Reform Commission. The Shanghai authorities however still follow the traditional process of approval by the Ministry of Commerce. The conflict has not been fully resolved.

1.2.2 Dispute resolution

Dispute resolution has become increasingly important for both local and foreign companies in recent times and continues to receive attention with China's accession to WTO and as China becomes the focus of more business activity.

1.2.2.1 Chinese courts

While litigation in any part of the world is unpredictable, it is even more so in China. Although it is difficult to draw conclusions without knowing the circumstances of each case there are unfortunately too many instances where decisions are "unexplainable" and laws inconsistently applied.

Another important characteristic of the Chinese Court system is that court decisions are not generally published and more importantly there is no established precedent system where decisions from higher level courts are binding on lower level courts. This results in difficulties in determining how a court might interpret a particular issue and adds to the uncertainty of the court process. The Supreme Court however sometimes issues "Interpretations" which forms part of the laws of China. Presently the Court system is an "inquisitorial" system, not an "adversarial" one.

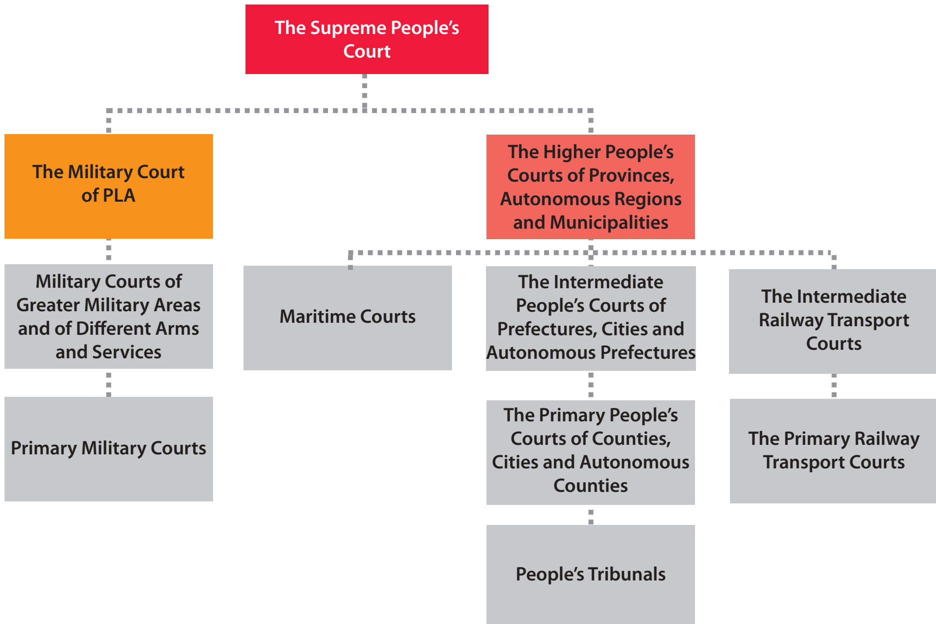
1.2.2.2 Problems

The Court system in China is also plagued by the following problems:

- The relative infancy of the current legal and judicial system in China results in some judges lacking relevant experience and training. Many judges in various parts of China may not even hold recognized law degrees.
- Local judges are selected and paid by local governments. Accordingly issues of outside influence in court decisions may arise. Issues of independence of the judiciary may also arise given the role of the Chinese Communist Party in the Court system. Judges are party officials and the policies of the party may influence court decisions.
- Instances of corruption still exist.

Fig II - 5

Structure of the People's Court of the PRC



Source: Finder, S. (2001). Business and Regulatory Environment, Chapter 2.1, Court System. In Doing Business in China (Vol. 1). New York: Juris Publishing.

From the above discussion, foreign companies doing business in China can be faced with a situation of potentially having similar matters being decided differently by courts in different parts of the country. As a general rule courts in the larger coastal cities may tend to enforce laws better than the courts of smaller cities in central and western China. The judges in the larger cities are better qualified, better trained, more experienced in larger complex cases and are less susceptible to outside influences.

China, however, is taking steps to address the problems noted above. At a forum for judges in 2002, the President of the Supreme People's Court called for increased training of judges especially in WTO related issues and the benefits of this training are slowly emerging. He also noted that steps should be considered to improve the integrity of the courts and judicial fairness. One recent Supreme Court initiative is to try cases involving foreign litigants in specially designated courts to counter local and departmental protectionism. The last few years have seen a definite progress in these areas.

1.2.2.3 Arbitration

For foreign parties the most popular form of dispute resolution is arbitration. Arbitration decisions have tended to be more consistent, professional and easier to enforce.

In China, there are four main types of arbitration institutions:

1. Local Arbitration Commissions set up in major cities by local government.
2. The China International Economic and Trade Arbitration Commission (CIETAC) which can hear both foreign related and domestic arbitration.
3. The China Maritime Arbitration Commission which as the name suggests, handles maritime disputes.
4. Labor arbitration commissions that hear local labor disputes.

If arbitration is to be held in China, most foreign companies or foreign invested enterprises will nominate CIETAC as the relevant arbitration commission. The panel consists of many foreign legal experts and also former foreign judges.

1.2.3 Conclusion

For foreign companies doing business in China, the following points are important regarding the legal system:

- **Know the local laws and policies and do not assume it is the same as other parts of the country**. Be aware of conflicts and overlaps in the numerous laws, regulations, rules, orders issued by various levels of government and different authorities·
- Be aware that local authorities may have different practices and policies and may exercise discretion in different ways.
- Be prepared to challenge the local authority if it is abusing its power or is acting in a manner inconsistent with national laws. For example, if a local authority has no power to approve a project under national laws, companies should demand that approval is obtained from the provincial or Central authorities and should not accept local level approval.
- If litigating in the Courts, local lawyers in that district with familiarity with the relevant Courts and personnel are important. A large Shanghai or Beijing law firm can not always advise or represent a company properly in a court case in, for example, Chongqing in Central China.
- **The importance of "guanxi" (relationship) when doing business is well known**. Local contacts within government are important and useful for conducting business and resolving conflicts and problems. **However changes in personnel in government also occur and companies should not be solely reliant on these "contacts"**.

Contributed by Blake Dawson Waldron
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1.3 Dispute Resolution In China

by Jean-Christophe (John) Liebeskind, Swiss and U.K. attorney-at-law and Vice President of SwissCham Beijing and China

Even though there are obviously local specificities, Chinese-related dispute resolution is not much different than anywhere else in the world insofar as the following basic, universal principle is respected: "prévenir, c'est guérir".

This discussion of Chinese-related dispute resolution is meant for entrepreneurs in China or in business with a Chinese party, not for lawyers. Along with a summary presentation, basic, practical advice will be offered.

We propose to discuss Chinese-related dispute resolution along three alleys and three stages. The three alleys are the three traditional ways of solving disputes: litigation, arbitration, and Alternative Dispute Resolution (ADR). The three stages occur before, during and after the dispute.

1.3.1 Before the Dispute

The first stage dramatically predetermines the fate of the two following. Yet it is systematically overlooked by clients (perhaps a bit less by the Anglo-Saxons, whose business culture is less hostile to legal matters) who consider it as a waste of time and money to consult a lawyer when all parties are eager to conclude a transaction. It is candidly assumed that there will be no dispute, or that disputes will be settled amicably.

As lawyers are well paid to know it however, experience shows that in many instances, there is no way out, and the whole investment or transaction is threatened at a price exceeding by a multiple the cost of an early legal advice.

There are two major points to decide before the dispute, at the time the contract is drafted: the forum and the applicable law.

1.3.1.1 Forum

The forum is the place where the dispute is decided. Without entering into more details, for the purpose of this discussion it really covers two notions: the geographical location of the place where the dispute will be trialed, and the type of institution which will decide it. In China maybe more than in other places, whether the issue will be decided in China or abroad has a particular significance. Therefore we will discuss together the dispute resolution mode and its location.

Chinese law recognizes the principle of contractual freedom also known as party autonomy. One of its consequences is that the parties to a contract are generally free to chose how to settle their disputes. In certain cases, this freedom may be restricted though (e.g., contracts with the state).

If the parties have not inserted a dispute resolution clause in their contract at the time of signing, they still may do so after the dispute has started, before they submit the dispute to the forum they have mutually agreed upon, but such agreement shall obviously be more difficult to reach as the parties are already tense.

a) Litigation

If the parties specify nothing in their contract, the dispute will be decided before a court. If the dispute is Chinese-related but involves a foreign element (for example, a foreign party, or foreign ship), it is possible that a Chinese court will be competent, but in deciding this issue Chinese courts will take into account the foreign element(s) of the dispute for determining whether they are competent or if the courts of another country are. They will do so in accordance to Chinese law and of any international treaty applicable to the case at stake.

The parties can also expressly foresee in their contract that Chinese courts will be competent. This choice can be reasonable provided the competent court is located in Beijing or Shanghai, as courts in other locations in China have been reported as being less experienced with disputes involving a foreign party and to produce uneven results. Indeed this choice must be consistent with Chinese judiciary law which set the rules for the courts' competence. Courts of the busy Southern coast of China (Shenzhen, Gangzhou) seem not to have convinced foreign investors of their efficiency and impartiality yet, therefore caution is needed.

It should be added that in an effort to reduce the workload of courts Chinese law occasionally prescribes compulsory (mediation and) arbitration, whereas the award can be appealed before the court. This is the case, e.g., in certain labor disputes.

b) Arbitration

Generally however, the majority of contracts involving a foreign party will provide for an arbitration clause. **An arbitration tribunal is a tribunal having powers similar to those of a regular, state court, but whose judges, the arbitrators, are selected by the parties**. The arbitration tribunal is in principle exclusively busy with the case at stake, unlike regular courts which are overwhelmed by a backlog of cases (even though prominent arbitrators tend to be as busy as courts).

The parties enjoy ample freedom to decide which rules of procedure (or arbitration rules) will govern the activity of the arbitration tribunal. The language is often a decisive issue in the choice of arbitration, as Chinese courts will exclusively seat in Chinese and offer little room for translation or interpretation.

Arbitration tribunals render their decision in the form of an arbitral award. **An award has the same value than a court judgment and can be enforced like the latter, with the help of a court**.

An arbitration will be agreed upon by the parties at the time of drafting the contract in the form of an arbitration clause. Most arbitrations are administered by a regional arbitration institution, the rules of which the arbitrators generally follow unless the parties decide otherwise. All these institutions propose a standard arbitration clause ready to be inserted in a contract.

Arbitration clauses obey strict legal rules. **Many clients prejudice their interest at the very time of signing a contract by inserting a defective arbitration clause**, the result of which being that the clause ultimately appears as being inoperative, thus adding to the cost and time of the dispute on the merits the costs and time of the dispute related to the clause's validity, whereas the dispute finally ends up before a court, not an arbitration tribunal. A competent lawyer will advise as to an effective arbitration clause.

i) China

Chinese-related arbitrations need not take place before a Chinese arbitration institution or in China. Quite on the contrary, the main characteristic of arbitration is to offer far more flexibility than courts. Because arbitration is designed to provide a neutral forum for the settlement of the dispute, ideally it should not be linked to any of the parties' country.

However, due perhaps to what is regarded by certain as an abuse of their bargaining power or a lack of understanding of international trade customary rules, the majority of Chinese-related arbitrations effectively take place before the Chinese International Economic Trade & Arbitration Commission (CIETAC) in Beijing, thus creating a certain imbalance in favor of the Chinese party.

Despite its undisputable success in the recent years as the strong progression of its cases shows, CIETAC has been, and still is sometimes severely criticized for its persistence in not correcting pro-Chinese party biases, even though improvement has occurred. Also, the administrative fees of CIETAC can reach a multiple of those of other international venues when the disputed value exceeds approximately half a million U.S. dollars, a point worth considering in advance.

The Beijing Arbitration Commission (BAC) is practically the only alternative to CIETAC in China. Even though competent for international arbitration, it focuses on domestic disputes. It is a little bit less expensive than CIETAC, but has less exposure to international affairs. There are other local arbitration courts, but their standards are considerably lower and they are not advisable for foreign-related matters. CIETAC has a branch in Shanghai too, but due to its influence Beijing is a preferable location.

ii) Asia

Provided the foreign party convinces the Chinese one to arbitrate in another place than China, **there are valuable, and preferable alternatives**. The first choice on the balance is probably the Hong Kong International Arbitration Centre (HKIAC). Even though Hong Kong is now part of China, thanks to a long standing tradition and the One Country, Two Systems doctrine, the HKIAC managed to maintain an untouched independence. Hong Kong is generally acceptable to those Chinese parties which are reluctant to arbitrate out of China.

Alternatives in the Chinese region include the Singapore International Arbitration Centre (SIAC) and the Kuala Lumpur Regional Centre for Arbitration Centre (KLRCA), both of which offer extensive Chinese language capabilities, an issue difficult to get around. As noted above, the three latter are also less expensive, up to a multiple depending of the amount considered, than CIETAC and BAC for litigations in excess of half a million U.S. dollars approximately. The two latter are generally also considered as less expensive than HKIAC, even though SIAC and KIAC's fees are disputed value-based whereas HKIAC's are time-based. Indeed the legal market is particularly expensive in Hong Kong, but the most experienced lawyers in the region for Chinese matters are Hong Kong, not Mainland China, based. Ultimately Singapore and Kuala Lumpur are preferable to Hong Kong in the sense that they are not on Chinese territory at all.

iii) Out of Asia

Any venue out of the Chinese region is theoretically suitable since China is member of the New York Convention on the Recognition and the Enforcement of Foreign Arbitral Awards of 1958 ("the New York Convention"), but **practice has proven uncertainty as to which arbitration institution Chinese courts recognize as rendering enforceable awards,** therefore qualified advice is recommended before selecting an unusual forum. Be as it may, whether practically it will suit the Chinese party is also unsure, and probably not a good idea since **language remains an issue in all Chinese-related disputes**.

The Arbitration Court of the Stockholm Chamber of Commerce has traditionally been a venue during the communist era and is still favored to some extent. **The Court of Arbitration of the International Chamber of Commerce (ICC) is represented in China but not authorized to administer arbitrations in China**. Finally it is worth mentioning the new Swiss Rules of Arbitration which apply before the court of arbitration of any chamber of commerce in Switzerland and which have been translated in Chinese.

It is worth stressing at this point that even though the arbitration clause might indicate the seat of the arbitration tribunal, it is still possible that the tribunal will meet at another place (typically, for collecting evidence on site), and render the arbitration award at yet another location. Utmost care is needed there as Chinese practice has been known for being quite restrictive in these and other respects, and related issues of non-enforceable awards have occurred.

iv) Treaty Arbitration

Lastly clients tend to overlook that the fact that no arbitration clause has been inserted in the contract does not necessarily mean that arbitration is excluded, as **certain treaties provide for arbitration when one party is a foreign investor and the other a state or a state-controlled enterprise, even though it has not been expressly foreseen between the parties**. Conceivably this situation occurs frequently in China since a lot of Chinese companies are still state-controlled to various degrees.

Switzerland and China are bound by a Bilateral Investment Treaty (BIT) which contains such solution. In other words, if a Swiss investor faces a dispute in China with a Chinese state-controlled enterprise and that their contract does not contain an arbitration clause, the Swiss investor will still be able to resort to arbitration thanks to the BIT between Switzerland and China. The arbitration is to take place before the Court of Arbitration of the Stockholm Chamber of Commerce.

Alternatively, both Switzerland and China are members of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States of 1966 (also known as the Washington Convention or the ICSID Convention). Therefore in the same situation a Swiss investor could chose instead to arbitrate before the International Centre for Settlement of Investment Disputes (ICSID) in Washington, U.S.A.

Other treaties to which both Switzerland and China are bound, such as for example the World Trade Organization (WTO)'s General Agreement on Trade and Services (GATS), also contain far reaching provisions for the settlement of certain disputes involving a state- or state-controlled party. [1]

c) ADR

The third venue known as Alternative Dispute Resolution or ADR in fact gathers several methods which we are not going to comment in details here but the main of which is mediation (or conciliation).
Mediation is a process by which a neutral mediator interposes him- or herself between the parties and help

them to find an equitable, amicable settlement. Unlike arbitration, the mediation results in non-binding recommendations which do not necessarily reflect the law but rather purports at balancing the interests of the parties.
Mediation has a long history in China and in Asia indeed and is still largely favored, including by Chinese courts. It can be said that there are three types of mediation in China: court or court-assisted mediation, informal (extra-judicial) mediation and formal or institutional (extra-judicial) mediation.

i) Court Mediation

Court mediation takes place when the parties settle their dispute before a Chinese court, and that Chinese law prescribes that, before the court trials the dispute, the parties have to undergo compulsory mediation. Such mediation may be assisted by the court itself, or delegated to an external mediation body.

This situation occurs when the parties have expressly opted for the competence of Chinese courts, or when they have not provided for dispute resolution, in which case Chinese courts would be competent by default.

As noted above, Chinese law occasionally prescribes that unsuccessful mediation shall be followed by compulsory arbitration. In such cases, only then can the arbitration award be appealed at court.

ii) Informal Mediation

The second is **largely favored in disputes between Chinese parties which often call an elder, mutually agreed personality for helping them to sort out their dispute and reach an out-of-court settlement. It does not follow any particular rules**, however, and it therefore often does not satisfy a western party accustomed to a judicial, or formal tradition.

One should insist that **provided the foreign party plays the game, informal mediation can be a considerable asset over traditional, formal western ways of solving disputes. Indeed Chinese, or Asian informalism is double-edged**. It is fair to say that Chinese parties generally feel less bound by a contract than western parties do. There are two sides to each coin however. The good one to this is that it is also easier in China than in the west to reach an agreement which gives full account of new circumstances, that is to say, of circumstances which did not exist at the time of signing the contract. The Chinese party will not mind if the western party changes its view, or even contradicts itself, whereas the formal, rigid western approach would prevent this. Therefore **with some mindset adjustment, what is often seen as a typically Asian flaw can be turned into a great dispute resolution tool and should not be mistrusted or underestimated as a matter of principle**.

iii) Institutional Mediation

The third one is formal or institutional extra-judicial mediation. The largest mediation institution in China is the China Council for the Promotion of Investment & Trade (CCPIT), which is in fact not only the federation of the Chinese chambers of commerce with strong extensions nationwide, but also plays a role to be compared to the Swiss Secretariat of State for the Economy (seco).

Even though CCPIT has rules of mediation, it is important to stress that such rules, or at least **CCPIT's practice, are generally considered to be far apart from the sophisticated, rigorous ethical standards required by Anglo-Saxon mediation** (namely as to the neutrality of the mediator). There have been attempts by the U.S.-based International Institute for Conflicts Prevention & Resolution (CPR) to enter into a cooperation agreement with CCPIT, but even though CPR is represented in China with a U.S.-China Business Mediation Center (also open to non-U.S. parties), it has been reported that **the cultural gap was so wide that such cooperation was hardly implemented**. CPR makes available highly trained mediators selected out of a Panel of Distinguished Neutrals.

One shall therefore remember that **to foresee Anglo-Saxon style mediation in a contract does not mean that at**

the time of a dispute the Chinese party will accept to play the game as a fundamental disagreement may appear only then.

d) Multi-Tier Clauses

It is possible to combine the dispute resolution modes reviewed so far with a so-called multi-tier, or **step-by-step dispute resolution clause**, providing for direct negotiations between the parties, followed by mediation and ultimately by arbitration if none of the two first succeed. If so, **it is vital to built-in (rather short) time-limits**, otherwise each step could last forever and the clause will be inoperative.

Clients however are often reluctant to insert long dispute resolution clauses in their contract (a multi-tier clause would typically be between half and one-and-a-half page long) as it suggests that a dispute is anticipated from the outset. Therefore clients would often favor a short clause like "CIETAC arbitration Beijing", but not always for the better.

1.3.1.2 Applicable Law

The second major point to specify in a dispute resolution clause is the applicable law. Again this element has a decisive influence on the outcome of a dispute but is more than often taken for granted, and wrongly so.

Foreign parties tend to assume that whenever a Chinese party is involved, Chinese law applies. This is simply not true. Chinese law is liberal from this point of view and has not much to envy to the best international practice. Basically, **in Chinese contractual matters, the parties are free to chose the law which best suit them**. There are, in China like anywhere else, exceptions, one remarkable being Sino-foreign Joint-Venture, to which the application of Chinese law is compulsory. Contracts involving the exploitation of natural or energy resources are another example. However, there remains ample room for contractual freedom.

The advantage of a foreign law offering a better, or an impartial protection must be balanced with the inconvenient of hampering a Chinese court not at ease with foreign law. Therefore a foreign law, if appropriate at all, should be reserved to arbitration.

In practice, the Chinese parties are rarely concerned about fairness and often abuse their bargaining power to impose both a Chinese forum and Chinese law. This is not a fatality though, but a matter of negotiation. If both a neutral forum and applicable law cannot be agreed upon, a solution can be to bargain say, a Chinese forum against a foreign law or the other way round.

Switzerland has a good reputation business wise and Swiss law is generally well accepted provided a foreign law is accepted at all. **If neither Chinese nor Swiss law is appropriate because neither is neutral, English, Hong Kong or Singapore law are probably a safe choice, namely in trading**. However, **in all matter where the Chinese element is dominant, in particular for investments with strong local roots (e.g., a factory), Chinese law will practically if not legally prevail**, whereas other crossborder transactions (e.g., a sale) offer more flexibility.

That being said, **Chinese law is generally fairly drafted**, sometimes better than western law; it is constantly improving, and it would be wrong, contrary to a widespread but unfair belief, to consider that is it generally less good than western law. Rather its **application is a matter of concern**, as there still is a considerable lack of well-trained judges, especially for foreign-related cases. The Chinese government is aware of it and is taking steps for improving the situation in line with its WTO commitments, but it will obviously take some time.

1.3.1.3 Making the Right Choice

There is no magic formula for determining which dispute resolution mode is best suited for any particular transaction. **Each contract shall be assessed on a case-by-case basis with the help of a qualified professional. The time and**

cost factor shall be carefully balanced against prospects of success. Basic considerations include the following:

- Dispute resolution should always be agreed upon at the time of entering into the contract, not later.
- Litigation is generally cheaper than arbitration and easier to enforce [2], but generally longer, more vulnerable to bias and less flexible. Arbitration is often protracted too though. A thoughtful choice of an arbitration institution (arbitration fees) and procedure (single arbitrator, fast track, etc.) commensurate to the nature of the transaction helps to control the arbitration costs.
- Successful mediation is less expensive than litigation and arbitration, but a failure will be an additional cost and time to litigation or arbitration with no added value.
- A foreign applicable law may help to maintain the balance of power between the parties, especially in case of Chinese forum. Depending of the nature of the transaction, it may also offer a better protection than Chinese law, but not systematically. It should be in principle reserved to arbitration as it might be counterproductive before Chinese courts.

These hints are by no mean exhaustive and do not replace the advice of a lawyer in each particular case as a multitude of factors shall enter into consideration.

1.3.2 During the Dispute

Should a dispute effectively arise, two points are key to success: take an early start, and getting qualified advice.

Strategy planning in case a dispute ultimately arise should start at the earliest stage and be implemented on an ongoing basis until final settlement of the dispute. Namely, records must be established and kept for evidence purpose.

Qualified advice implies both Chinese and western legal counsel. Chinese have often (but not always) limited qualifications in foreign-related dispute management, but generally know the law in more details and have no language issues. Western lawyers are generally more experienced in international dispute resolution and a have better understanding of the foreign client, but less level playing-field knowledge.

As far as litigation is concerned foreign lawyers are barred to appear before Chinese courts anyway, so that a Chinese lawyer is necessary at court whereas the role of the foreign lawyer is limited to litigation supervision. However that may be, that latter role is often necessary in case of Chinese lawyer having limited experience of international disputes.

In practice international arbitration can be managed exclusively by foreign lawyers, but there have been attempts by the Chinese governments to restrict this. Such restrictions are not applied though. There are a lot of Chinese lawyers pretending to be experienced in arbitration, but so far international arbitration still is entirely western dominated. Because of the limited experience of China in this relatively new field in the Mainland, there are no internationally recognized specialists of international arbitration among Chinese lawyers yet.

A lot has been said about the corruption of the courts, which is reported from time to time indeed. However there are no reliable statistics. Be as it may, it is probably fair to say that **the bias of certain courts remains a serious issue in China**. That being said, **the situation is generally acceptable in Beijing and Shanghai, whereas it is mostly unpredictable and uneven in the provinces**. The busy southern coast (Shenzhen, Guangzhou) has been consistently reported as maintaining courts showing little understanding for foreign-related disputes despite being heavily foreign-invested. Therefore it is probably best practice to submit contracts to arbitration.

The latter is not flawless either however. **Issues have been known about the reliability of CIETAC, but generally speaking even though there still are substantial concerns about the ability of CIETAC to meet internationally accepted ethical standards, it remains an acceptable mode of dispute resolution**. As discussed above Singapore or Kuala Lumpur based arbitrations, if not Hong Kong, are preferable as far as possible.

1.3.3 After the Dispute

Once the court has rendered a judgment, or the arbitral tribunal an award, the third stage is concerned with the execution of the decision. Assuming that the Chinese party lost, and is reluctant to spontaneously pay or do whatever the court or the arbitral tribunal has ordered, it will be necessary to assist the enforcement of such decision.
Court judgments are generally considered to be easier to enforce than arbitral awards, but this is not quite fair. Doubts have been raised about how far Chinese courts would help to enforce a court judgment rendered against a Chinese party in favor of a foreign party, especially when the court competent for enforcing the decision is not the same than the one which rendered the decision, for example because the assets against which the enforcement is sought are located in another place than where the decision was rendered.

There is one additional, preliminary problem in case of arbitral award, which is that in order to be enforced, the award must beforehand have been recognized by the court of the place of enforcement under a procedure known as exequatur. Even though as noted above China is part of the New York Convention which provides for a flawless recognition and enforcement of international foreign arbitral awards, **the history of such recognitions and enforcements in China has drawn much criticisms until recently**.

Many award were reported not to be recognized and/or enforced because of the ignorance, deliberate or not, of certain judges of the New York Convention and its significance on China's international obligations. It is also fair to say that **improvement has occurred recently** and that Chinese courts now have a better understanding of the New York Convention than in the past.

Criticisms remains however due to the fact that the People's Supreme Court, which is competent among other things for deciding in last resort claims related to New York Convention, **persistently refuses to publish statistics of unsuccessful enforcements, thus fueling doubts as to the cause of such failure**.

Nevertheless **it is possible if not probable that, maybe in the majority of cases, the failure of enforcement is rather due to the insolvency of the debtor** rather than to the refusal of the court to cooperate or its bias.

To conclude, generally speaking, foreign awards are enforced in China, and even though issues have occurred and still do, they are not enough for offsetting overall the advantages of arbitration which remains a valuable option to courts.

1.3.4 Conclusion

Despite the issues recalled above, one should recall that **beyond cultural prejudice, the judicial system is more than often hardly better in certain European countries** where justice is chronically protracted or the independence of judges questionable, **the U.S.** where the costs of access to justice and over-lawyering pose comparable and sometimes bigger problems, **or other Asian countries** where the judicial system including arbitration is simply inoperative. **Arbitration is not yet to the state-of-the-art but it works**, and CIETAC now has one of the biggest case log worldwide. **ADR's weakness is in fact its strength if used with the proper mindset**.

Chinese-related dispute resolution system is not perfect, but none is. The bottom line is that **it works well enough to guarantee a reasonably stable business environment**. To get the best out of it needs **thoughtful adjustment including anticipation and qualified advice**. Those who will ignore it, and there are many, will learn the hard way that "une mauvaise expérience vaut mieux qu'un bon conseil", but those who will recall it will certainly avoid most pitfalls.
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Sources:

1 WTO offers a remedy against barriers to trade and services
2 See below, "After the Dispute".

1.4 The Customs system and bonded areas

by Meng Ling, project manager and head of the legal department, CH-ina

1.4.1 Rights and power in general

As an administration, China's Customs controls all incoming and outgoing transport conveyances, goods, baggage; mail and parcels; collects Customs duty and the various import/export taxes. It also works to combat smuggling; produces Customs Statistics and handles all other Customs affairs, functioning exactly as the Customs operations of other countries.

Yet, in **China, a foreign trade transaction involves not only Customs but also other institutions (banks, foreign exchange administration and so forth). Each authority has its own function but works closely to match records with the others**.

Besides, Customs has a lot of autonomy and is the final approving authority in some crucial cases. For instance, 'encouraged status' - approved by the Foreign Economy and Trade Committee to allow a foreign-owned company to import production equipment free of duty (variable, typically around 8%) and VAT (17%) for its own use - could be rejected by Customs if it deems that the product to be manufactured by the importing company is not encouraged, even though the 'encouraged status' is approved by the Foreign Economy and Trade Committee according to the relevant laws.
The Law of Customs of the PRC stipulates the general outline of Customs functions and power but does not go into any detail with regards to their operation. Customs from time to time makes public announcements — 'gong gao' — to introduce supplementary rules and regulations and usually includes detailed explanations of these rules. www.customs.gov.cn as an internet tool details these laws, regulations and 'gong gao'. But besides this limited information, **much of the bureau's ways and procedures of handling Customs affairs remains inexplicit or unclear, making dealing with Customs particularly difficult for foreign-owned companies with little experience in China**. For instance, Customs checks the prices of import goods during importation to minimize the risk of tax evasion by the importers. Customs has the right to query declared prices and in cases where the importer cannot convincingly justify these prices, Customs will then itself determine the final price and impose taxes (mainly duty and VAT) accordingly. Although the comparatively-detailed principles of determining final import price are stipulated in Customs Law of the PRC and Regulations on Import and Export Duty of the PRC, the detailed price reference for commodities that Customs uses is not publicly known. This ultimately has the effect of forcing the importer to declare the true prices of imported goods, which consequently helps to protect the country's in-flow of tax revenue.

1.4.2 Customs organizational structure

China's Customs is a gigantic organization, with numerous branches throughout the country, in port cities, airports and other areas where Customs functions are required.

Customs' organizational structure has three levels:

- General Administration
- Customs directly under General Customs, most of which are on a provincial level
- Sub-Customs, which are set up by district or by function within the jurisdiction areas of Customs' upper levels, for example: airport Customs, seaport Customs, industrial park Customs and bonded area Customs.

General Administration of Customs mostly focuses on administrative issues, for instance:legislation; the establishment of tariffs in conjunction with other authorities; ruling in disputes over tariffs; administrative punishments; the preparation of statistics; and drafting (or being partly engaged in the drafting) of, international treaties on Customs issues, amongst other tasks. A total of 43 Customs divisions report directly to General Administration of Customs and are responsible for:

- The implementation of Customs laws, regulations and policies
- Centralized document examination and approval
- Settlement of administrative disputes
- Carrying out examination, approval, registration and filing for various Customs affairs
- Organizing and conducting their own sub-Customs operations

In turn, the various Sub-Customs branches are responsible for:

- Customs clearance of import and export goods
- Receipt and examination of documents
- Charging of duty and VAT
- Valuation, inspection and discharge of goods
- Supervision of bonded goods and goods imported duty- and VAT-free; supervision of bonded goods involved in processing trade for re-export
- Customs registration and filing of enterprises within the sub-Customs office's area of jurisdiction
- Other operations authorized by their superiors

The Entry and Exit Inspection and Quarantine Bureau (EEIQB), affiliate of the Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), works closely with Customs. It concentrates on commodity and sanitation inspection and quarantine, as well as the inspection and quarantine of imported and exported animals and plants. The EEIQB operates in ports and at other Customs locations (more details can be found in Chapter IV Exporting to China).

1.4.3 The China E-port Information Data Center

With modern communication and working methods becoming increasingly available in China, the Chinese Customs system has been modernized. **Customs now has its own computer system, 'China E-port Information Data Center' (www3.chinaport.gov.cn), which contributes to greater efficiency and consistency between all levels of Customs and the various institutions involved in import and export.** The system is a data-exchange platform, based on the national public internet. It connects the following Administrations and Ministries:

- Industry and Commerce
- Taxation
- Customs
- Foreign Exchange
- Foreign Commerce
- AQSIQ
- Public Security Bureau

At the same time the system also links other related organizations, such as the banks, import and export agencies, processing trade enterprises and foreign trade service agents and consignees. Not only does the China E-Port store information about the flow of management, goods and funds related to import and export activity in a centralized database, but the system also assists in the verification of transactions between the various departments, regions and industries. **Systematic data exchange is enabled between nationwide administrative departments and banks at all levels allowing detailed controls**.

Importantly, **the system also provides instant on-line services to enterprises (Customs clearance, foreign exchange transactions, refund of export VAT and payment of tax, for example)**.

1.4.4 Determination of import prices by Customs

Now that China has entered the WTO, its method of determining import prices has been changed, and Customs has the right to question the amount of import tax paid by importers. The Customs Law of the PRC and Regulations on Import and Export Duty of the PRC stipulate that import price determination must be consistent with China's commitment to the WTO. As a matter of fact, negotiations between Customs and the importers go much deeper than this: **the importer has to justify and explain its claims of reasonable prices when Customs so asks. In most cases, if Customs is not convinced by the explanation, it may recommend the importer to increase its prices, and normally the importer will comply**, as it would not make sense to argue unless it can present really strong conclusive evidence in its favor. Eventually both parties will reach a compromise on the price.

There is no standard price list that Customs can use to make its determination, however, the organization does keep and refer to statistics on commodity prices. These statistics are not accessible to the public and they are only used internally as a reference for Customs to be able to question or determine the import price.

1.4.5 The Customs clearance process

Customs working efficiency has improved in recent years as a result of China's drive to reform and render more effective the operation and organization of government bodies. It now takes a total of around three or four days to complete Customs clearance process for importation via sea, and even less for shipments by air if the importer does a good job of preparing the required documents (mainly the Bill of Lading or airway bill, packing list, invoice, contract, and other documents relevant to the specific situation). The inspection process is normally included in the Customs clearance process as the goods pass through Customs after their arrival. The major steps in this process are:

- Arrival of goods in the port
- Application to EEIQB for inspection of goods and application for Customs clearance
- Package inspection or compulsory inspection of goods by EEIQB at the port if needed: machinery and equipment that are difficult to be repacked or inspected at the port can be inspected at the factory site later.
  In some cases (for second hand equipment for example) Customs may require the inspection of goods prior to its shipment, in the country of origin.
- Computerized and officer auditing by Customs
- Duty and VAT calculation by Customs
- Duty and VAT payment by importer
- Random inspection by Customs
- Clearance by Customs

Customs requires importers to apply for Customs clearance within 14 days after the shipment's declared entry into China, otherwise a fine will be charged by Customs for the delay: 0.05% of the value of the imported goods per day overdue. In addition to this, more fees become due: storage fees and container rental are charged by the port and forwarding company if the goods or rented containers continue to remain in the warehouse after the initial free period of seven to ten days after arrival of the goods.

1.4.6 License for company staff handling Customs clearance

Only people with a Customs clearance license are allowed to physically handle the Customs clearance process. Many Customs clearance agencies and import and export agents are available for this role, and foreign-owned companies normally have to hire them to cope with the detailed working process (unless the company has any employees with their own license that are able to handle the job). Any person over 18 years old, with full capacity of conduct, high school-or-above education and a clean record are entitled to sit an annual exam to qualify for a Customs clearance qualification certificate. Customs clearance specialists with this certificate that are subsequently hired by a Customs clearance agent or by any company with import and export rights must register at Customs with the following documents:

- Customs Registration Certificate of the employer
- Employment Contract
- ID of the applicant
- Valid qualification Customs Clearance certificate
- a number of passport-sized photographs

Customs then issues a one-year Customs clearance license within 20 working days. The license may then be renewed annually for a further year, subject to routine checks by Customs.

1.4.7 Black and red lists

The General Administration of Customs has a policy of publicly announcing 'red listed' and 'black listed' companies yearly, starting from 2003. From these two labels it is possible to understand very quickly those companies' relationships with Customs. Red-listed companies are those whose good behavior has enabled them to win a great deal of trust by Customs, which in turn facilitates and simplifies the Customs clearance and the related import and export processes. Black-listed companies, on the contrary, are companies that have to endure strict supervision by Customs at all stages of import and export because they are no longer qualified to handle any part of the process. The procedures that they are forced to undergo are long and complicated and in fact, some black-listed companies are even prohibited from carrying out certain import/export business. In 2004, Customs announced 139 red–listed, and 68 black-listed, companies on its books. A black-listed company can be written off the black list in the following year if it does not conduct any activities that are deemed to be contrary to the regulations.

1.4.8 Bonded Areas

In principle, goods shipped into bonded zones are tax bonded and are not required for quotas and licenses. The customs duty and VAT on these goods will become payable only when they are transported into areas that are within the PRC but outside of the bonded zones.

Foreign companies can set up in such bonded areas and may benefit from bonded zones. The advantages of bonded warehousing or processing are:

- reduction of the need for capital to pay taxes on stored goods whilst maintaining a local inventory
- possibility to re-export goods without losing on paid duty and VAT and also the ability to use the bonded areas as a regional logistics hub
- simpler procedures for import of materials to be processed and re-exported as finished goods
- trading and providing after-sales services for traded goods

Waigaoqiao in Shanghai, Tianjin's Trade and Economic Development Area, and Shenzhen are three examples of such bonded areas.
However, additional specific regulations apply for foreign companies in bonded areas, increasing some other parts of the administrative burden.

With the promulgation of the 'Foreign Trade Law of PRC', 'Administrative Measures on Foreign-invested Commerce' and the latest policy: 'Circular on Problems Concerning Trade Management in Bonded Zones and Bonded Logistics Zones' (issued July 13, 2005), foreign invested enterprises can now expand their business scope to do include trading with enterprises in Chinese territory outside the Zones. This means that trading and after-sales services will no longer be a reason to register in a bonded zone (see Chapter I, General Environment, 'Registering trading, distribution, retail and franchising operations in China').

1.4.9 Recommendations

Foreign-owned companies need to establish and maintain good communications with local Customs or work with experienced service providers in order to develop the necessary knowledge about the foreign trade system and its practices. Acquiring an understanding of relevant Customs laws, regulations, rules and actual practices is time-consuming, yet it will also help avoid unnecessary wastes of time and the risk of being suspected by Customs of smuggling, evading taxes or breaking the law. In addition, a good company image, reputation and good relationship with Customs is very helpful when it comes to finding effective and rapid solutions to the problems that are bound to happen considering the complicated and non-transparent nature of the system.

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1.5 Differences between the Chinese, International and Swiss Accounting Systems

by Wang Tao, Senior Consultant of a European IT company in Shanghai with CH-ina

This chapter provides an overview of the PRC's new accounting standards for foreign invested enterprises (FIEs). It reviews the history of their development and highlights the differences between the Chinese accounting standards and tax system and the International Accounting Standard (IAS). This is followed by an overview of the differences between the Chinese and Swiss accounting systems. Finally, some of the implications of these changes for foreign companies are provided.

1.5.1 The Development of Chinese Accounting Systems

Up until the 1990s China used the Soviet system, making no distinction between management or tax accounting practice. Under that system, the financial management of enterprises was strictly controlled by central government, and the main reason to submit accounts was to assist the government in the planning and control of funding and economic activities.

In the early 1990s, China developed its plans for a reform of the accounting system, with the restructuring of state-owned enterprises (SOEs) and attraction of further foreign investment as the main goals.

In 1992, the Ministry of Finance (MOF) issued the first of the PRC's new IAS-based accounting standards – Accounting Standards for Business Enterprises (ASBE) – as generic standards. Specific standards – Chinese Accounting Standards (CAS) – have been developed by the MOF in accordance with these generic standards.[1]

The MOF's objective was to bring accounting standards into line with International Financial Reporting Standards (IFRS), formerly well known as IAS, while taking into account the PRC's existing laws and circumstances. The MOF intended the new system to be used by all local large- and medium-sized enterprises and all foreign invested enterprises (FIEs), with the exclusion of those in banking, insurance and other financial enterprises.

The new accounting system, with its policy of slightly less rigid requirements, provides greater flexibility for companies when preparing their accounts. It **is much more in line with IFRS, although inconsistencies still exist**. Additionally, the Chinese tax system has not been reformed along quite the same lines as its accounting systems. Therefore there are quite a number of discrepancies between accounting and tax requirements in China.

As a result, **finance managers working for FIEs often have the vastly complicated task of reconciling the requirements of group policy and international accounting practice with those of China's accounting practice and tax requirements, while optimizing the tax burden**.

1.5.2 Differences between International Accounting Standards (IAS) and China's tax system

Differences between the CAS, IFRS and tax systems are illustrated in Table 1.
Remark: the above table only provides brief details of certain examples; it is not a complete list of all differences.

Additionally, **requirements by the new Chinese accounting standards and regulations for disclosure are not clearly stated in all situations - in the case of a merger, for example**.

Fig II - 6

Examples of the differences between CAS, IFRS and China's Tax System

	CAS	IAS	The Chinese Tax System
Inventory valuation	Valued at cost or net realizable value, whichever is lower	Valued at cost or net realizable value, whichever is lower	Valued at cost price
Amortization of intangible assets	Amortized over the useful or legal life of the intangible asset, whichever is shorter. If the legal life of the asset is not stipulated (either by law or contract), the amortization must be effected over a period of ten years at the most	Amortized over its estimated useful life	An intangible asset with an indefinite useful life (when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity) should not be amortized, but evaluated – annually or more frequently – whenever there is an indication that the intangible asset may lose its usefulness.
Pre-operating expenses	Charged to P&L in one lump sum in the first month of operations	Charged to P&L when expenses occur	Amortized over a period of no less than five years
Borrowing costs	Project-specific borrowings costs must be capitalized as part of the cost of acquiring or constructing a tangible fixed asset	Optional – the enterprise has a choice whether or not to capitalize borrowing costs	Project-specific borrowing costs must be capitalized as part of the cost of acquiring or constructing a tangible fixed asset

Source: Comparison between PRC GAAP and IFRS, April 2005, Deloitte Touche Tohmatsu.New York: Juris Publishing.

There are also differences in the classifications of assets on the balance sheet by CAS standards. Under IFRS, assets are either not classified or are classified into current (liquid) and non-current assets, while under CAS, it is stipulated that assets must be classified into one of five different categories:

- current assets
- intangible (and other) assets
- fixed assets
- long-term investments (for example, treasury bonds)
- deferred taxes [2]

The differences between the new tax and accounting standards imply a number of potential income tax adjustments, for example:

- pre-operating expenses: tax policy requires even amortization over at least five years of operation, while accounting policy requires a one-time expense
- bad debts provisions for outstanding customer balances: tax policy does not recognize provisions as tax deductible unless debts are proven as impossible to collect by confirmation of customer bankruptcy.

1.5.2.1 Differences between CAS and the Swiss Accounting System

a) The Principle of Prudence

Although, CAS, IFRS and Swiss accounting system all promote the prudence principle, the levels of allowed prudence are quite different. Prudence has been always stressed in Switzerland. **Most Swiss individual company accounts are prepared in such as a way as to offer the most reliable picture of the income and financial situation of a company - not the true and fair view as defined by other accounting standards**. Therefore, equities of these companies are understated, not only to reduce the tax liability, but also to better protect the interests of creditors, such as banks. As a result, the true and fair view of Swiss company performance is distorted to some extent. However, big Swiss companies, responding to pressure from international capital markets, have been publishing consolidated accounts that include a true and fair view.

Yet, unlike in China, accounting for tax purposes is still allowed in separate (non-consolidated) financial statements. To a large extent, the vast majority of items, such as 'hidden reserves', are accepted by the Swiss tax authorities. (for example, for tax purposes the net value of an inventory can be further reduced by a third) [3].

Under the new Chinese accounting system, the principle of Prudence states that over-statement of assets or revenues, or understatement of debts or expenses is not allowed. Yet, Chinese prudence does not allow an enterprise to set up hidden reserves, either.[4]

In contrast to large hidden reserves accepted by the Swiss tax authorities, those reserves cannot be made according to Chinese accounting regulations.

b) Book-keeping

Unlike Switzerland, company accounts in China must be prepared according to Chinese ASBE, not the head office regulations.

It is mandatory for Chinese accounting records and ledgers to be set up and kept at the transaction level. Transactions need to be continuously logged from the beginning of the year to the end. **For example, under the Swiss system, inventories can be determined on the basis of stocktaking at the year-end. In China, a perpetual inventory accounting system is mandatory, so that all inventory transactions must be recorded**.

Additionally, inventories must be valued at production cost; that is at the cost of materials plus all costs incurred during production, including labor, energy, premises and machinery. Consequently the set up and implementation of a production costing system for each product is a requirement of Chinese accounting; only in this way can products be valued according to the cost of production in inventories in a perpetual way.

1.5.3 Business implications for foreign investors

1.5.3.1 Mergers and Acquisitions (M&A) and Joint-Ventures

As a result of the differences that currently exist between Chinese GAAP and IFRS, financial reports in China do not always accurately reflect an enterprise's actual financial position or operating results according to international standards. In addition, the new accounting system is now compulsory for all publicly-listed companies and FIEs in China, but a high proportion of local firms (private, small- and medium-sized companies) are not yet affected by the new standards.

These current differences can cause particular problems if a foreign investor needs to ascertain the true worth of a domestic Chinese company that it might be interested in acquiring. Also, this even creates difficulties when trying to evaluate the true situation of one's own China-based subsidiaries.

The accounts of local companies are also often distorted on purpose and for tax evasion by under-reporting sales, and booking imaginary expenses.

1.5.3.2 Statutory compliance

Setting up a business and maintaining it in China involves far more bureaucracy than in Switzerland

a) Tax filing

It is the taxpayers' responsibility to file tax. The filing method varies depending on location, with some cities using electronic filing whilst others still require hand delivery.

There are 13 types of Chinese taxes that are applicable to FIEs, mostly consisting of taxes on income, transactions, and taxes levied by Customs.

Accounting reports of most enterprises are required to be officially filed monthly for tax purposes.

b) Audit requirements

All FIEs in China are required by law to be audited on an annual basis by a Certified Public Accountant (CPA). All audited accounts, balance sheets, income statements and other specified documents, such as foreign currency accounts and usage, statistic information, copies of company registrations documents, must be filed in multiple hard copies with seven relevant authorities by the end of April of the following year.

New requirements on reporting transactions with related parties are expected by end of 2005 to monitor transfer pricing.

All audited accounts must be prepared in accordance with Chinese GAAP.

Besides this, companies are also required to complete a separate annual foreign currency audit, summarizing all foreign currency transactions during the year. This is filed with the State Administration of Foreign Exchange (SAFE) by end of April, as well.[5]

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1.6 China's Banking and Currency System for Foreign Invested Enterprises

by Wang Tao, Senior Consultant of a European IT company in Shanghai with CH-ina

Despite having undergone significant changes in the last two decades and even though banks have gained more autonomy, **China's banking industry remains highly government-controlled. The renminbi (RMB), or Yuan, China's currency, is neither freely convertible nor floating in capital markets**.

Focusing particularly on the differences when compared with international systems, this section gives an overview of the structure of China's financial institutions, the services of foreign banks and the foreign exchange control regime.

1.6.1 Banking Industry Overview

1.6.1.1 Hierarchy

The central bank of China is the People's Bank of China (PBOC), which formulates and implements monetary policy. It oversees the State Administration of Foreign Exchange (SAFE) for setting foreign exchange policies.

China Banking Regulatory Commission (CBRC) was officially launched in April 2003 to take over the regulation of banks and other financial institutions from the PBOC, which remains in charge of monetary policy.

Currently China's banking system is made up of a network of state policy banks, state-owned commercial banks, joint stock commercial banks, private commercial banks and a range of provincial level financial institutions and leasing companies. The four major state-owned banks: the Bank of China; the Industrial and Commercial Bank of China; China Construction Bank and the Agricultural Bank of China, control an overwhelmingly dominant share of the banking sector, with over 70% of the sector's total assets and loans, and over 80% of its total deposits.[1]

The four major state-owned banks control 70% of the sector's total assets and loans, and over 80% of its total deposits

In terms of overseas banking institutions, out of the nearly 200 foreign banks operating in China, 116 had won approval to do RMB business by December 2004 [2].

1.6.1.2 Chinese banks compared with foreign banks

Foreign banks in China currently have a 2% share of China's banking market in terms of assets and loans, but they account for 40% of the country's international settlement business and 23% of foreign currency lending.

However, the activities of foreign banks in **China are still limited in order to protect domestic banks, a clear indication that domestic institutions are in no state to compete with the wide range of products and efficient services provided by foreign banks**. In contrast, the considerable competitive advantage of Chinese banks is their huge, all-pervasive domestic network.

Chinese banks cannot compete with the wide range of products and services of foreign financial institutions, yet they own a huge domestic network that is of much interest to foreign banks

For traditional Chinese banks, the biggest threat is the huge amount of non-performing loans (NPLs) on their books, estimated to be around 30% of the total number of outstanding loans in 2003 [3]. Yet recent evaluations show a less-critical proportion of around 20% of outstanding loans to be non-performing. Besides, Chinese bank public listings are well-received by the markets, creating additional liquidity. Foreign banks are also taking stakes in the State-owned banks, to gain credit with the central government and hoping to benefit from the local institutions' domestic networks — or to obtain a controlling stake in the long term.

All restrictions on foreign banks in terms of providing RMB and foreign currency deposit and loan services will be lifted by 2007, though asset management will remain possible only through joint ventures with Chinese banks.

However, foreign banks will still face regulatory barriers to entry, post-2006. These include: high working capital requirements of RMB100m per branch; an 8% capital adequacy ratio for RMB loans, calculated at branch level; foreign currency lending subject to the restriction of foreign exchange approval, and restrictions on the interest rates applicable to foreign exchange deposits [4].

Overall, the Chinese banks' Non Performing Loans (NPLs) situation is not considered critical by experts.

1.6.2 Foreign Bank RMB Services

At the moment, foreign banks can offer all types of foreign exchange services and RMB business to foreign-funded enterprises, Chinese enterprises and non-Chinese residents in designated area.

In order to engage in RMB business, foreign banks must be qualified and approved by the CBRC. In addition to this qualification, RMB services by foreign bank can only be conducted in regions where foreign financial institutions have already been permitted to offer RMB services. At this point in time, 18 cities have been opened up, including Shanghai, Shenzhen, Tianjin, Dalian, Beijing, Guangzhou, Zhuhai, Qingdao, Nanjing, Wuhan, Jinan, Fuzhou, Chengdu, Chongqing, Xiamen, Kunming, Xian and Shenyang.

Following WTO agreements, the CBRC will continue to open China's banking industry and remove the last restrictions (both geographical, and client, limits) on overseas banks' RMB businesses by the end of 2006 [5].

As a result, more banking products will become available to both Chinese and foreign companies in China, and furthermore, commercial lending principles will be increasingly applied by Chinese banks.

Interestingly, however, foreign banks currently observe more restrictive lending principles towards foreign companies than they do towards the local Chinese banks. Therefore, one may not expect the implementation of WTO agreements to generate additional competition in this respect, so that the local availability of financing for foreign SMEs in China will not improve (also see Chapter II, Preparing for China, Obtaining Financial Resources).

Implementation of WTO agreements will not improve local availability of financing for foreign SMEs in China

1.6.3 Foreign Exchange Controls

Foreign exchanges dealing in China are authorized and closely monitored by SAFE. Following December 1996 and the Asian financial crisis, China has introduced a strict system of foreign exchange control, mainly through mandatory registration of foreign exchange income and expenses, and an account categorization system.

1.6.3.1 Foreign Exchange Registration

A Foreign Invested Enterprise (FIE) shall — within 30 days of obtaining its business license — go through the procedure of foreign exchange registration, obtain an FIE Foreign Exchange Registration Certificate and a foreign exchange account IC card.

1.6.3.2 Control over Foreign Exchange Accounts

An FIE may open foreign currency accounts at an approved bank after going through the foreign exchange registration procedure. The major types of foreign exchange accounts are:

1.6.3.3 Foreign Exchange Capital Account

The receipts on this account are registered capital funds injected by the foreign investors of wholly-owned foreign enterprises (WOFE) or joint ventures (JV). The expenditure of operational expenses and investment expenses paid out of this account are directly examined and handled by the foreign exchange banks authorized by SAFE. **The total deposited amount in Foreign Exchange Capital Accounts cannot exceed the FIEs' registered capital funds**. If this is not the case, the excess amount in the account cannot be transferred out until a capital increase has been applied and approved by authorities.

1.6.3.4 Foreign Exchange Settlement Account

The receipts on this account are the current-account earnings of an enterprise, while the expenditures are the enterprise's operational and investment expenses. The ceiling amount on this type of account is set by SAFE by taking into consideration the business's actually invested capital and its operational needs. The bank may approve payments out of this account provided adequate supporting documents (such as contracts, customs clearance documents for example) are provided.

Dividends may be paid out of this account, provided corporate income tax has been paid and a corresponding Board resolution is also available.

From May 2004, all enterprises authorized to conduct foreign exchange current account transactions may retain foreign exchange revenues equivalent to 50% of their foreign exchange export earnings (up from 20%). The amount of foreign exchange in excess of the ceiling must be sold to specifically-appointed foreign exchange banks against RMB at the market rate.

1.6.3.5 Special Account for Loans and Repayments

The receipts on this account are foreign debts from outside of China, loans converted from foreign debts and foreign exchange loans borrowed from Chinese financial institutions within the borders of China, while the expenditures are expenses for purposes specified in the loan agreements: no additional permission by SAFE is required for payments made in accordance with the loan purpose. However, repayment of the loan principal and interests is subject to SAFE approval.

1.6.3.6 Special Provisional Accounts

Special provisional accounts can be opened by a legal person or a natural person from outside China. The incomes are funds in foreign exchange remitted by them into China to establish foreign-invested businesses. The expenditures are the set up costs and other relevant expenses and investment made while setting up foreign companies.

1.6.3.7 Annual Foreign Exchange Audit

FIEs shall entrust a qualified accounting firm to conduct an annual foreign exchange audit and to issue audit reports. The annual audit includes paid-in capital by investors, opening and using of the foreign exchange account, foreign exchange revenues, expenditure and balance of foreign exchange debts. **FIES must present their forex audit report annually to SAFE to renew their Foreign Exchange Registrations and continue operations**.

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1.7 RMB Exchange Rate Reform and RMB Revaluation

by Wang Tao, MBA, CFO with CH-ina

Revaluation of the RMB against the USD of more than a few percent per year in the coming years is unlikely

The People's Bank of China (PBOC), China's central bank, announced that with approval from the State Council, starting on July 21, 2005, China would implement a regulated, managed, floating exchange rate system based on market supply and demand. The rate is determined by a basket of currencies whose exact weightings are not known, yet heavier weight is given to USD, Euro, Yen and South Korean Won [1].

According to the PBOC, the general objective of the reform is to keep the basic stability of the RMB exchange rate to a rational and balanced level [2].

At the time of printing, with respect to the USD, the RMB had increased in value by about 3.1% from the date of introduction of this exchange rate reform.

Further revaluation outside of this new managed floating rate mechanism is unlikely in the short term. Within the current exchange mechanism, and depending on the USD movement against other currencies, the RMB may continue to rise against the dollar in the mid-term. Yet, a revaluation of more than a few percent per year in the coming years is unlikely in the opinions of economists (Wang Jianmao, Economist at CEIBS), banking and business circles [3].

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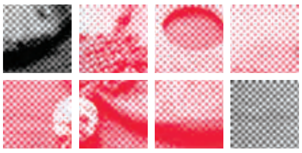

2 Legal entities for FDI, taxes and transfer pricing

2.1 Summary of Major PRC taxes

2.1.1 Value Added Tax ("VAT")

VAT currently applies to all individuals and enterprises engaged in supplying goods or rendering specified services or in importing goods (not services). Provision of services that are not covered by VAT may be subject to Business Tax (see below).

The standard VAT rate is 17%, except in relation to agricultural supplies, water, gas and central heating where a lower rate of 13% applies. VAT rate for small-sized enterprises is 6%.

2.1.2 Business Tax

Business Tax is a local tax on business activities, including services not covered by VAT, the transfer of immovable property as well as intangible property within China. The rates of tax vary from 3% to 8%, except for the entertainment business where rates may be as high as 20%. No credit is allowed of VAT against Business Tax.

A Business Tax of 5% will also be imposed on rep offices of foreign enterprises in certain industries such as law firms, accounting firms and tax consulting firms etc.

2.1.3 Foreign Enterprise Income Tax

Foreign Invested Enterprises (FIE) and domestic enterprises are currently still taxed under two different regimes. FIEs and foreign enterprises are subject to the foreign enterprise income tax, the rate of which is lower than the respective rates for domestic enterprises. However, there have been ongoing discussions for both regimes to be unified in the future.

Enterprise income tax adopts the classical system whereby profits distributed by a company in the form of dividends will then also be subject to individual income tax in the hands of individual shareholders.

Income derived in the PRC (e.g. dividend, interests or royalties) by a foreign company with domicile outside the PRC maybe subject to Enterprise Income Tax. Reductions may apply in case of bilateral treaties (from 20% to 5% or 10%).

2.1.4 Individual Income Tax

There is no system of personal deductions, though a standard monthly deduction is allowed for some income (such as employment income) and specified deductions may be made for some types of income. Each individual is considered to be a separate taxable person, and there is no aggregation of the income of, or joint taxation of, spouses.

Income is taxed at different rates depending on the nature of the income. Whereas wage income, business income, and management fees are subject to progressive taxation, some other types of income such as remuneration for professional services and rent, royalties, interest and dividends, are taxed at a flat rate.

With regard to the employment income, residents of the countries or regions having concluded bilateral treaties with China, will generally only be taxed in China for China-related income, as long as they stay in China for less than 183 days and the income is not paid by a permanent establishment (PE) of a foreign enterprise in China.

2.1.5 Main Other Taxes

Consumption tax, agriculture tax, stamp duty, deed tax, land appreciation tax, urban property tax, vehicle and vessel use tax, slaughter tax, tax on tonnages of ships, vehicle purchase tax and resource tax.

2.1.6 Authorities

The State Administration of Taxation (SAT) is the Ministry of Finance's department which implements the tax law. It is situated in Beijing and has many branch offices throughout the country. In addition to local SATs, there are local tax authorities responsible for collecting and managing local taxes.

With regard to the major tax categories, SAT is primarily responsible for the levy of corporate income tax, VAT and consumption tax whereas local tax administrations are mainly responsible for the levy of business tax and individual income tax. However, for the sake of efficiency, they may also collect each other's taxes upon mutual request.

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2.2 Foreign Investment and Corporate Tax Rates

by Rainer Hausmann and Kerstin Heidrich, Ernst & Young

It has long been the strategy of Chinese Government to provide foreign investors with preferential corporate income tax treatment in order to attract foreign direct investment (FDI). In 2004 FDI in the Chinese economy was USD 54.9 billion – the highest level on record (OECD: Trends and recent developments in foreign direct investment, June 2005).

2.2.1 Forms of Foreign Investment

2.2.1.1 Foreign Investment Enterprises

In general, Foreign Investment Enterprises (FIEs) must contribute to the development of China's economy and promote exports. FIEs may take the form of Sino-foreign equity joint ventures, cooperative or contractual joint ventures, wholly foreign-owned enterprises, holding companies and foreign investment companies limited by shares. FIEs may hire Chinese employees directly, without the use of government employment agencies.

- Equity Joint Ventures
  An equity joint venture (EJV) must be formed as a limited liability company and have the status of a legal entity. Parties to the joint venture may include Chinese corporations, enterprises or other entities, and one or more foreign companies, enterprises or individuals. Under the Law on Joint Ventures, joint ventures must promote the development of China's economy and meet certain requirements with regard to technological equipment and scientific management, export-orientation and foreign-currency income or the training of technical and managerial personnel.
  Parties share profits and bear risks and losses in proportion to their equity contributions. The most common contributions from Chinese partners are land use rights, labor, factory buildings and raw materials. A Chinese partner to the joint venture can greatly assist foreign investors in interacting with government officials, accessing the labor market and material supply sources and, if appropriate, accessing the domestic market.
  Cooperative Joint Ventures

Cooperative joint ventures (CJVs) are based on contracts between venture partners. CJVs are formed to develop projects that have a limited duration and a specific objective, such as the construction of a building, hotel or factory. The venture must take the form of a limited liability company and have the status of a legal entity, unless the cooperative contract stipulates otherwise.

In contrast to EJVs, CJVs offer greater flexibility in structuring investment contributions because they are governed according to the provisions of the contract entered into by the partners. In addition, the partners may determine the method and timing of profit distributions upon their specific needs. The approval and registration process for a CJV is similar to that of an EJV.

- Wholly Foreign-Owned Enterprises
  More than 65% of newly approved foreign enterprises in the PRC take the form of wholly foreign-owned enterprises (WFOEs). Generally, a WFOE is formed as a limited liability company, but may be established as another form of entity upon government approval. Foreign investors may transfer profits earned from the enterprise or other income abroad. Similar to EJVs, WFOEs must promote the development of China's economy.
- Chinese Holding Companies
  In 1995, the government announced interim provisions on the setting up of foreign-backed investment companies, which permit foreign investors to form holding companies in China (CHCs), subject to the approval of the Ministry of Commerce (MOC). The law aims to attract foreign investors with advanced technology and management expertise to China. A CHC may be a wholly foreign-owned or joint venture investment vehicle that groups multiple investments together in China. CHCs must take the form of limited liability companies with a minimum registered capital amount of USD 30 million. Contributions must be made in cash, and foreign as well as Chinese investors in CHCs must meet certain standards of creditworthiness.
  Typical functions and activities of CHCs are the support of lower-tier entities, the centralization of distributing and sourcing functions on a cost-sharing basis, the provision of funding and currency swap services at reduced tax rates or the redirection of dividends from subsidiaries utilizing tax refunds.
- Foreign Investment Companies Limited by Shares
  Chinese and foreign investors may establish a company limited by shares. In addition, FIEs, particularly production enterprises that use advanced technologies, may be transformed into foreign investment companies limited by shares and the shares may be listed both in China and overseas.

2.2.1.2 Foreign Enterprises and Other Arrangements

Foreign enterprises (FEs) are forms of foreign companies' activities and operations other than FIEs. These activities and operations include representative offices, contracted projects and foreign companies receiving income and payments from Chinese sources other than contractual agreements.

Other types of business arrangements include leasing and licensing arrangements, compensation trade arrangements, counter-trade arrangements, processing and assembly agreements, and direct sales. In general, only certain foreign business entities may establish representative or branch offices.

- Representative Offices
  Foreign companies may establish representative offices in China under limited conditions. Representative offices may only engage in indirect operating activities, including liaison work, consulting, market research, general information gathering, and sourcing and procurement of products and materials. Representative offices may not conclude or direct product sales. In addition, a representative office may not employ local Chinese nationals in its own name. The office must use employment agencies.
  To establish a representative office, a foreign company must have a local Chinese organization sponsor its application and must complete a formal registration process. Currently, most foreign companies are not permitted to establish branch offices in China.
- Branch Offices
  Currently, only FIEs, foreign banks, foreign insurance companies and foreign law practices may establish branch-

es in China with the approval of the relevant authorities.

2.2.2 Taxes on Corporate Income and Gains

2.2.2.1 Corporate Income Tax

FIEs and FEs are subject to the PRC's income tax caw on enterprises with foreign investment and foreign enterprises, which is levied by the central government. In addition, local authorities are entitled to levy a surcharge and collect certain registration and license fees. A FIE is subject to tax on its worldwide income. However, a foreign tax credit is allowed for income taxes paid to other countries by branches of the FIE, limited to the PRC income tax payable on the same income. If CJVs are not legal entities, the parties to the joint ventures may elect to be taxed separately on their share of the income received or, with the approval of the local tax bureau, taxed as a single entity.

FEs are subject to tax only on their income from PRC sources. The taxation of FEs depends on whether the enterprise has an establishment in China. FEs with establishments in China are subject to tax on all income derived from the PRC; however, those without establishments in the PRC are subject only to withholding tax on income from PRC sources.

The term "establishment" is broadly defined to include the following: a place of management; a branch; an office; a factory; a workshop; a mine or an oil and gas well or any other place of extraction of natural resources; a building site; a construction, assembly, installation or exploration project; a place for the provision of labor services; and business agents.

2.2.2.2 Rates of Corporate Tax

As a basic principle, **FIEs and FEs with establishments in China are taxed at an effective rate of 33% (national tax rate of 30% plus local tax rate of 3%). However, the Chinese government provides a wide set of possibilities allowing foreign-backed companies to profit from taxation at reduced rates.**

A reduced rate of 15% applies to FIEs and FEs with establishments in China located in Special Economic Zones (SEZs), which are in Shenzhen (including Shekou), Zhuhai, Shantou in Guangdong Province, Xiamen in Fujian Province and Hainan Province. The reduced rate of 15% also applies to FIEs engaged in production or manufacturing activities located within the Pudong Development Zone in Shanghai and within the Economic and Technology Development Zones of the 14 Open Cities, which are Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangdao, Shanghai, Tianjin, Wenzhou, Yantai and Zhanjiang. FIEs engaged in infrastructure projects, including energy, transportation and port development, are also taxed at the reduced rate of 15%.

FIEs engaged in production and manufacturing activities located within the Coastal Open Economic Regions (Liaodong Peninsula, Shandong Peninsula, Changjiang and Pearl River Deltas, and Southern Fujian, including Zhangzhou and Quanzhou Delta Areas) and within the 14 open cities, provincial capitals and Changjiang cities, are taxed at a reduced rate of 24%. FIEs engaged in production and manufacturing activities in Beijing and Chongqing are also taxed at a reduced rate of 24%.

2.2.2.3 Capital Gains and Losses

Capital gains and losses are subject to the same treatment as other taxable income. Capital gains realized by foreign investors who dispose of an interest in a FIE are subject to a 10% withholding tax, even if the gain is realized outside the PRC.

However, certain double tax treaties including the Swiss Chinese Double Tax Treaty provide for an exemption from withholding tax on capital gains.

2.2.3 Tax Incentives

In addition to the abovementioned reduced rates applicable for FIEs and FEs located in SEZs or Open Economic Regions, foreign-owned companies may request tax incentives comprising tax holidays as well as significant reductions in the applicable tax rates which are granted subject to certain conditions.

2.2.3.1 Tax Holidays

The following enterprises may qualify for tax holidays:

- FIEs engaged in production and manufacturing activities with an operating period of ten years or more; FIEs engaged in production and manufacturing activities in SEZs, the Pudong Development Zone, and economic and technology development zones; Export-oriented and technologically advanced FIEs; FIEs established in the designated Midwestern regions to carry on an encouraged project; and Infrastructure projects in SEZs and in the Pudong Development Zone scheduled to run for 15 years or more.
  Moreover, FIE's will be granted a new tax holiday for additional equity investments (known as "registered capital" in China) invested by their owners, provided that the additional registered capital satisfies one of the following conditions:
- The additional registered capital is not less than USD 60 million; or The additional registered capital is not less than USD 15 million and, at the same time, exceeds the FIE's original registered capital by at least 50%.

Nonetheless, new tax holiday benefits will only be applied to profits generated from the additional registered capital. In this respect, it would be recommendable to agree in advance with the governing tax authorities on a profit allocation methodology acceptable for both parties.

2.2.3.2 Start-Up Tax Benefits

FIEs engaged in production and manufacturing activities are granted favorable tax treatment during their start-up period. These entities are granted a two-year tax exemption and a three-year 50% tax rate reduction beginning from the venture's first profit-making year. In addition to the initial five-year tax holiday, China also grants special tax concessions for certain priority industries, low-profit operations and projects in remote or economically depressed areas.

2.2.3.3 Reinvestment Tax Incentives

Foreign investors reinvesting their share of profits in the same investment venture or in a newly created foreign investment venture for a period of five years or longer are entitled to a 40% refund of the tax paid on the amount reinvested. The tax refund increases to 100% if the reinvestment is in an export-oriented or technologically advanced enterprise.

2.2.3.4 Export-Oriented Enterprises and Technologically Advanced Enterprises

A FIE that exports 70% or more of its total output value for any year may enjoy a further 50% tax reduction for that year after the end of the five-year tax holiday. Enterprises that are already subject to a reduced tax rate of 15% and that are eligible for the reduction applicable to export-oriented enterprises are subject to corporate income tax at a rate of 10%.

If a FIE qualifies as a "technologically advanced enterprise" after the tax holiday period, it is granted a three-year extension of the 50% tax reduction.

2.2.3.5 High-Technology Development Zones

China has established more than 110 high-technology industrial development zones to promote the development of technology. Enterprises in such development zones enjoy a reduced tax rate of 15%, a tax holiday for the initial period and other preferential treatment.

2.2.4 Profit Repatriation to the Swiss Headquarters

Based on Chinese unilateral tax law, withholding tax of 10% may be levied on dividend distributions to a foreign parent company. However, China has not yet introduced such withholding tax.

In order to avoid a later restructuring and since the Double Tax Treaty between Switzerland and the PRC does not provide for a lower withholding tax rate on dividend payments to shareholders holding a certain minimum quota of the distributing company's capital, a Swiss based multinational group may consider a structuring of its investment into China by, for example, interposing a sub-holding company for its Asian activities in Hong Kong which would levy neither income tax on income generated outside its territory nor withholding tax on dividend distributions to a foreign shareholder.

The cost and potential benefits of such structuring, however, will have to be analyzed on a case by case basis.

Contributed by Ernst & Young
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2.3 The Importance of Chops

by John Eastwood and Nathan Kaiser, Wenger & Vieli

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For centuries, the Chinese have used carved stone and wooden seals (often called "chops") for individuals, companies and officials as a means of authenticating documents. Anyone interested in the imperial artwork of China can see a wide variety of red-ink chop stamps used by past emperors to indicate the ownership and approval of various paintings. Despite the popularity of distinctive handwritten signatures in Western countries, the preparation of documents in the Chinese world led to the chop stamp as a different solution. Through to the present day, these chops are a regular part of everyday dealings in China.

While chop stamps were once hand-carved artworks with great individuality, in the modern era most chop-carving shops use computerized equipment that allows a wide selection of calligraphic styles done in a very standardized way. This standardization has, to some extent, reduced the irregularities of hand-carved chops that made them useful as security devices, but that has generally not stopped companies from using them in their daily business activities despite the growth of popularity of e-signatures and other authentication technologies. **A typical contract will not only bear chop stamps at the signature line areas, but often times there will be stamps on each page or, if a very large contract, spread along the edges of sheets so as to indicate authenticity of all the pages**.

2.3.1 Different Chops

In this course of a company's business dealings, a company may maintain a small set of chops or, if necessary, may choose to expand that set. A small set may only include the main company chop and a "representative person" chop. The company chop is usually a larger square stamp featuring the company name in Chinese and sometimes, if a foreign company, a band bearing the romanized name of the company. The representative-person chop is usually smaller and represents the signature of a high-level person with the authority to represent the company in its transactions, a Chairman or President for example.

Some companies limit the scope of authority for departmental chop stamps, setting aside some stamps to be used exclusively for smaller contract signings, for human-resources matters, or other issues that might not necessary require getting the main chops out. Further, companies may sometimes maintain a set of chops with their legal counsel to ensure that corporate transactions move more quickly or for litigation – such chops normally are under strict power-of-attorney restrictions to prevent use beyond the direct written instructions of the company.

2.3.2 Chop Handling by Companies

Because documents that bear company chops will normally be treated as having been signed with the full authority of the company, it is absolutely essential that the chops are kept securely enough to protect against possible misuse yet flexible enough to allow the company to function in everyday commerce. The possession of chops should be set out and kept track of carefully, as well as the lines of authority for using the chops. Safeguards should be in place to ensure the return of chops prior to the departure of personnel. Many companies provide clearly for the securing of key chops stamps at the close of each business day.

Contributed by Wenger & Vieli
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2.4 Establishment of Trading, Distribution, Retail and Franchising Operations in China

by Jonathan Selvadoray and Ji Yuan

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This contribution is for general information purposes only and cannot replace the advice of competent legal counsel.

The Measures for the Administration of Foreign Investment in the Commercial Sector (the "Measures") promulgated by the Ministry of Commerce ("MOFCOM") on 16 April 2004 and entered into effect on 11 December 2004 has considerably facilitated the access by foreign investors to the Chinese distribution market creating new perspectives of development.

The Measures have introduced important changes to the previous legislative framework and offer broader possibilities to foreign investors:

- It is not mandatory to have a Chinese partner anymore since it is now possible to set up a Wholly foreign owned enterprise ("WFOE") conducting the said activities;
- The minimum capital requirements have been considerably reduced: the minimum capital is now lowered to RMB 500'000 for wholesale and RMB 300'000 for retail activities whereas previously RMB 80 millions or RMB 50 millions were respectively required;
- Geographical restrictions have been abolished; and
- Procedure for the approval of the company has been simplified: the measures provide that the MOFCOM may delegate to local provinces the authority to approve.

Since the beginning of this year until May 2005, the first statistics shows that out of 292 received applications, 222 approvals have been granted.

Though the Measures have to a great extend paved the way for foreign investors to engage in distribution in China, investors have to keep in mind several practical recommendations.

The following developments will aim at providing some general guidelines for Foreign Invested Enterprises ("FIE") to engage in distribution in China together with a Chinese partner (in the form of a JV) or alone (in the form of a WFOE).

2.4.1 Wholesale

2.4.1.1 Minimum registered capital and total investment

The actual minimum capital requirement is RMB 500'000 for companies engaging in wholesale.

However it is highly recommended for investors to work on their business plan and to assess the working capital needed until break even before deciding on the amount of registered capital. Chinese law foresees a fixed debt quota for FIE subsidiaries. The parent company cannot simply channel money on the current account of its subsidiary whenever needed. The debt quota equals the delta between the total investment of the company and the registered capital. The total investment amount shall be calculated as follows:

- for subsidiaries with a registered capital above USD 2.1 million, the total investment amount shall be twice the registered capital; and
- for subsidiaries with a registered capital below USD 2.1 million, the total investment amount shall be up to 10/7 of the registered capital.

It is worth mentioning that any increase of registered capital follows the above rules. An increase of the registered capital below USD 2.1 million would be subject to the 10/7 rule even if the aggregate registered capital after the capital increase would eventually exceed USD 2.1 million.

Once the debt quota has been reached, the only way to finance the subsidiary is to increase the registered capital and indirectly also increase the debt quota. The only other way would be to apply at a local PRC bank for a RMB loan and provide a local guarantee. The guarantee compliance is particularly difficult for new comers who did not yet have the time to build a solid track record.

Since 1 April 2005, the State Administration of Foreign Exchange has adopted a new notice, called "Notice on Checking and Ratifying the Quota for 2005 for Short Term Foreign Debts Granted by Foreign Bank In China" (the "Notice"). According to the Notice, banks, whether domestic or foreign, will not grant loan secured with foreign guarantees to foreign invested companies, whose loans and authorized credits exceed the delta between the total investment of the Company and its registered capital. The Notice has caused many subsidiaries to have to increase their registered capital to secure their financing capabilities.

Further, investors, among them especially small and medium sized enterprises (SME) have also to be aware of the conditions for applying the VAT General Tax Payer Status. Without this status, the wholesale company will not be able to deduct the VAT paid to its supplier and will have to invoice its clients at the rate of 4% instead of the general applicable rate of 17%. This shall again create at the client's end further disadvantages. According to tax regulation, the capital shall reach at least RMB 5 million in order to get this status from the establishment date of the company. Nevertheless some local authorities agree to grant a temporary one-year status subject to a registered capital of at least RMB 1 to 2 millions as long as the investor can evidence firm orders for at least RMB 1.8 million and evidence at least twenty employees under contract. This temporary status can be cancelled at the start of the second year if the investor fails to reach the minimum threshold.

Concerning VAT refund, exporting companies shall pay attention to the fact that, in practice, the procedure may take long (up to 18 months) and thus create important needs for capital. Consequently many foreign companies still prefer to entrust a Chinese export agent rather than directly exporting themselves.

2.4.1.2 Business scope

Foreign investors who want to engage in wholesaling may engage in the following activities: wholesale of goods, commission agency, import and export goods and other relevant accessory businesses. Further, wholesaling is defined as selling goods to retailers, to industrial, commercial and institutional customers or to other wholesalers and providing relevant attached services.

2.4.1.3 Approval procedure

The investors must submit an application for approval to the provincial authorities, i.e. the local Foreign Economic Relation and Trade Commission ("COFTEC") and Foreign Investment Commission. After a preliminary examination, the provincial authorities transfer the application file to the central authorities in Beijing. According to the Measures, the MOFCOM shall deliver its decision within three months from the date of receiving the application documents.

The estimated period for the approval of a wholesale FIE shall be nearly six months. However, the procedure may be accelerated in certain cases. We have already experienced an approval of a wholesale WFOE within one month on what is called the "fast track" procedure. Note that the approval and registration date does not mean that the subsidiary is operational. Other post registration procedures with the tax, custom and other authorities are necessary to allow the subsidiary to invoice (with VAT), import and export products for instance.

Documents to be provided for the application:

- application letter
- joint venture contract (if any)
- articles of association
- feasibility study report
- bank reference letter concerning the investors
- investor's audit reports relating to the most recent year
- import-export goods catalogue (if applicable)
- list of the directors
- certificate relating to the land use right or lease agreement and title of property which shall correspond to the legal address of the future entity

In practice, some local districts propose to provide FIE with "mail box addresses" in order to attract foreign investors since the registration location of the company will also determine its tax registration.

Once the company is approved by the MOFCOM, it shall be registered within one month with the Administration of

Industry and Commerce (AIC), which will deliver the business license. At this stage, the AIC exercises a control especially on the lease agreement for the premises and the title of property of the landlord.

2.4.1.4 FIE Manufacturing companies: Expansion of business scope to wholesale

A notice dated April 2005 (The Circular on relevant Issues Concerning the Expansion of the Business Scope of Foreign invested Non-commercial Enterprises to Include Distribution Operations) made clear the conditions for the manufacturing JVs and WFOEs to expand their business scope to a distribution activity without loosing their status of manufacturing companies.

According to this notice, production companies may engage in distribution activities provided that this activity does not represent more than 30% of its turnover. Such consideration is closely linked to the tax incentives granted to manufacturing companies that can enjoy the 2 + 3 rule (2 years of tax exemption and 3 years of 50% tax off) provided they operate for at least 10 years.

Before the adoption of this notice, local authorities were reluctant to approve such expanding of the business scope of manufacturing FIEs. According to statistics until May 2005, upon 59 applications, 21 have been approved.

2.4.2 Retail

Since, over the last decade, the urban income level in China has grown at an astonishing average annual rate of nearly 10%, many foreign investors who have developed successful retail models in Switzerland and Europe are more and more willing to try to duplicate their success story in China. This contribution shall not comment too much on the commercial feasibility of such endeavors but one has to take into account the PRC legal framework at an early stage already. One of the common misconceptions is that the retail sector is only economically viable for large multinational groups such as Carrefour, Wal-Mart or Metro to name three of the main foreign invested retailers in China.

2.4.2.1 Business scope

Retailing covers the following activities: retail of commodities, import of self-managed goods, purchase of domestic products for export and other relevant accessory businesses. According to the Measures, retailing is selling, from a fixed place or via television, telephone, mail order, Internet and automats, goods for consumption and use of individuals or groups and offering related services.

2.4.2.2 Minimum registered capital

Foreign investors may set up a WFOE engaging in retail with a minimum capital of RMB 300’000. However, the same remarks as for wholesale apply as far as working capital requirements and VAT General Tax Payer Status are concerned (see above chapter 1.1.).

2.4.2.3 Approval procedure

For retail, according to the Measures, an approval by the provincial level COFTEC and the Foreign Investment Commission is sufficient in the following cases:

- 3 stores in each Province or Municipality and 30 stores in whole China, if the surface of the stores is between 300 to 3,000 m^2;
- 30 stores in each Province or Municipality and 300 stores in whole China, if the surface of the stores is under 300 m^2.

The Ministry of Commerce in Beijing must approve any other project. As for wholesale, the procedure will then consist in:

- An application with the local authorities; and
- A transfer of the application to the central authorities in Beijing. The central authorities shall approve or reject the

application within three months from the submission.

In practice, foreign investors shall wait nearly two months for an approval at the local level and add at least one additional month in case of approval at the central level.

After obtaining the approval by the COFTEC, the WFOE shall then apply for the registration of the stores with the Administration of Industry and Commerce (AIC) in each district where the stores will be established.

The Measures also provide that in case the FIE intends to open stores in different provinces, the "opinions" of the local authorities where the intended store will be located is necessary. So far, the regulation does not specify whether this "opinion" means a mere registration or approval by the local authorities.

Moreover, retailers intending to open new stores shall conform to relevant provisions on urban development and urban commercial development plans.

2.4.2.4 Documents to be provided

Documents to be provided are quite the same as those required for wholesale activities, except that the FIE shall provide a certificate of land use or lease agreement corresponding to each store it intends to operate.

2.4.3 Franchising

The Measures for the Administration of Commercial Franchise Operations, promulgated on 30 December 2004 and entered into effect on 1 February 2005 define "commercial franchise operation" as:

"an arrangement whereby a franchiser, by contract, authorizes a franchisee to use its operational resources (trademark, trade name, business system, etc.), and where the franchisee conducts business according to the franchiser's standardized business system and pays franchise fees in accordance with a franchise agreement".

The new regulation has clearly described conditions to be satisfied by the franchiser, the rights and obligations of each party to a franchising contract generally in a more protective way for the franchisee.

Amongst these conditions, the Measures provide that a franchiser shall have at least two directly operated stores that it has operated for more than one year or directly-operated stores established by its subsidiaries or holding company within the territory of China. In other words, it means that a newly established WFOE may not grant a franchise until it has operated at least two stores in China during one year, directly by itself or through a holding company or the mother company. Hence the franchising right shall be granted through an expansion of the business scope. Investors shall also keep in mind that franchising implies being the legal right holder of one or several trademark(s) duly registered in China.

2.4.4 Distribution rights granted to foreign companies in Free Trade Zone

The Measures laid down the possibilities for Trading Companies in Free Trade Zone to distribute in China. Before the adoption of the Measures, they operated through representative offices outside the zone and had to go through an agent to import and export goods. The new regulation on distribution and a Notice relating to Relevant Issues Concerning the Administration of Bonded Zones and Bonded Logistic Parks issued by MOFCOM and the General Customs on 13 July 2005 provide that trading companies may now apply for import/ export right, wholesale and retail right inside China. In other words, according to the new regulation, they could proceed to custom tax clearance by themselves. However, this regulation does not ascertain the conditions for the trading company to issue VAT invoices.

2.4.5 Conclusion

Many Swiss and European wholesale and retail companies are eager to duplicate their success story in China. The PRC government has laid down the foundation of the legal framework of wholesale, retail and franchising activities in China late last year and throughout 2005. Detailed provisions are still missing but to the exception of, in certain cases, time-consuming approval procedures at the central level (MOFCOM in Beijing), foreigners are now able to establish in reasonable time and conditions their own wholesale/retail structure. However, daily operations of such entities as well as tax considerations still require thorough legal analysis and anticipation.

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2.5 Transfer Pricing among Related Companies

by Urs Bruegger, Partner, International Tax Services, Zurich and Monika Robustelli, Manager, International Tax Services, Peking / Zurich, Ernst & Young

2.5.1 Introduction

With accession to the WTO, **China has been progressively liberalizing its market and now offers tremendous business opportunities for multinational enterprises**.Besides manufacturing, more and more business functions such as trading and R&D services are moving into China. As a result, the volume of intercompany transactions is growing rapidly and the nature of these transactions is becoming more complicated. To this end, the issue of various circulars by the State Administration of Taxation (SAT) in the last few years indicates that the Chinese tax authorities are determined to take a more centralized and stringent approach to enforcing transfer pricing laws.

2.5.2 Regulatory Basis of Transfer Pricing in China

The development of Chinese transfer pricing legislation can be traced back to 1991. Both Article 13 of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (Foreign EITL) and Chapter 4 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (Foreign DRR) provide general guidance on intercompany transactions among related (or associated) parties.

In addition to the law, the SAT has released transfer pricing regulations that cover many aspects of transfer pricing compliance and enforcement. In 1998, the SAT released Guoshuifa [1998] No. 59 Taxation Management Regulations for Business Transactions between Associated Enterprises (Circular 59). In 2004, SAT issued Guoshuifa [2004] No. 143, Amended Taxation Management Regulations for Business Transactions between Associated Enterprises (Circular 143), which refines and supplements Circular 59. Circular 143 and Circular 59, together with the Foreign EITL and DRR, form the basis of the current Chinese transfer pricing regulatory regime.

Circular 143 was unexpected, considering that the SAT and the Ministry of Finance are drafting a new unifying corporate tax law.

2.5.3 Arm's Length Standard

For tax purposes, transfer prices must be determined according to the methods and procedures defined under Chinese transfer pricing laws and regulations. The main transfer pricing principle under relevant laws and regulations is the "arm's length" principle. The arm's length principle is met if the terms of an intercompany transaction are comparable to those of a similar transaction between unrelated parties.

2.5.4 Related Parties

Similar to transfer pricing rules in other jurisdictions, Chinese transfer pricing laws and regulations determine that enterprises are related when [1]:

- one enterprise holds, directly or indirectly, 25% or more of another enterprise's shares;
- a third party owns or controls, directly or indirectly, 25% or more of the shareholdings in both enterprises;
- debts owed by one enterprise to another enterprise exceed 50% of the enterprise's own capital, or 10% of the total debts owed by one enterprise are guaranteed by another enterprise;
- more than half of one enterprise's senior management (including the board of directors and the general manager), or at least one of the executive members of the board of directors are appointed by another enterprise;
  one enterprise's normal production and operation activities rely on the provision of a right by another enterprise (including industrial property rights or patented technology);
- the purchase of raw materials or spare parts by one enterprise is under the control of or has to be supplied by another enterprise (such control includes control over prices and terms of transactions);
- one enterprise relies on another enterprise for the production or sale of its products;
- one enterprise has actual control over the other enterprise's production, operation and trading activities through relationships associated with other interests (including family relationships).

In summary, compared with the OECD definition of related parties, the Chinese definition is wider in scope. The OECD suggests that enterprises are related when there is more than 50% direct or indirect ownership. In contrast, China uses only 25% or more direct or indirect ownership. More importantly, under the Chinese rules, two enterprises can be related by reason of effective control even when there is no actual legal owner relationship. Hence, **enterprises can be more easily treated as related and fall into the transfer pricing regime in China**.

2.5.5 Transfer Pricing Methods

The transfer pricing laws and regulations prescribe various methods that should be used by the Chinese tax authorities when assessing the arm's length character of intragroup transactions. Operational details for these methods are provided in Circular 143. Essentially, the methods prescribed in Circular 143 are largely consistent with those in the OECD guidelines. Circular 143 specifically referenced the following:

- The comparable uncontrolled price (CUP) method
- The resale price (RP) method
- The cost plus (CP) method
- Other appropriate methods. If the three methods mentioned above are not appropriate, other reasonable methods such as transactional net margin method, profit split method and net profit method may be used.

SAT rules do not give priority to any of the methods. However, the CUP, resale, and cost plus methods are regarded as more traditional methods by tax officials and are therefore preferred by local tax examiners. Other methods may be considered when these three methods are not feasible. The SAT realizes that the three traditional methods require extensive analysis of hard-to-find comparables and have been encouraging local tax authorities to try profit splits and other methods. **Companies should be particularly attentive to how the tax authorities use the profit split method**. In some local audits, tax officials suggested using a profit split to attribute additional profits to the Chinese entities that found themselves in a loss or low-profit position although the group companies were profitable overall.

2.5.6 Documentation

As a big step in the development of the Chinese transfer pricing regulations, **the issuance of formal contemporaneous transfer pricing documentation requirements is expected before the end of 2005**. For the time being, although relevant Chinese regulations do not yet specifically require taxpayers to maintain contemporaneous documentation, the transfer pricing rules effectively impose a contemporaneous requirement since taxpayers have only 60 days to respond to tax officials' requests for information, although the deadline may be extended for another 30 days upon approval. Under Circular 143, taxpayers are required to provide upon request:

- facts relating to transactions with affiliated enterprises and third parties, including sales and purchases, financing, provision of labor services, assignments of tangible and intangible assets, and provision of rights for tangible and intangible assets;
- facts on elements that may contribute to the prices, such as the amount, place, form, and payment method of the transaction; and
- other relevant materials for determining the transactional prices or basis for charges.

In addition to the above, under Foreign DRR, foreign capital enterprises are required to provide the local tax authorities with details of their transactions with associated enterprises. Two types of forms must be used by Foreign Investment Enterprises (FIEs) and Foreign Enterprises (FEs) to disclose their related-party transactions. Form A is for enterprises with only one type of business transactions with associated enterprises while form B is for enterprises with various types of business transactions with associated enterprises. In effect since January 1, 2000, these two forms have been incorporated into the newly designed enterprise income tax return. Transactions between FIEs and FEs and their associated enterprises are now reported in Appendices 13A and 13B of the enterprise income tax return.

2.5.7 Transfer Pricing Audit

The Chinese tax authorities see transfer pricing as the most common form of tax evasion by foreign companies. The trend toward greater enforcement of transfer pricing regulations has been confirmed by the issuance of several circulars including the latest SAT notice in March 2005 concerning anti-tax avoidance [Guo Shui Han (2005) No. 239].

In addition, Circular 143, which has just recently been issued, has defined the circumstances under which high-risk taxpayers can be identified for transfer pricing audits. In recent years, local tax authorities in major cities have set up transfer pricing specialist teams to collect taxes resulting from transfer pricing adjustments. Tax authorities examine the information about related-party transactions contained in Appendices 13A and 13B and in financial statements and typically perform an analytical review (e.g., ratio analysis) to identify audit targets.

According to Circular 143, enterprises selected for audit and inspection will primarily be those: whose production and operation decisions are controlled by associated enterprises;

- which have significant amounts of transactions with associated enterprises;
- which report losses for extended periods (for more than two consecutive years);
- which report marginal profits or marginal losses but continuously expand the scale of their operations;
- with fluctuating profits (for example, enterprises making profits or losses every other year);
- having transactions with associated enterprises established in tax havens;
- with profit margins that are lower than those of enterprises in the same industry and region;
- with lower profit margins than other enterprises in a group of companies (i.e., enterprises with lower profit margins than their associated enterprises);
- who pay unjustifiable fees to associated enterprises.

The focus for transfer pricing audits is mainly on foreign owned companies. Recently though, there were also cases of audits of local Chinese companies regarding their pricing of intercompany transactions between different provinces in China.

Companies chosen for tax audit are subject to a "desk top audit" based on financial and business records supplied by the taxpayers and to a "field audit" carried out at the taxpayers' business premises. If the audit reveals non-arm's-length pricing practices between related parties, the tax authorities will write to or meet with the taxpayer seeking representations before formally issuing a transfer pricing adjustment notice. In principle, the transfer pricing adjustment is prospective, but retroactive adjustments of up to ten years are also permitted. Taxpayers that dispute the transfer pricing adjustments may apply for administrative review by a higher-level tax authority. Taxpayers who are not satisfied with the result of the administrative review may petition the People's Court.

Audited companies are put on a "watch list" and their tax compliance, investment structure, business operations and related parties transactions will be under scrutiny for the following three years.

2.5.8 Penalty Regime in China

A wide investigative power gives the tax authorities in China a strong position. Based on the Amended Administrative Law on Levying and Collection of Taxes issued in 2001 (the "2001 Administrative Law") they are allowed to do the following: inspect documents, physical goods, and operations at the site of the taxpayer;

- obtain proof of tax payments;
- inquire about tax matters;
- inspect bank accounts;
- obtain support and assistance from other government departments and third parties;
- make necessary records (e.g., tape-record, video-record) of relevant information;
- carry out tax recovery procedures with a time bar of three years for arithmetical errors and of five years for special cases; and
- carry out tax recovery procedures without any time bar for tax evasion cases.

Surcharges and/or penalties for acts of tax avoidance and tax evasion can be heavy and include the following:

- A daily surcharge of 0.05% of the tax overdue in tax avoidance and tax evasion cases.
- A penalty of 50% to 500% of the tax underpaid in tax evasion cases.
- A penalty of 100% to 500% of the tax underpaid and imprisonment or confinement for relevant persons for up to three years for tax evasion cases involving 10% to 30% of the total tax payable and an underpayment that ranges from RMB 10,000 to RMB 100,000 (or about USD 1,300 to USD 13,000).
- A penalty of 100% to 500% of the tax underpaid and imprisonment for relevant persons for three to seven years for tax evasion cases involving more than 30% of the total tax payable and an underpayment that is larger than RMB 100,000 (or about USD 13,000).

2.5.9 Advanced Pricing Agreements

In order to minimize the costs of tax auditing of transfer pricing in respect of associated enterprise transactions, enterprises are permitted under Circular 143 to apply for advance pricing agreements (APAs) with the relevant tax bureau for the determination of the transfer price for transactions with their related parties. China first began processing APAs in 1998 and has completed some 300 unilateral APAs since then. The SAT released its formal APA guidelines, Guoshuifa [2004] No. 118, The Implementation Rules on Advance Pricing Agreement for Related-Party Transactions (Provisional), (the "APA Guidelines") on 20 September 2004. Under the APA Guidelines, the APA process includes six major phases: pre-filing, formal application, review and evaluation, negotiation and drafting of the APA, signing the APA, and administration.

APAs provide certainty for taxpayers with respect to the transfer pricing policies for transactions with their related parties. The release of the APA Guidelines may open the door for taxpayers to negotiate agreements for entities in different regions directly with the SAT. **China's first bilateral APA was signed in April 2005 between the tax authorities of China and Japan**. This APA covers the manufacturing transactions of a leading Japanese electronics manufacturer and its subsidiary in China.

2.5.10 Recent Developments

The latest circular issued by the SAT is Guoshuihan [2005] 745 specifying whether (working) capital adjustments should be made when conducting a TP audit/investigation. In summary, the SAT suggests that no working capital adjustment should be performed in determining the arm's length prices unless an approval from the SAT is obtained.

As already mentioned, the most important development is expected to happen before the end of 2005. **The SAT is currently drafting the transfer pricing documentation requirements, which are expected to be rigorous**. The new regulations will likely require companies to submit detailed related-party transaction information with their annual tax return and to maintain a sound contemporaneous documentation which could be presented during an.

2.5.11 Summary

As investments rapidly increase and the regulatory environment changes, Chinese tax authorities are showing a strong resolve to ensure compliance with transfer pricing rules. Particularly with the expected enforcement of the contemporaneous documentation requirements, transfer pricing becomes a major area of importance for tax directors, in terms of both compliance and planning.
Based on current information, it is expected that **the transfer pricing documentation requirements in China will be extensive, but basically in line with the OECD guidelines**. **Corporations should start preparing their transfer pricing documentation as soon as possible. There is even a possibility that the transfer pricing documentation has to be filed for the fiscal year 2005 together with the tax return by April 30, 2006**.

Contributed by Ernst & Young
website: www.ey.com/ch/china

Notes

[1] Guoshuifa [2004] No. 143, Amended Taxation Management Regulations for Business Transactions between Associated Enterprises

2.6 Mergers and Acquisitions in China

The following part provides an introduction to ways of entering the market or expanding through Mergers & Acquisition (M&A):

- The first expert contribution by Franc Kaiser of Fiducia Management Consultants gives an overview of Chinese legal forms and preferred acquisition targets and a comparison of M&A vs. JV and WFOE. The M&A Compass indicates what can be bought by in China and what not. In the last part, Franc Kaiser explains, in which cases M&A makes sense and discusses special China related risks of M&A.
- The second contribution written by Stephan Haagmans and Robert Patridge of Ernst & Young goes into detailed aspects of due diligence when actually going through a M&A process in China by first describing the differences between China and Europe when conducting due diligence and then listing the procedures of a due diligence process in China.

2.6.1 Chinese Legal Entities and M&A

by Franc Kaiser, Senior Consultant Fiducia Management Consultants

Fig II - 7

Company form	Shareholding requirement
Limited Liability Companies (FIE, SOE, POE)	At least 2 shareholders
Company Limited by Stocks (CLS) (listed / non-listed SOE, POE, FIE)	At least 2 shareholders
SOE	Only 1 shareholder (Chinese Government)
Collectively Owned Enterprises Township & Village Enterprises	Not regulated by Chinese Company Law

Source: Fiducia Management Consultants

2.6.1.1 Chinese Legal Forms

The legal forms of enterprises in China are distinctively different to the Swiss Code of Obligations. The following overview shows the current legal forms of Chinese enterprises. The most important forms are, however, the Limited Company, the Joint Stock Company, and the State-Owned Enterprise (SOE).

Structuring Chinese enterprise forms according to shareholder structure: Overview of Legal Forms of Chinese Enterprises

Fig II - 8

	Enterprises in transformation / in reform						**Old system**	**enterprises**
	Listed or non-listed			**Limited**			**SOE**	**COE**
Equivalent to	Equivalent to „corporation"			Equivalent to „limited liability" company				
	Joint Stock Company (JSC))	**Corporatized Enterprise ("Min Qi")**	**Private Enterprise ("Si Qi")**	**Limited Company**	**Corporatized Enterprise ("Min Qi")**	**Private Enterprise ("Si Qi")**		
Description	Transformed SOEs	SOEs, sold to corporatized business units. They do not report to the state anymore, but are controlled by the ministry, provincial government, or other state enterprises	Original capital contribution from private individuals or companies	Including Holdings, FIEs	SOEs, sold to corporatized business units. They do not report to the state anymore, but are controlled by the ministry, provincial government, or other state enterprises	Original capital contribution from private individuals or companies	**Reform processes:** - Listing (1,200 enterprises) - Legal transforming(80% of all small- and medium-sized enterprises) - Selling out	
Prominent Examples	Petro China	Legend; Haier; Huawei	Eurasia					
	Shares (if listed)							
	Tradable	Non-tradable						
Share types	A, B, H, L, N, S	State-owned shares	Legal-person shares (include founders)					

Source: Fiducia Management Consultants

2.6.1.2 Preferred Acquisition Targets in China

In general, the "best" targets in China are wholly foreign owned enterprises (WFOE), that is, the subsidiaries of foreign players which are for sale mostly due to a global group's strategic repositioning. The quality standards of such targets are often higher than for Chinese targets, but may lack of domestic sales volume.

When looking at Chinese companies, it is advised to consider privately-owned enterprises rather than State-owned enterprises due to a more proportioned size of targets, an easier transaction, and probably higher competitiveness in the market.

Fig II - 9

Target	Pros	Cons
Wholly foreign owned enterprises(WFOE)	■ Easier deal structure (offshore equity transaction) ■ Is likely to adhere to international accounting and management standards ■ Opportunities for sector consolidation ■ Higher transparency, and investment groundwork has already been done	■ Why is the WFOE for sale? ■ Profitable successful companies will demand a premium ■ Subject to WFOE regulations ■ Investment incentives may have expired (tax holidays etc.)
Foreign-invested enterprises FIE (JV or WFOE)	■ Deal structure flexibility: FIE's can be acquired by holding companies, foreign entities, or other FIE's ■ An opportunity to buy a foreign investment ■ Several methods of structuring deals ■ Higher transparency than Chinese company	■ Why is the FIE for sale? ■ Tough restrictions on holding companies (not ideal to set up as a pure acquisition vehicle) ■ Local partner consent on management (JV partner veto right) ■ If asset deal, buyer's FIE needs to function as an absorption vehicle.
Chinese Privately-Owned Enterprises (POE)	■ More dynamic management style than with SOEs ■ Decision making much clearer, the owner is the decision maker ■ Timing of a deal can be faster ■ Private entrepreneur might need capital for further expansion (inter-provincially or nationally), or technology for moving up-market, and managerial expertise ■ Private entrepreneur might be looking to "cash out" of part of his business	■ POE owners are savvy and tough negotiators ■ Lack of corporate governance, transparency, and tax compliance ■ Around 20 to 30% or all POE business is conducted off-the-books - Possibility of cost explosion due to tax adjustments after acquisition ■ Clients / suppliers may disappear when foreign ownership is in place ■ Relative lack of contacts with government and banks

Chinese State-Owned Enterprises (SOE)	■ SOE's needing capital can sell equity to foreign companies ■ Opportunity: Governmental mandate to restructure most of the 305,000 SOE's with foreign and / or local investment ■ Matching official goals: Government has selected 1,000 SOE's to become China's modern conglomerates	■ In case of an equity deal: Assumption of hidden liabilities, or costly employee settlement plan ■ SOE may be selling-off non-performing divisions ■ SOE's account for 80% of loans to State banks and most of the NPL's ■ Opaque structure: Hard to identify the decision-makers
Companies listed in Chinese stock exchange markets	■ Stock exchange qualifies benchmark in terms of profitability, distinguishes between good and bad companies ■ Companies abide by standard accounting procedures	■ Companies listed in domestic stock markets are notoriously overvalued – a devaluation is probable ■ Hostile takeovers not allowed ■ All share purchases need State approval

Source: Fiducia Management Consultants

2.6.1.3 JV vs M&A vs WFOE

Investment form	Advantages	Disadvantages
Forming a Joint Venture with a Chinese company	▪ Can be established in "Restricted" sectors ▪ Minimize upfront investment risks, as upfront costs would be shared, and may be cheaper than WFOE ▪ Partner could assist in application for Business Licenses ▪ Can leverage customers, supply chain and infrastructure already in place ▪ Will have an instant cadre of people who know the business in China ▪ Partner may have slack recourses ▪ Leverage position with customers who want a "foreign" supplier ▪ Could be first step to acquiring partner (gradual buyout)	▪ Partner can have power of veto over major decisions, including assignment of interest etc, thus risk of losing control of JV because of politics / future disagreements ▪ Lack of control over the JV partner: Could be the first step of building up a potential competitor ▪ Possibility of competing with partner, loss of know how to partner, general leakage of trade secrets ▪ Will inherent the baggage (both negative and positive) associated with prior customer relationships ▪ May have to assume former liabilities of partner, including excess workers ▪ No unilateral control of management, products, costs etc ▪ Partner may have more diverse product range than intended core competence
Setting up a WFOE / green field project	▪ Complete control over management, strategy, products, distribution, quality, intellectual property ▪ Patents and intellectual property not endangered ▪ Simple to establish and terminate. flexibility of location ▪ Strong leverage position with clients who want a "foreign" supplier	▪ Time and effort required to attract trained local personnel and to establish an extensive distribution and procurement network ▪ Cost disadvantages: No access to the cheaper forms of land acquisition that are available to JVs, higher cost structures ▪ No assistance from a partner in securing approvals and dealing with the bureaucracy, lack of Chinese partner and local contacts, no access to restricted industries
Acquisition of a company in China	▪ Short cut: No start up phase required: Possibility of taking over distribution and supply structures (fast set-up) ▪ Control over company management and business structure ▪ Access to connections and relationships ▪ Possibility of buying a competitive cost structure	▪ Complicated regulatory environment, including possible reapplication for Special Business Licenses ▪ Probability of paying a premium over asset value to close the deal is high ▪ Proper due diligence required ▪ Questionable value and operational status quo of Chinese enterprise ▪ Asymmetric information and expectations of buyer and seller due to opaque company structures and business environment ▪ Cultural barriers and difficult negotiations, difficult post-deal integration

Source: Fiducia Management Consultants

2.6.1.4 Regulations related to M&A in China

Regulations	Function	Issued by	In effect since
Provisional Rule on Foreign Investors Merging and Acquiring Domestic Companies	■ General Measures for M&A ■ Regulates the acquisition of non-listed targets ■ Regulates equity and asset deals ■ Antitrust limits	MOFTEC, SAT, SAIC, SAFE	April 12, 2003
Tentative Provisions on the Use of Foreign Investment to Restructure State-owned Enterprises	■ Governing acquisitions of non-listed ■ SOEs by foreign investors ■ Workforce settlement plan ■ Asset Valuation by 3rd party ■ Overlap with "Asset Reorganization by SOEs using Foreign Investment Tentative Provisions"(SETC, Sept 14,1998)	SETC, MOF, SAIC, SAFE	Jan 1, 2003
Administrative Procedures on the Acquisition of Listed Companies (also known as: Takeover Rules)	■ Rules on the acquisition of listed targets ■ Takeover by agreement (< 30% stake) ■ Takeover by offer (> 30% stake, general offer to all shareholders) ■ Pricing procedure ■ Regulates control over target ■ Linked to "Administrative Measures on Disclosure of Change of Shareholdings in Listed Companies"	CSRC	Dec 1, 2002
Interim Regulations for QFII (Qualified Foreign Institutional Investor) to Invest in Securities	■ Governing A share acquisitions ■ Linked to "Interim Regulation for QFII's Foreign Exchange Conversion"	CSRC, PBOC	Dec 1, 2002
Notice Regarding the Transfer of State Shares and Legal Person Shares of Listed Companies to Foreign Investors	■ Governing the sales of non-tradable shares of listed companies to foreign investors ■ Lifts the notorious ban from 1995 ■ 12 months minimum holding period	CSRC, MOF, SETC	Nov 4, 2002
Regulations for the Merger and Division of Foreign-Invested Enterprises	■ Governing mergers involving FIEs ■ Permits combinations with Chinese companies ■ Complicated division approval procedures	MOFTEC SAIC	Nov 22, 2001 (revised from 1999)
Tentative Provisions concerning Investment] within China by Foreign Invested Enterprises	■ Governs the acquisition activity of (non-investment) FIE's ■ FIE must be profitable ■ Investment not more than 50% of FIE's net assets ■ Acquired Chinese target does generally not achieve FIE status	MOFTEC SAIC	Sept 1, 2000

Provisional Regulations on the Change of Equity Interests among Investors in Foreign Invested Enterprises	■ Governing the sales and purchase of equity interests in FIE's	MOFTEC SAIC	May 28, 1997
Securities Law of PRC	■ Regulates stock issuance and transaction	NPC	1998
Company Law of PRC	■ Regulates establishment and operation of limited companies and joint stock companies	NEC	1998

Source: Fiducia Management Consultant

2.6.1.5 M&A Compass: What Can Be Bought, What Not?

The introduction of M&A laws and regulations in the recent years weaved a complex but more or less complete framework. Basically, the set rules and regulations do allow to acquire assets and equity in all forms of Chinese companies, with the exception for the acquisition of A shares (which can be acquired only by institutional investors, but not allowing a majority stake).

Theoretically, every enterprise form is acquirable with the exception for Non-Limited Liability Enterprises.

Non-Limited Liability Enterprises are Wholly Individually Owned Enterprises (unlimited enterprise, held by a single natural person), and Private Enterprises Under Partnership (unlimited enterprise, jointly invested, managed, profit and loss sharing by 2 or more natural persons), hence small companies less likely to be interesting or serious targets for foreign investors.

The M&A Compass helps to quickly assess if the planned transaction is on safe ground or not.

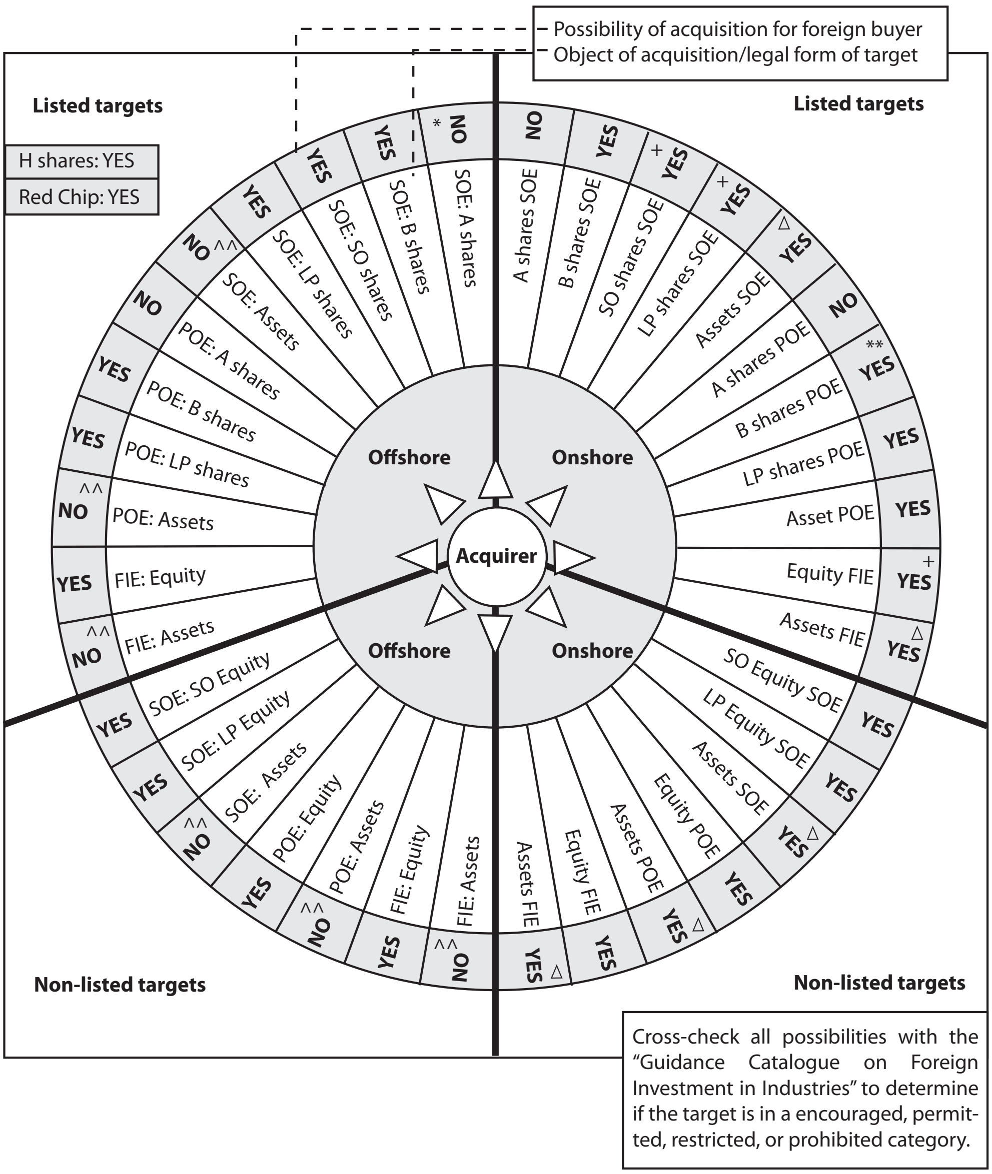
In principle, except for A shares, all Chinese companies are acquirable. Since November 2002, the ban against the transfer of State-owned and Legal Person Shares for foreign investors is lifted. Still, most other transaction forms are subject to restrictions.

- "Offshore" means to establish an acquisition vehicle not located in China, ideally an offshore holding company on a territory with juridical advantages, e.g. Hong Kong, Cayman Island, British Virgin Island, Mauritius etc. The buyer is therefore not within Chinese territory and not subject to Chinese law and regulations.
- "Onshore" means to establish an acquisition vehicle within China, normally a Foreign-invested enterprise, subject to Chinese law and regulations. The business scope of the entity describes the allowed activity. Therefore, a FIE is often not allowed to hold or invest in shares, except if the FIE is a holding company according to Chinese law.
- "Listed targets" includes targets listed in the domestic stock markets (Shanghai, Shenzhen), but our legal compass here does not include targets which are listed as H shares or Red Chips in Hong Kong.

As a general rule, assets (both of Chinese and foreign-invested enterprises) cannot be purchased directly by an offshore buyer, but it is required to set up an absorption vehicle on-shore, in which the assets can be injected.

2.6.1.6 For which cases does M&A make sense?

If an acquisition in China makes sense depends first of all on the motivation and the set up of the buyer. Choosing an acquisition as a form to enter China may be less advisable than for expanding already existing operations in China due to a high risk exposure. As such, foreign companies already active in China are on a safer trail when acquiring their well-known business partners (e.g. existing suppliers or distributors).



Definitions of abbreviations:		**Legend of effects:**	
SOE:	State-owned enterprise	*	Acquisition of A shares only possible if offshore acquirer has QFII status
POE:	Privately-owned enterprise	**	Acquisition of B shares only by individuals and holding companies possible
FIE:	Foreign-invested enterprise	+	Acquisition only if acquirer is a Holding Company acc. to PRC Law
SO shares:	State-owned shares (JV, WFOE, or, if listed, JSC)	Δ	Acquisition possible if acquiror is in the same (or related) business / industry
LP shares:	Legal person shares	^^	Acquisition possible if offshore acquirer opens up a tentative account, as approved by SAFE, and to form an onshore FIE with assets after payment

- As a first consideration, the foreign buyer needs to consult the "Investment Guideline Catalogue" if an acquisition is possible at all within his industry. For governmentally restricted or only partially permitted sectors and industries, holding the full or majority ownership of a Chinese company is typically not yet possible.
- Secondly, the buyer needs to be aware that the integration process and future continuation of the acquired China business is nevertheless resource-intensive. As such, a designated team / task force formed by the buying company is often required to facilitate an acquisition and its integration thereafter. If the buyer does not have an in-house manager equipped with the necessary competences, who could be assigned as e.g. the future General Manager of the to be acquired target, and / or the objectives of the China acquisition are on loose ground in front of the board of directors or share holders, then an acquisition of Chinese business might need to be reconsidered.
- Thirdly, the objective needs to be aligned with a realistic time frame. Although the approval steps may in theory be faster facilitated than for e.g. setting up a WFOE or a JV, the negotiations on details between the parties may extend the time frame from the first contact up to a deal closure up to one year or longer. If the corporate goals for China have an imperative deadline, then it is advisable to pursue those goals simultaneously with a back-up plan (e.g. partnership, or WFOE), in case the negotiations with one or several targets would not progress.

2.6.1.7 Special Risks for M&A in China

Opaque targets: Chinese target companies are mostly not transparent in their stakeholder structure, shareholder structure, and business practices. The conduction of a thorough due diligence on several fronts (commercial, legal, financial, environmental) is a must.

Assuming hidden liabilities: When transferring equity stakes, the buyer will also assume all liabilities, even if they were previously hidden.

- Achieving real control: Difficulty to control and integrate leadership of targets. Except for a 100% acquisition, other forms of holding shares in a Chinese company (e.g. majority share) does not guarantee control over management and corporate decisions. Furthermore, buying into an existing network of relations
- New competition: The previous owner of the acquired company may use the foreign buyer's acquisition price as his new investment to set up a new competitor, and transferring the customers at the same time.
- Approval system (for onshore deals): Since the Chinese laws and regulations regarding M&A are rather an approval system on a both national and regional axis, the risk of experiencing delays as well as potential deal breakers along the way of taking the approval hurdles are present. Additional time and costs may need to be taken into account due to re-negotiations with authorities.
- Integration: Converting Chinese companies in foreign-invested enterprises may have negative impacts on the profitability, especially due to
- Transformation of Chinese sales practices into a Western corporate governance, which may cause the future company to lose certain customers (which want to avoid invoices, or are motivated through cash incentives). Furthermore, private Chinese companies often avoid cost of paying the required taxes, and after a take over, the new foreign-invested company, being subject to a closer scrutiny by Chinese tax authorities, may end up with much higher tax costs than projected before.
- Changing the previous Chinese business model and cost structure by injecting new technology, quality and management standards, and cutting on current suppliers and customers.
- Changing / replacing the previously responsible managers: Especially for Chinese privately-owned companies, the customer relations are knitted by the owner of the company rather than by the dedicated sales force. Such customer relationships may disappear entirely if the owner is bought out.

Contributed by Fiducia

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2.7 Due diligence factors of success in M & A

by Stephan Haagmans, Partner of TAS Zurich and Robert Partridge, Head of TAS China-Hong Kong, Ernst & Young

For European investors seeking to participate in China's M&A opportunities, **due diligence is a critical step, not only for risk reduction but also as a process hurdle — the great majority of Letters of Intent (LOI) never close**.

Many state-owned enterprises (SOEs) and other companies are still operating in a business environment and system that is radically different from enterprises in western economies, raising numerous issues for foreign acquirers

One common issue encountered by potential acquirers of SOEs, and most other Chinese companies, is that land is owned by the state, not companies or individuals. Questions related to the transferability of land-use rights often arise in due diligence and sometimes have significant financial implications as the state may require payments for the land use rights before allowing a transaction to close.

In addition, most SOEs in China operate as "social communities". It is common to see acquisition targets that maintain employee housing hospitals schools, restaurants, and even roads on their books. As these are carved out from a target entity, foreign investors may be expected to continue to provide these social services post-closing.

A lack of good tax compliance is another common issue. Many companies often maintain inappropriate books in order to defer or avoid taxes, particularly value added tax which is typically the largest form of taxation. In many cases, income tax may be insignificant due to historic or potential tax holidays.

2.7.1 Successfully Closing Deals

With the right preparation, expectations and process, it is possible to successfully close deals in China despite the pitfalls. We believe there are a few basic suggestions to maximize your chances of deal success:

- **Early involvement of advisors:**
  Engaging advisors prior to a Letter of Intent helps increase a target's transparency, thereby accelerating the time-

line to LOI execution. **It is important not to intimidate the Chinese party by characterizing advisor involvement as "due diligence" because when translated into Mandarin this term means "investigation"** which has a negative, even frightening connotation in any language. **It is better to refer to an "initial data gathering" process that is designed to "facilitate" the potential transaction**.

- **Understand there are significant differences between conducting due diligence in Europe and China:** Entering into the due diligence process with the right expectations is a critical success factor for European investors. **The quality of financial statements, financial infrastructure and business process will be lower than western investors are accustomed to, resulting in the need to explore more risk areas and take more time for due diligence**. Some of the differences between due diligence in Europe and China are illustrated below.

Fig II - 3
Conducting Due Diligence: Europe vs. China

Conducting Due Diligence: Europe vs. China		
	Europe	**China**
1. Level of transparency in financial information	High	Low, if any
2. Normal duration of due diligence	1-8 weeks	3-12+ weeks
3. Preparation time required by target company before due diligence	Minimal	May require extensive assistance
4. Basis of financial statements	US GAAP or IFRS	People's Republic of China (PRC) GAAP, at best
5. Audited financial statements	By reputable standards	Typically not reliable from a US GAAP or IFRS perspective
6. Extent of related party transactions	Varies, typically fully disclosed	Usually extensive; inadequate disclosure
7. Disclosure of contingent liabilities	Usually transparent	High risk area and rarely disclosed
8. Reliance on computerized accounting systems	Typical	Evolving; large dependence on manual processes
9. Reliability of representations and warranties	Normally reliable	Untested
10. Enforceability of indemni fication claims	Strong; backed by courts	Untested; may need to consider "holdbacks"

In addition to general deficiencies in the accounting records the local accounting rules are as well different to standard true and fair accounting rules and have to be understood by investors. One of the easiest accounting illustrations to understand is how allowances for doubtful accounts under Chinese GAAP often do not adequately provide for old receivables (see table on the right). In almost every industry Chinese companies receivables are aged by years, not months. For this reason, accounting due diligence should focus on identifying these types of issues early and evaluate the quality of earnings and working capital implications that result.

Typical PRC Accounts Receivable Aging

		Amount	%
< 1 year		5500	55
1-2 years		1000	10
2-3 years	4500	1000	10
> 3 years		2500	25
Total		10000	100%
Allowance		-50	=0.5%
Net		9950	

Fig II - 4
Typical PRC Accounts Receivable Aging.

- **Listen for the word "no":**
  Asian culture is less direct in some respects than Western culture, which often leads to misunderstanding in the business milieu. Western investors rarely hear their Chinese counterparts say "no," even though they do not mean "yes." **Do not be drawn into a false (and drawn-out) process of assuming cooperation by the other side without defined actions and deadlines. When discussing potentially contentious items, reduce discussions to writing (English and Chinese) and agree on dates, if appropriate**.
- **Manage internal expectations:**
  Closing a deal in China too often becomes the goal in and of itself and companies lose sight of the business rationale. Corporate development officers. say that one of their biggest challenges is managing their company's internal expectations. **Start managing internal expectations early and do not over-commit to the potential of a Chinese investment without fully considering the valuation shortcomings that may be found during due diligence**.
- **Be prepared to go the distance:**
  In any good investment market, deal success requires a certain degree of diligence and patience. This is particularly true in the case of China, a market which tests investors' stamina and where only 20 percent to 30 percent of LOIs ultimately close.
- **The three main reasons for deals failing to close in China are:**
  - Quality of earning issues
  - Lack of transparency in the due diligence process
  - Too long time between LOI and closing

  There are three primary reasons for deals failing to close in China: quality of earning issues; lack of transparency in the due diligence process; and a timeline from LOI to closing that stretches from 6 to 18 months or more.

2.7.2 A staged approach

We strongly suggest conducting due diligence investigations in different phases. A typical approach would be to define certain tasks in order to be able to sign a LOI. Such tasks could include the following:

Survey chart - 5
Typical Post-LOI Due Diligence Procedures

Possible Pre-LOI Initial Data Gathering	
Possible Tasks	**Objectives**
1. Screen historical auditor's report	Understand key business drivers, quality of earnings and related issues, working capital requirements, etc
2. Evaluate key accounting policies	Identify potential risky/sensitive areas that need additional attention in due diligence, valuation and structuring.
3. Perform high level overall analytical review	Assess integrity and quality of financial data.
4. Assess financial/accounting environment	Understand the limitations of the current accounting software, set expectations of the extent of financial data available for further analyses.
5. Review internal management reports	Identify useful business statistics that are instrumental to in-depth analysis.
6. Understand business and their financial impact	Determine impact on valuation and identify areas for further detailed due diligence.
7. Develop a comprehensive /Information Request List for detailed due diligence	Ensure sufficient information and data are available to facilitate appropriate analyses.

After having signed the LOI we propose continuing the investigation in two stages:

Fig II - 6

Possible Pre-LOI Initial Data Gathering

Typical Post-LOI Due Diligence Procedures	
Possible Tasks	**Objectives**
Stage I	
1. Review audit workpapers	Identify risky areas that need special attention.
2. Raise asset/liability questions	Validate the book value of assets/liabilities and assess the impact on future earnings.
3. Analyze income statement fluctuations	Understand the /seasonality of the business, assess quality of earnings, etc.
4. Identify potential pro forma adjustments	Ensure the historical /profitability of the acquired business in truly reflected.
5. Assess stand-alone matters	Evaluate the /hidden costs of the NewCo.
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence.

Fairly often the findings of stage 1 lead our client to reconsider their M&A projects: on the one hand prices are lowered, on the other hand deal opportunities are aborted due to reassessment of the risks. If, however, the /investigation should continue we suggest analyzing the following issues in more depth:

Typical Post-LOI Due Diligence Procedures	
Possible Tasks	**Objectives**
Stage II	
1. Evaluate profitability by product/segment/geography	Develop in-depth understanding of the business, assess the quality of earnings.
2. Analyze correlation between price and volume	Same as above.
3. Identify key cost drivers and expenses variability	Same as above.
4. Review capital expenditure history	Determine impact on valuation.
5. Analyze working capital sensitivity and seasonality	Determine impact on valuation and buyer's financing needs.
6. Analyze projections versus history	Assess the practicability of the projections and profitability of the NewCo.
7. Evaluate the human resources and benefits issues	Determine impact on valuation.
8. Quantify pro forma/EBITDA	Same as above.
9. Finalize due diligence report	Summarize key findings and observations, raise alerts, if any, to facilitate client's purchase decision making.
10. Develop representations and waranties for /purchase agreement from a financial perspective	Assist client in minimizing the /investment risk.

2.7.3 Conclusion

Foreign companies aiming to invest in China are faced with language barriers, cultural differences and unfamiliarity with local business rules. For these reasons. we advise our clients to **approach acquisition opportunities using a system of well-defined steps that consider both internal opportunity costs as well as external advisory fees**. In addition, China is undergoing a dual transition from a centrally planned economy to a market economy and from an emerging economy into an industrialized economy in which the business environment is in constant change. As an example, the accounting profession in China has recently undergone a period of rapid development but we estimate that currently only about 10% of the final /number of accountants required have already been trained. Understanding some of the main cultural differences, potential pitfalls and due diligence success factors will help you to approach investing in China with greater confidence as well as to determine when greater investigation and the assistance of a professional advisor are needed.

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2.8 Foreign Investments in Capital Markets

2.8.1 Overview

Since their opening over 10 years ago, China's capital markets are now best de-scribed as emerging. The WTO also opened the door to foreign participation in China's capital markets. A number of new regulations issued since 2002 have made it possible for foreign firms to establish joint-venture fund management companies as well as securities companies. In addition, a Qualified Foreign Institutional Investor (QFII) scheme was introduced to permit major foreign financial institutions to invest directly in the domestic bond and equities markets. There is a general assumption in the market that China will continue to liberalize its capital markets.

2.8.2 Fund Management Companies

Current regulations limit foreign participation in fund management companies to a maximum investment of 33 percent. The regulations, however, permit this stake to increase to 49 percent in 2007, but make no provision for further increases. Despite this limitation, several joint-venture fund management companies have already been established in the expectation that, over time, foreign partners will be able to assume majority control.

2.8.3 Securities Companies

Regulations limit foreign participation in the domestic securities industry to joint ven-tures, with a maximum foreign shareholding of 33 percent. Although foreign joint-venture securities companies are permitted to underwrite Renminbi-denominated so-called „A shares", there is no provision for when brokerage licenses will be made available.

2.8.4 Qualified Foreign Institutional Investors (QFII)

In December 2002, QFII regulations were enacted, allowing foreign institutions to in-vest in the domestic stock and bond markets. Subsequently, a number of foreign ap-plications have and continue to be approved.

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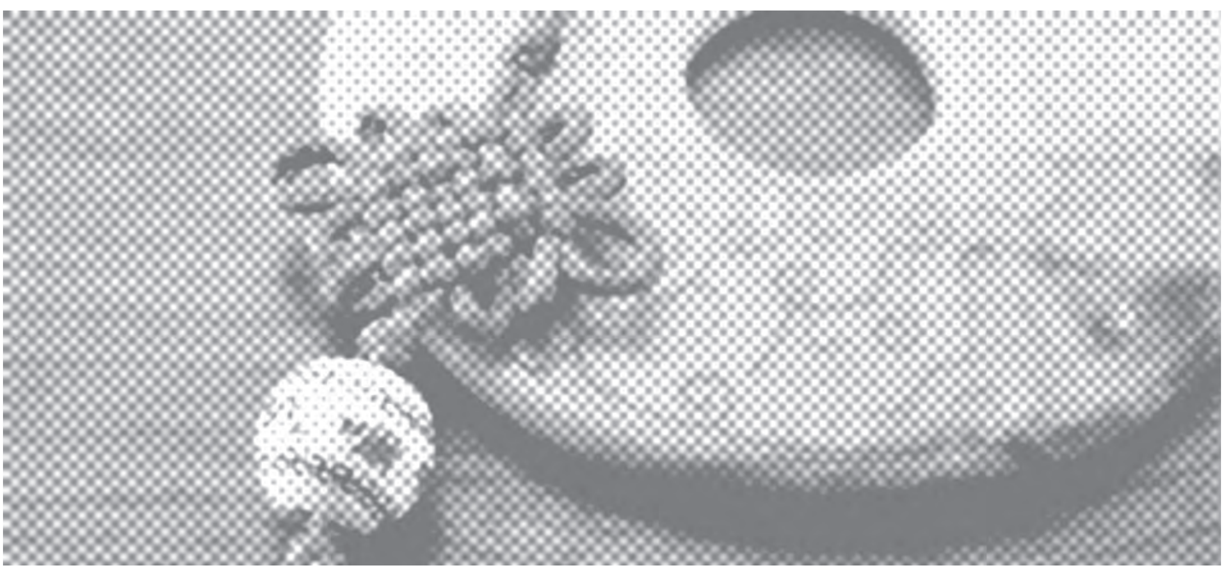
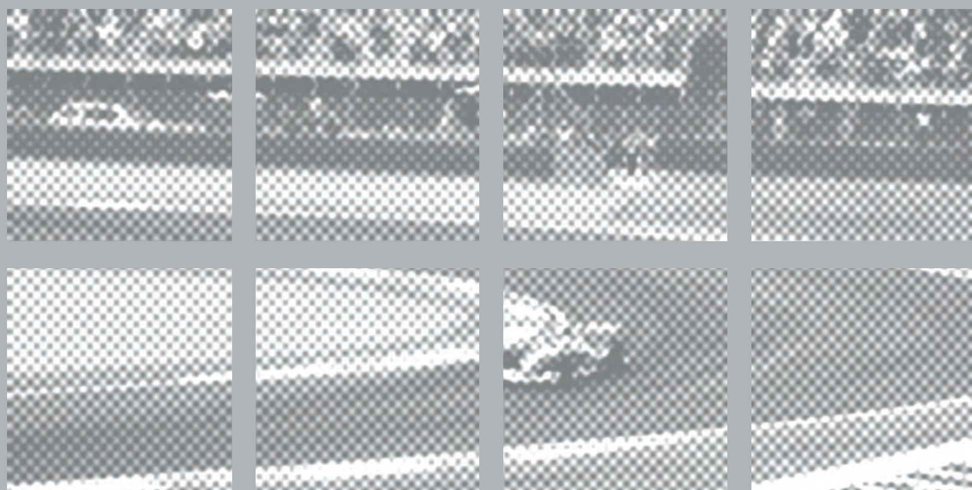


III Preparing for China



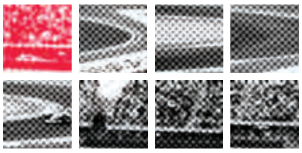
The complexity, the lack of transparency and consistency of local regulations combined with the competitiveness of the business environment make it particularly important to effect careful preparation and planning while setting up a business in China.

China is very much a 'Do It Yourself' ground; Swiss companies that invest directly, without a partner are more successful than those who work with licensees, franchisees or joint-venture partners.

Conducting initial research to define adjustments to the products and ways they should be sold and establish a strategy and concept are of key importance so that essential pointers are provided for this purpose.

The selection of a location has a major influence on success, since it defines essential aspects of the future business - human resources and the quality of law enforcement, among others . Ten criteria for location evaluation are proposed to ensure a right choice.

Key findings about the opportunities, risk and difficulties of Swiss firms in China, reasons for doing business, the type of agents and partners as well as joint-ventures, are also analyzed for the benefit of a better preparation.



1 Difficulties met by Swiss enterprises

Surveyed managers rate:

- **'local human resources not up to necessary standards'** and
- **'major changes in market circumstances (e.g. smaller size, heavier competition, more difficult access to client)' after set-up**

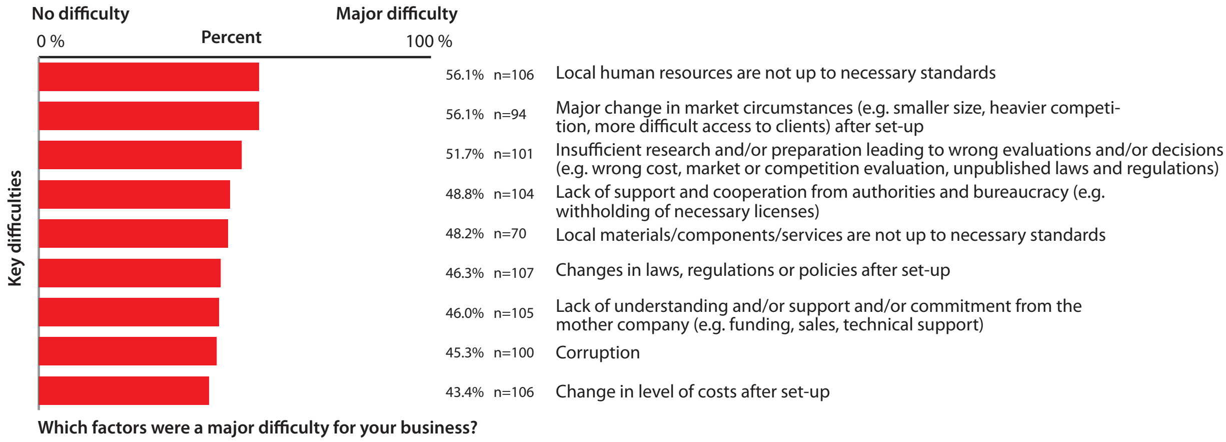
as their top difficulties.

'**Insufficient research and/or preparation leading to wrong evaluations and/or decisions**' comes right after (See Survey chart III-1), indicating the value of a good preparation when entering China.

Since market elements are key to success and seemingly difficult to predict, in-depth information about a company's market and its trends is an essential part of the preparation.

Survey chart III - 1

Difficulties met by managers in China
(All companies in China N=111)



Source: Swiss China Survey, 2005

2 Opportunities and risks

China may be viewed as the land of opportunities. Yet, for Swiss subsidiaries, the best opportunity that China offers remains 'potential': the very large 'potential market', not surprisingly, is still what generates most economic interest.

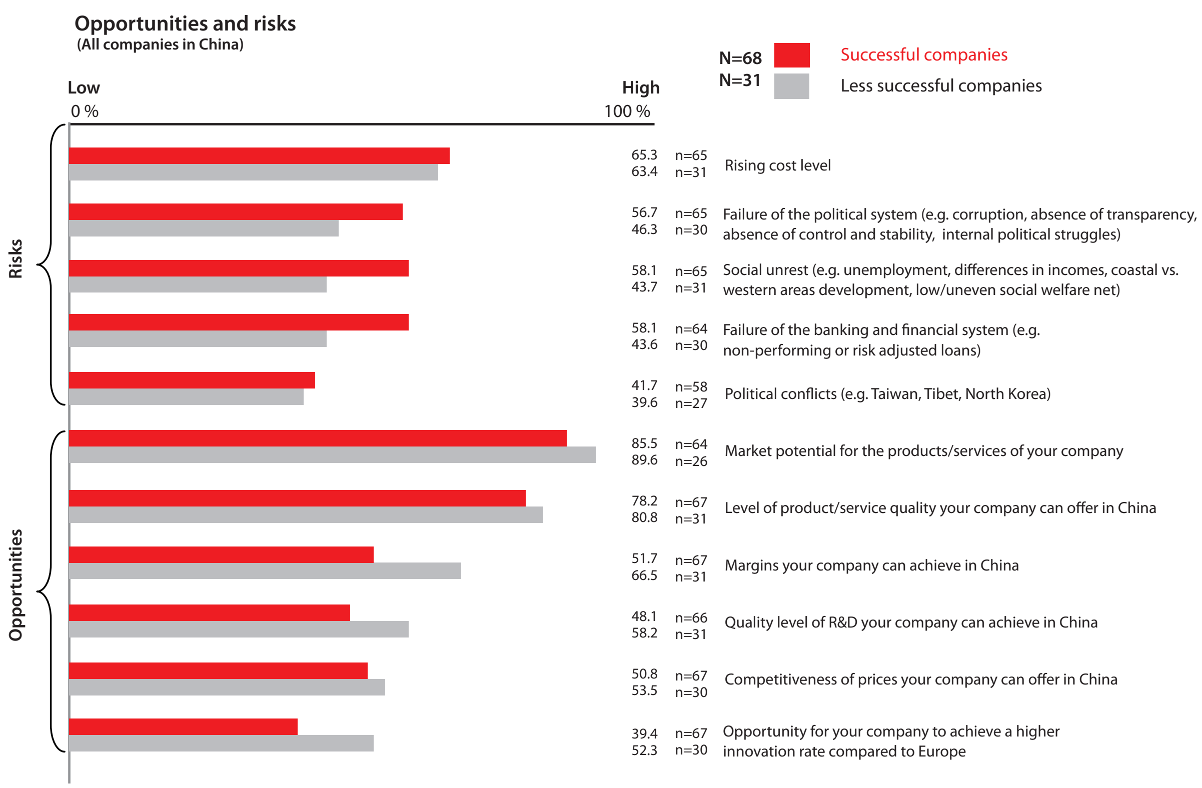
In terms of other opportunities, Swiss companies see the quality level they can offer to be a very strong opportunity. This matches data from Young & Rubicam showing that strongest brands in China are perceived to have **'quality'** as their strongest attribute.
The perception of Switzerland by Chinese is excellent, offering extra opportunities to Swiss companies.
(See Chapter I General Environment & Trends; Culture, history and consumer psychology; China, brands and consumer psychology'.)

Risks are consistently rated lower than opportunities, illustrating a generally positive view of China. Besides, the economic risk of 'rising costs' is perceived as most important while the more socio-political ones come last, indicating relatively high confidence in the stability of the country. Costs are however rated last, by all respondents, in terms of current difficulty, as the Survey chart III-2 shows, indicating that they remain a risk.

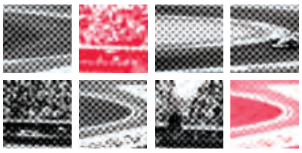
For information about the financial system, the RMB (Yuan) value and an indication of financial risks, also see Chapter II Legal, Tax & Finance, 'China's banking and currency system for foreign invested enterprises'.

The risk of a flu pandemic has been often highlighted at the time of print. An uncontrolled outbreak of avian flu would certainly cause much of China's economy to slow down - as it did at the time of SARS.
A recession may have additional consequences as it may well undermine the social balance. Indeed, the largest fraction of the population is very poor but accepts its fate as long as its social condition improves fast enough.

Survey chart III - 2



Source: Swiss China Survey, 2005

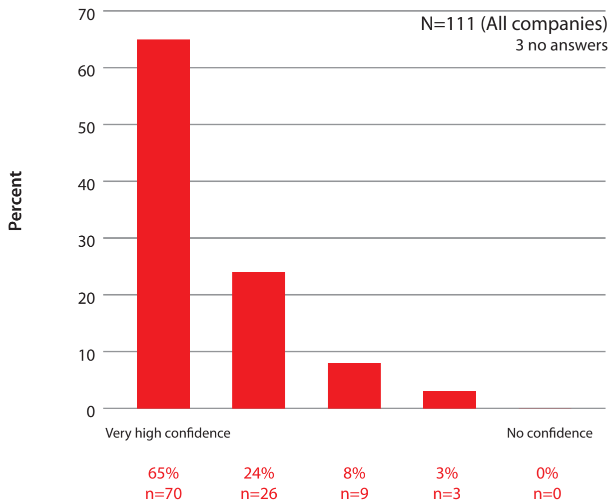


3 Success Level

The Survey charts III-3, III-4, III-5 show the answers of Swiss subsidiaries with respect to the confidence they have and the efforts they had to make.

Survey chart III - 3

Swiss companies are very positive …

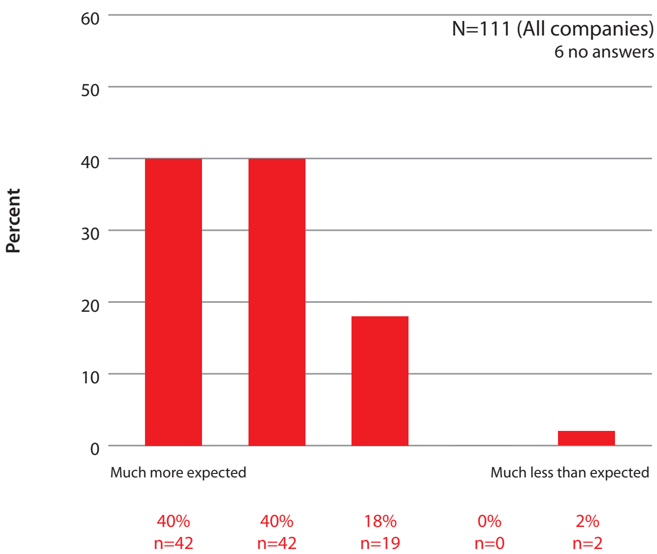


How much confidence do you have in the ability of your China subsidiary to do successful business in China in the next 3 to 5 years?

Source: Swiss China Survey, 2005

Survey chart III - 4

…though the efforts are (much) more than expected...

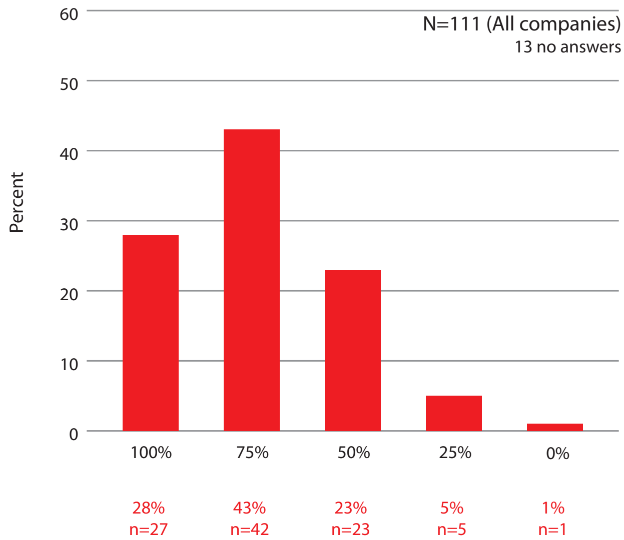


How much effort did it take to reach those objectives?

Source: Swiss China Survey, 2005

Survey chart III - 5

… and 29% of the companies have not met more than half of their objectives



What percentage of your original strategic objectives did you meet since you entered the Chinese market?

Source: Swiss China Survey, 2005

China remains a (very) difficult market!
As a result, it is fair to say that careful and detailed preparation should be conducted and extra resources be prepared for success in China. For more details on success and success factors also see the initial Chapter, Swiss China Survey.

4 Acquiring information and management capacity

Successful companies are using more external support than unsuccessful ones. Besides, most experts agree that acquiring support from external sources is necessary for a China entry, particularly for smaller companies.

It allows reducing risks and mistakes while starting in a difficult, new environment. More importantly in some cases, it increases speed, more and more of the essence in the world's most competitive environment.

Surveyed Swiss subsidiaries favor support organization based in China among the different options. See Chapter X for a description of organizations of support and what they can offer.

5 Time needed for preparation

Entrants take various amount of time for preparation, from less than a year to more than five. No correlation could be observed between successful companies and time of preparation.
The previous survey of Swiss and German companies effected in 1998 by Roland Berger and Partners was able to correlated success with time of preparation. The current situation indicates that the environment has become easier, possibly because support services are better and less preparation is needed in many cases (for example Joint-Venture partners are not required anymore in most industries).

It's Time to Invest in China

Get Your First Benefits from the Swiss-Chinese Chamber of Commerce

Contribution to the Sino-Swiss Economic Relations

The Swiss-Chinese Chamber of Commerce is a Swiss-based private association registered in Zurich. Over 700 corporate and individual members, among them the leading banks, trading companies, insurances and industrial firms have joined the association in Switzerland and its partner-organisations in the People's Republic of China; making it one of the largest Chambers. Since its foundation in 1980, the Chamber has not only contributed to the development of the Sino-Swiss economic relations but has continuously assisted the many Swiss companies doing business with and investing in China.

Quality Links for Your Network

A membership opens the doors to a large network of members providing know-how or to discuss business opportunities. Members' interests are also promoted through the Chamber's governing body, which determines Chamber policy and comprises high ranking Swiss businessmen, representing international leading Swiss industrial and commercial organisations. The Chamber is a member of SwissCham (Association of Swiss Chambers of Commerce Abroad) and of the Euro-China Business Association (ECBA). It also maintains contact with Government departments, institutions and trade associations in Switzerland and China.

Moving with Your Needs

In 1995 the Chamber extended its services by setting up Chapters in Geneva and Lugano to suit the requirements of the regional interests and has also founded Legal Chapters in Zurich and Geneva with the objective of facilitating a greater understanding of legal and tax issues between Switzerland and China. Partnerorganisations in China, among them the former Chapters in Beijing and Shanghai, provide a forum for local Swiss and Chinese business people and also assist those members travelling to China.

Thanks to Your Support...

As a non-profit and non-governmental organisation, the Chamber receives no grants or financial aid of any kind. Therefore, to maintain an efficient and member-oriented activity, serving the interest of Swiss and Chinese business, the Chamber depends on the financial support of a strong and growing membership. Income is also derived from commercial work undertaken for non-members, who are charged a fee to cover know-how, outlay on time and secretarial expenses. Any such services to members are either free of charge or provided at a reduced rate.

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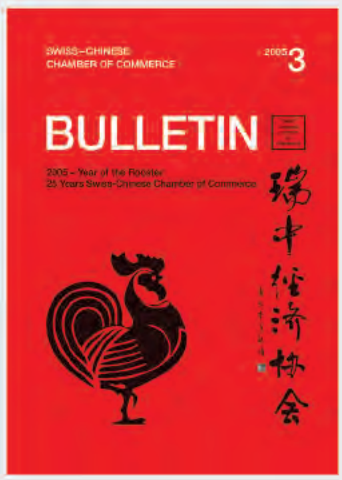

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6 Researching and establishing a concept

Though research-related success factors do not appear high on the list rated by all companies, a deeper analysis by activity shows that they appear in top or key positions for companies having a focus on sales:

- For companies producing and selling only, **'market research and evaluation'** comes first out of all factors
- For companies exporting to China **'competitiveness of your products/service in the market'** comes first, indicating that understanding of the market is also of key importance to position it in a competitive way.

Looking at the well-known complexity of the market, the differences it presents with western markets and lack of detailed data, the key importance of research for success in China is indeed understandable.

In order to carry out entry market research valuably and efficiently the following questions, among others, need be answered reliably.

This Chapter focuses on preparing with a sales focus, since Chapter VIII is dedicated to sourcing & purchasing and offers details on supplier research.

6.1 Is there a market for my specific product and/or services?

There is actually a market in reasonable (if not large) volumes for almost everything in China. Yet and after 25 years of development, the economy is functioning and the market is not just waiting for new products. As a matter of fact and when going into details, one realizes that the market needs to be served in specific ways, for which a Swiss company may not be well equipped. To avoid wrong evaluations, answering the following questions is necessary before selling successfully.

6.1.1 How do my potential clients handle at the moment without my products? Do they buy from competitors, local or foreign? Do they have a substitution product or technology?

Often, the equipment that Swiss companies produce provides excellent quality and considerably reduces need for labor. Yet, in China labor is usually cheaper than machines produced in developed economies. Large, high-speed assembly or processing machines, for example, can be replaced with just a lot of people. In that case, to sell, a favorable price and performance of the product in comparison with the substitution technologies used in China will be necessary.

At the end, to be competitive, the Swiss product must allow sizeable cost savings or be unique, in the sense that it provides a quality that is absolutely needed and that is not otherwise available. If there is no clear unique selling proposition for the product in China, a product/price analysis is key:

6.1.2 At what price can I sell on this market? Do I need to adapt my product to meet the specific needs and the price the market can take?

It is often so that product functionalities may be too much for the Chinese market. Or in another way, a simpler product (or the combination of 2 - or more - much simpler products) may be used to reach the same end-result for the potential client.
This is often the case for Swiss machinery or components: they may incorporate functions that are unessential to a Chinese company to achieve the best quality/price ratio for the product that they manufacture. In such a case, in order to be cost efficient, amendments have to be brought to the product.

It may also be the case that cost efficiency is only achieved while adapting the product and producing it locally, at Chinese costs.

Yet, after a clear need, product and price are established, there is still a key additional element to consider:

6.1.3 Does my product need to be included in a system or be part of a solution package to be successful?

Particularly for technical products, the variety and maturity of the Chinese industrial fabrics may not be sufficient to provide some of the components or services – usually outsourced - needed to give full value to the product. In the printing industry, for example, should the quality of local printing plates not be sufficient, an excellent machine will not provide good end-result. Inks may also be an issue. As a result, in order to sell machines, a company may have to offer printing solutions, including services to make plates and mix inks.

Offering packages or solution provides an additional advantage: the potential client feels more confident having to deal with only one supplier: he does not risk that responsibility for problems could be blamed by one supplier to the other. Selling packaged solution appears to be an important factor in the case studies of successful Swiss companies. (See Sulzer case study, Chapter V, Market Types for an example)

Once the market is ascertained for a product and the adaptations it will need identified and initially considered possible, the potential size for the specific product need to be verified and the ways to sell ascertained. This is best done through evaluating the competition (or evaluating the competing substitution product providers) in detail:

6.2 Who are my competitors? How and how much do they sell?

Competition in China and Asia is strongest in the world, according to Swiss companies (also see Chapter I, General Environment, Trends). Therefore understanding competitors is of a stronger need in China and Asia than elsewhere. Competitors are usually both local and foreign. It is essential to understand:

- their strengths and weaknesses,
- the extent of their sales
- their sales strategies and distribution channels

Based on this information, it is usually possible to evaluate:

- most suitable options to sell and distribute
- adaptation and best positioning of the product according to market segments, production costs, sales price and distribution strategies
- actual share of market that can be captured from competitors (or substitution products) in different options

With that base information, to make an initial decision to start a China business, one still need to answer three key questions covered in the following sections 6.3, 6.4 and 6.5.

6.3 What are the trends? Is timing right?

Identifying market trends allows determining the optimal time for a start. An early start brings a first mover advantage, but a too early start may inflict losses for a longer than necessary time.

On the other hand, starting late can be even more costly: catching up can require considerable resources. Should one wait too long, local competitors may become so strong that they start competing on international markets and become dominant, as experienced by many textiles producers.

Anticipating the right time is an art that requires an excellent feel for the market. In any case, investigating and researching early is a very small risk to take in order not to be late.

6.4 Do we have or can we acquire the needed resources?

In order to answer this question the following need to be established in reasonable details:

- A financial business plan based on the research that identifies investments, working capital and losses until break even
- From the mother company's side, the needs in project management capacity, know-how / technology transfer and staff training, financial controlling, technical support
- In China, the availability of human resources needed to run the operations

Human resources and project management capacity are generally available in China (also see section 'Acquiring information and management capacity'). Financial resources may also be acquired (see 'Obtaining financial resources' below) in quite some cases. As a result, the bottle neck is more often found in the ability to divert resources for technology transfer, technical support and training.

6.5 Does it make sense to enter China at all?

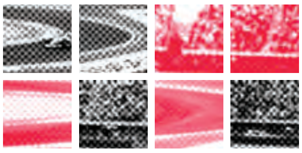
When all the information in terms of feasibility and timing is available, a final evaluation is still necessary and some last answers given to these questions:

- What are the risks?
  In addition to political risks, there are economic ones (the market may change unexpectedly), operational ones (the project may not run as planned) and risks in terms of know-how loss. (See Chapter VII IP protection and R&D for more information in this respect.) Finally there is also a risk **not** to go. Indeed, not covering a market like China leaves the door open to competitors, present or future, which may take advantage of China's market and low costs to develop and, later, become serious international competitors.
- Are returns compared to risk worthwhile? Return here need to be considered in the short term financially and in the long term with respect to a strategic position.

6.6 Executive visits as entry market research

One of the best way to acquire a first impression of the answers to the above is the combination of a trip organized through specialist who arrange visits to representative potential clients, suppliers and to other foreign companies in the industry.
In order for the trip to be efficient, research is carried out to identify the right companies and persons to meet. Questions to these contacts also need be prepared in advance so that during the visits, the right questions are asked. If needed, additional research is carried out after the meetings and answers to most of the above questions can be provided in broad lines. The advantage of such a market research combined with a manager's visit are multiple:

- While meeting contacts, depending on answers to questions asked more pertinent ones can be asked directly by the manager traveling with the specialists
- By physically visiting, the company manager gets a direct feel for the situation
- Costs are minimized to gather the necessary information



7 Defining an Entry Strategy

7.1 Reasons for entry

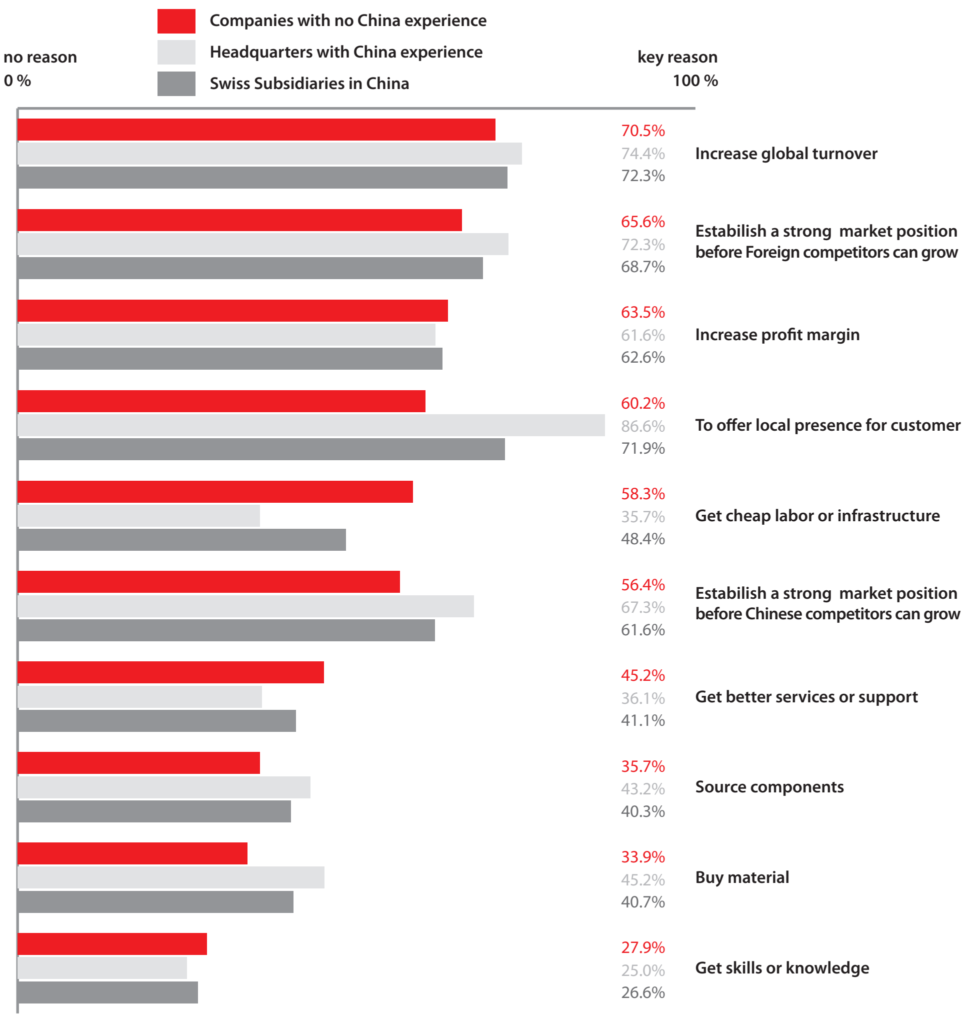
They are of three kind:

- China's market, current and potential (exporting to China or producing in the country for selling domestically)
- China's production base (purchasing or producing locally for export)
- Achieving a strategic position (supporting a global customer, acquiring the market before competitors)

The chart below shows clearly that strategic reasons dominate. However, more and more subsidiaries try and benefit from all that China has to offer, i.e. acquiring low cost materials, selling into the market and building a position offering strategic advantages.

Survey chart III - 6

Reasons to enter China for Swiss companies



Source: Swiss China Survey, 2005

7.2 Entry Strategies

Pure selling is generally more difficult than purchasing, while producing is often the end result of either of the activity. Setting up a production is clearly a complex and difficult enterprise, yet it may bring more success in the future.

Two major activity strategies, covered in section 7.2.1 and 7.2.2, make particular sense while entering China as they allow a step by step investment, lower risk entry.

7.2.1 Purchase then sell

Starting with purchases of components or materials or (semi-) finished products a company may relatively easily gain a China experience while having reasonably quick returns on a first step (purchasing is easier and brings fast returns).
Savings made on purchases in China may allow a combination of bigger market share and better profits on the firms' traditional markets.

After having identified components more efficiently produced in China, established a China supplier-base and sufficiently expanded its traditional markets to need additional production capacity, the firm may go one step further and establish a foreign-owned assembly subsidiary.

High value-added components and materials can be imported from the mother company. The mother company then specializes in the higher technology range of the production, R&D and international distribution of the group.

Initially the venture may export 100% of its products. With a well-prepared set-up the operation can bring fast returns again. While the operation matures for export production, the export products can be adapted to the local market and tested. Locally adjusted products, local assembly of locally sourced materials and components with higher-tech imported elements should bring a most efficient mix of quality and product competitiveness.

As a result of this step-by-step approach, the local venture should find itself on a most suitable footing to tackle the Chinese market, without committing large investments with slow returns. Cash generation is ensured and need for financing is minimized.

7.2.2 Sell then produce

A similar, step-by-step approach can be developed from a sales point of view, if a product is initially competitive on the Chinese market (to local or global clients in China). In such a case, once sales are successful and in sufficient volumes to add a production site, the step-by-step entry strategy would call for the set-up of a local production, to be nearer to the customers and acquire more of the China market share.

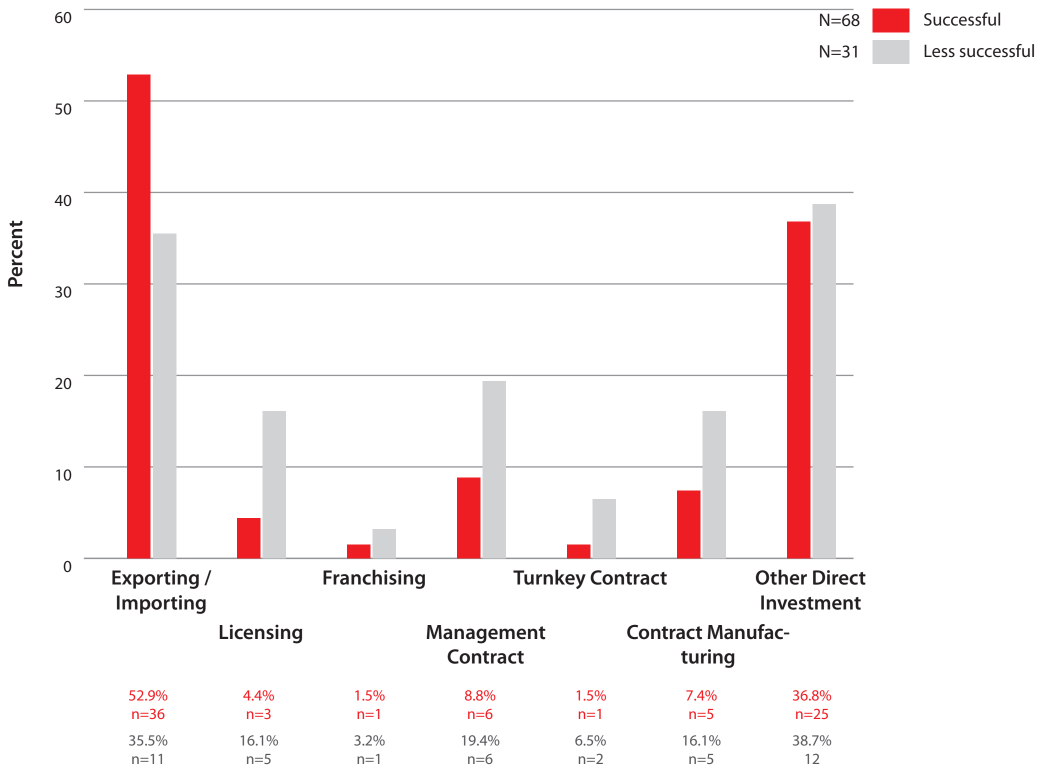
In order to make this step faster, exports from the new production sites can initially supply the Asian or traditional markets and a specialization strategy with the mother company (as for the 'purchase then sell' strategy) can be pursued.

7.3 Entry way

An analysis of successful companies against the others shows that enterprises starting in China with a management contract, licensing or contract manufacturing are less successful when compared to those who invest or trade: producing by proxy gives less success. Pure trading (importing/exporting only) is an activity showing more successful companies than less successful companies in proportion to the total.

Survey chart III - 7

Entry way: Successful and less successful companies
(All companies) N=111

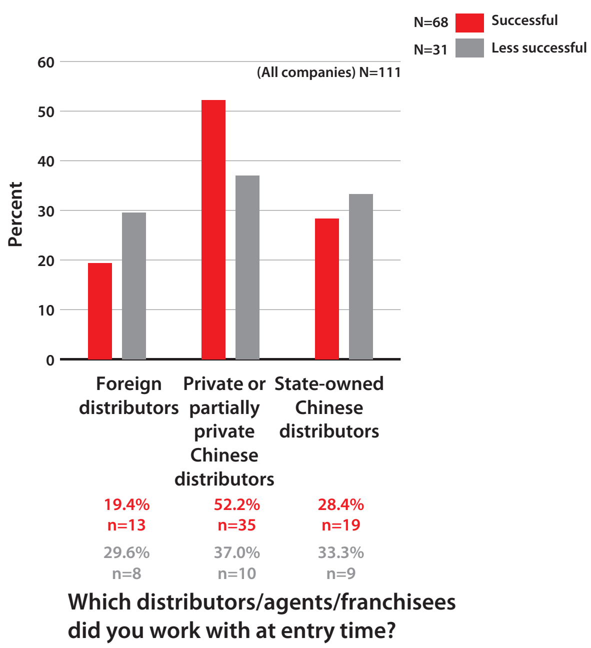


Which entry mode did you choose to start your business activities in China?

Source: Swiss China Survey, 2005

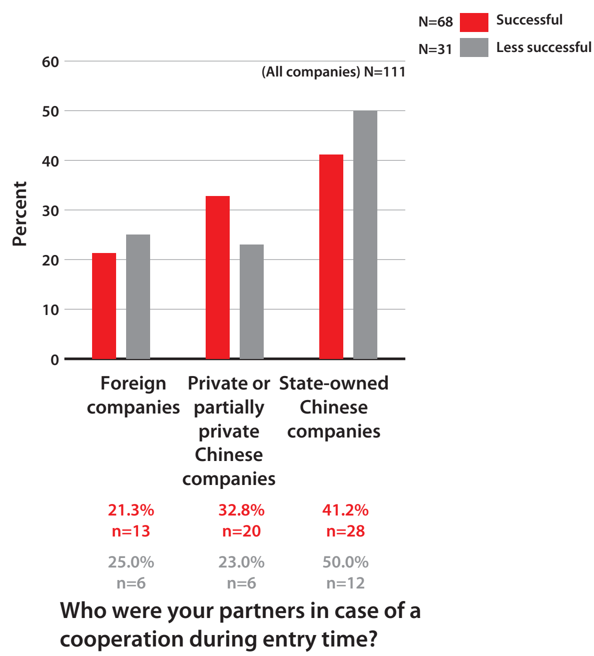
Survey results also show that for companies using an agent, those using a private Chinese agent do better than those working with foreign distributors, or Chinese state-owned companies.

Survey chart III - 8



Source: Swiss China Survey, 2005

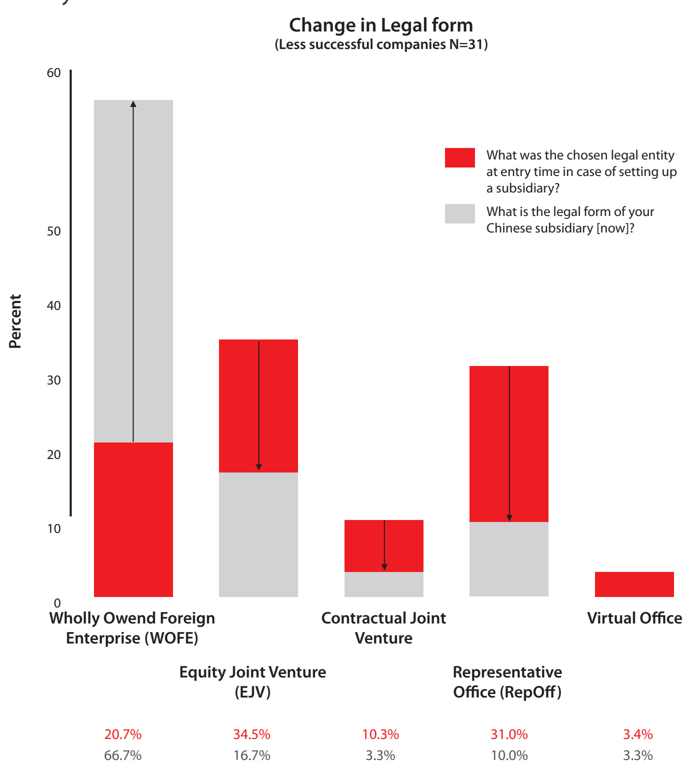
Survey chart III - 9



Source: Swiss China Survey, 2005

The two Survey charts III-10 and III-11 show that more successful companies set-up less Joint-Ventures (JVs) than less successful ones.

Survey chart III - 10



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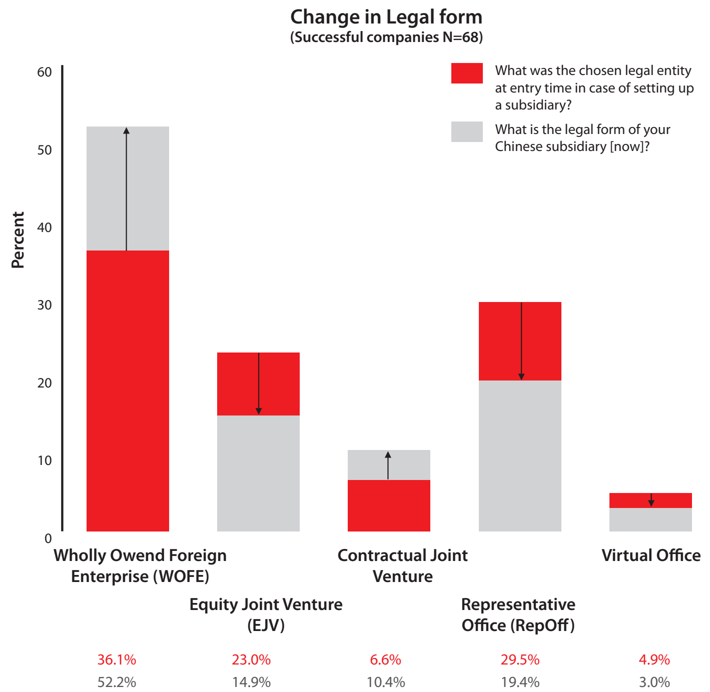
ource: Swiss China Survey, 2005

Survey chart III - 11



Source: Swiss China Survey, 2005

JVs and Representative Offices, both, are replaced with time by Wholly Owned Foreign Enterprises (WOFE).

Against often represented ideas, the above elements on entry way and joint-venture point to invest directly, being involved directly with the mainland and avoiding Chinese investment partners.
All indicate that a hands-on approach to operating in China is favorable to implement a strategy successfully.

7.4 Entry legal forms, Joint-Ventures

Joint-Ventures have largely been unsuccessful so that most multinationals who started with JVs in the early days have switched to WOFEs, either through buying out their partners or setting-up additional operations on their own.

The main reason for the failure of JVs is certainly the lack of converging goals of the partners, or as often mentioned: "sleeping in the same bed but having different dreams". Different management styles, different mentalities, different cultures have been blamed. Yet, such reasons for failure still can be analyzed back to misspelled or misunderstood expectations and, finally, different interests.

JVs were still set-up because there were no alternatives until WOFEs became a standard option in the early 90s.

Today, only a few strategic sectors still require the foreign investor to take a JV partner; among others, infrastructure and energy, the production of automobiles, aerospace and military related applications, high potential business to consumer services (such as education, health care, financial services, telecommunication operation).

As a result, most enterprises can set-up a wholly owned subsidiary. In such a case, the pre-requisites for setting-up a JV can be generally based on the same principles as in other countries:

- Common goals and interests of both partners

- The contribution of assets from both parties that truly add value to the venture and that either partner would not be able to bring together alone
- A tested relationship: ensuring through sufficient experience in previous business and personal dealings that both partners understand each other and do not have hidden agendas.

Such conditions are more likely to be fulfilled with private Chinese who own and develop their businesses at fast speed. They either established their own company or bought out former state-owned companies. Indeed entrepreneurs have a profit motive that is not biased by the socio-political goals of state run units. This is however not enough, in many cases the foreign company's purpose have strategic long term goals that go against the pure profit motives of Chinese entrepreneurs. As a result, common resources would then be allocated in different ways by the partners. The Chinese will be looking for fast cash generation and growth while the Swiss intends to achieve market position and to protect its operations at home.

Representative offices present considerable limitations since they do not allow business to be done directly, but only through agents. Their potential replacement - the 100% foreign owned trade and distribution companies - have started to be registered in 2005. They will most probably become a standard and preferred entry legal form for foreign companies.
(Also see Chapter II Legal, Tax & Finance, 'Establishment of trading, distribution, retail and franchising operations in China', for more information on this new legal form and 'Foreign investment and corporate tax' for details of legal forms that foreign companies can select to register in China.)

8 Selecting a location

A large majority of Swiss companies are in the Shanghai, Beijing and Guangdong areas, while an important concentration is also found in Jiangsu and Shandong, on the coast between Shanghai and Beijing. (See Chapter I, General Environment, Switzerland in China for the breakdown of Swiss subsidiaries in China by industries and legal forms.)

In general lines, Guangdong and the Pearl River Delta are known for the price-sensitive mass consumer goods industry (electrical appliances, consumer electronics, apparel, toys, pens, low-cost watches, giveaways, for example). The Yangtze Delta, while covering the consumer goods sector, is a base for higher-tech industries, equipment and industrial goods. The Beijing area, while strong in IT is otherwise more focused on government controlled or heavier industries.

The rule of law is generally better respected in big centers, with Shanghai at the top. Indeed, owing to the more political nature of Beijing's environment and the smuggling tradition of Guangdong (the single door to China's trade until 25 years ago), these 2 areas have been traditionally more flexible in terms of legal aspects.
(Also see Chapter I, General Environment, Geographical Areas for more information on China's regions.)

8.1 Criteria for the Selection of a Location

The considerably different ratings that managers give to different difficulties in different regions according to regions shows that location selection has a major impact on the future success of a business venture in China. (See Chapter I, General Environment & Trends, 'Geographical Areas' for an analysis of difficulties by regions)

'corruption', for example, is rated last as a difficulty in Shanghai, while it takes middle position in Beijing.
On the other hand, respondents in Beijing perceive **'changes in laws and regulation'** as their most important difficulty while it comes second and third to last in Guangdong/Jiangxi and Shanghai, respectively.

For another example, **'local materials/components/services are not up to necessary standards'** is rated last in Beijing but second in the South.

The following general criteria should be considered when selecting a location. Their importance may be different depending on the particular needs of a company. And though the list is extensive, other criteria may need to be added to meet very specific cases:

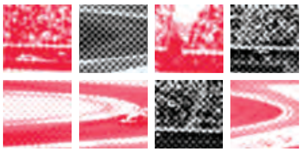
1. Possibility to register the legal type of company needed by the considered company and interest of the local industrial zone or community to attract such industry and company (e.g. attention must be paid to pollution and emission levels, some areas accept only industries classified as hi-tech or companies that only export, many types of service companies are usually allowed in restricted, designated areas only).

2. Actual availability of premises the company would need in case of rental or purchase of an existing building (size and other specifications such as floor load, cranes, for example). In such a case, the willingness of the landlord to accept necessary modifications to his building needs to be confirmed.
In case of buying land for construction, minimum plot size and the required density of investment might be an issue. Indeed smallest plots of lands are usually around 12'000 sqm. and many areas require a minimum value of investment per square meter to be effected within a limited period of time.

3. Access and quality level of infrastructure
   - Availability and reliability of utilities (electricity, gas, phone lines, broadband internet are most important)
   - Road size and load to the factory site, allowing loading and off-loading of materials and finished goods (40' container trucks need space to maneuver)
   - Public transportation for personnel (Chinese employees usually do not own cars)
   - Transportation to airports, train stations and seaports. Destinations and service that they offer for people and cargo.

4. Level of rule of law, fairness of the court system and its ability to enforce decisions. This has a considerable impact on the general culture of the local population in terms of respecting agreements:
   - Suppliers, business partners and other stakeholders are more likely to respect their agreements where rule of law is stronger.
   - Employees, in particular, will respect non-disclosure and confidentiality agreements better, which allows a better protection of know-how and trade secrets.
   - The legal seat of a company may often be the location where a contract will be brought to court and enforced: a location enjoying better rule of law increases chances of success in case of conflicts.

5. Human Resources quality and availability
   This aspect has a major impact on every company since HR elements are considered one of the three key categories of success factors. The following elements are worth considering:
   - While workers are mobile (there are about 100 million migrant workers in China) and top management can be moved from one place to another with adequate compensation, it is not practical (or often impossible) to motivate middle-management to leave its home location. Most middle-managers have families, own a house and are therefore not naturally a mobile workforce. Besides, most companies face more difficulties with recruiting adequate middle management than with the rest of their personnel.
     In this respect, it is important to realize that if the qualification level of the local workforce (particularly the middle-management) is not adequate, relying on training personnel to a considerably higher level than the average is a risky solution. Indeed:
     - to train staff and maintain an acceptable level of operation, a larger number of expatriates is needed, at higher costs than in the home country



- convincing foreign personnel to join an operation in a lesser developed area of China and retaining them is an additional difficulty
- trained people are vastly better but much rarer than the average, so that other (particularly foreign) companies setting up in the area have the natural tendency to poach them and offer higher salaries
- the initial employer who has born the training costs, finds itself obliged to increase salaries of skilled people to retain them or lose them to newcomers
- Due to the general short supply of hi-skill employees, their remuneration increases faster than in areas with sufficient supply
- as a result and to keep their workforce, pioneers companies in less developed areas finally work as free schools, while having to pay more than they planned for their personnel if they are to retain them.

All in all, setting up in an area where the workforce does not meet the standard level of skills and qualification may become a source of constant difficulties or generate hidden training cost, unless the area does not attract any new foreign companies at all. In such a case, trained employees may not have other job opportunities in a foreign working environment and accept relatively low pay. However, in an environment that does not attract additional foreign investment, other major difficulties are to be expected.

In general, the pioneering role of investing in newly developing areas should only be undertaken by large companies with sufficient resources; by playing it right, they may generate considerable credit from the local authorities through their development efforts and establish a good local reputation for the long term.

6. Quality of services
   - maintenance and repairing for technical equipment
   - local administration (customs, tax bureau, foreign exchange administration, among others)
   - banks, legal & business counseling, HR & training support
   - IT, graphics design and printing, among others

7. Support of local authorities for troubleshooting

8. Visibility and prestige

9. Location of main potential clients and suppliers

10. The related ratio of quality/costs of the above aspects, with respect to the company's needs in these terms.

- Quality is a key factor for success and one of the areas where Swiss companies have a strong competitive advantage over other foreign or Chinese companies. Foregoing quality for lower costs rarely ensures success. As a result, location selection (as well as other factors influencing success) needs to ensure quality before considering costs.
- To ensure quality, human resources, particularly management, need to be available in the right quality as well. In most cases, having the possible local human resources guarantees quality and then success. Or, in other words, paying less for less good people than available usually ends up costing more in productivity, wastes or bad service and lost clients than the savings made on employees costs, particularly since salaries are relatively low.
  As a result, it is essential to make sure that a location offering cheaper personnel does not translate in actually less able employees, when considering all elements, including character, attitude, ability to think in the terms needed by the company, exposure to Western ways, etc …
- In terms of costs, areas that are often considered low-cost actually may include hidden costs that finally make the overall operation more expensive, depending on the type of operation to be set up:
  - In operations that are management and skilled-work intensive, the additional cost of management (including expatriates), training, transportation to ports (for goods, visitors and foreign personnel) may well be more than the savings on workforce salary. The situation may be different for companies that are labor inten-

sive and need a high amount of relatively low-skilled workers in comparison to management.

- Operations that rely on expensive equipment can quickly generate high unexpected costs by remaining idle should machine operators generate more failures, the servicing be ineffective, or the infrastructure be inadequate (power failures, for example)
- The cost of maintaining relations with local authorities may also be much higher than expected in the form of, for example, undeclared or new taxes, requests for sponsoring or expensive entertainment.

Costs in different regions according to respondents of the Swiss China Survey are analyzed in Chapter I, General Environment, Geographical Areas.

8.2 Evaluating different locations: a note of caution

Industrial zones are heavily competing for foreign investments. They may show a lot of interest in attracting a Swiss company to add prestige and attract further foreign companies. Indeed, Switzerland has an excellent (if not the best) name in China and abroad in terms of the quality of its enterprises.

To achieve this purpose, a local government may make very attractive and sometimes wild promises. No matter how official and duly chopped and signed is a document promising special treatment or incentives, its benefits may be reversed anytime by a superior authority if the offers made are beyond the competence of those who signed it. Such a case, for example, delayed the set-up of the USD 50 million German Center in Pudong for over four years.
In order to properly evaluate local authorities' promises, two precautions maybe taken:

- Review the local rights with experts to ensure that conditions offered are legal
- Have discussions with other foreign invested companies in the area to understand what the actual local practice is. Make sure, however, that such companies are not selected by the local authorities themselves and that their needs are on a similar level as those of the prospecting company.

9 Selecting local or foreign management

In terms of appointing their China subsidiaries general managers, Swiss firms are of two minds, they relatively equally have a foreigner run the company or select a Chinese (in that case the Chinese is rather fully local than a Chinese with experience abroad).

The trend for localization of foreign general managers is there. Still, slightly more than half of successful companies intend to keep an expatriate to run their China operations for the coming three years.

Chinese, though, are the clear preference for the position of Sales Manager and for the other direct subordinates to the general manager. (For the corresponding charts and a more detailed analysis, see Chapter IX Human Resources Selection and Management, 'Localization of management'.)

By experience, more important than the nationality, are the abilities and attributes of the manager. Nowadays, there is a number of non-Chinese holding considerable local experience, while there are even more trustworthy Chinese that worked in top positions of foreign companies for ten years or more.

At the start of an operation, however, mother company staff will almost certainly be needed to handle technical aspects, if there are any.

Finally, a foreigner may be entrusted with the general management of a daughter company in China to generate the necessary trust between the headquarters and the subsidiary. However, experience shows that able local Chinese

management will cost less and proves more efficient - to understand the local market and to handle the numerous government related officials, for instance.
In the case of selecting a local General Manager, China-based expatriate operations support professionals may coach the local General Manager until the operation is running smoothly and the relation between mother company and subsidiary has been established in a solid way.

(Also see Chapter IX Human Resources Selection and Management for details on how to select and manage Human Resources in China.)

10 Financing Businesses in China:

10.1 Relevant Swiss and International Funds & Risk Guarantees

by Susanne Grossmann, Regional Head for Far East, SOFI

10.1.1 Supporting Investments in Countries under Development and in Transition

The Swiss Organization for Facilitating Investments (SOFI)
was created in 1997 on the initiative of the Swiss State Secretariat for Economic Affairs (seco) in cooperation with KPMG. SOFI's role is to promote investment projects of companies in Switzerland in countries with developing and transition economies, and to enable the transfer of capital, technological know-how and managerial expertise through this process. www.sofi.ch

For additional information on financing your China business, contact:

- **Ms. Susanne Grossmann**, SOFI Regional Head for Far East at: telephone:**+41 1 249 28 88** or e-mail: susanne.grossmann@sofi.ch
- **the service centre - business network switzerland:**
  website: www.cross-border.ch
  address: Stampfenbachstrasse 85, 8035 Zurich
  telephone: 0844 811 812 (CHF 0.07/min), fax 0844 811 813 or email: info@cross-border.ch The service center is operated by four core partner organizations of the network, all supported by the State Secretariat for Economic Affairs (seco) - erg, Osec, sippo and SOFI. Other organizations within the network include bilateral chambers of commerce, Swiss embassies abroad, Swiss business hubs abroad and local specialists. In Switzerland this network consists first and foremost of the cantonal chambers of trade and industry, sector associations, multilateral economic promotion instruments, foreign embassies in Switzerland as well as of private sector experts and firms.

10.1.2 Providing Loans to SMEs Investing in China: the seco Start-up Fund (SSF)

The SSF is a credit facility established by the State Secretariat for Economic Affairs (seco) in 1997. The administration of the fund was delegated to the Swiss Organization for Facilitating Investments (SOFI). This fund is designed to promote private sector investment projects in countries with economies under development or in transition. The projects must be commercially viable and meet recognized environmental and social standards.

The early phases of investment in developing and transition economies involve business risks beyond those generally encountered in Western countries. The aim of the SSF is to share these costs and risks with the investor. It does so by

- facilitating and supporting systematic preparation of private investment projects (studies) through feasibility studies and business plans, and/or
- co-financing the initial investment phase (up to 3 years after start of operations). Financing by the SSF is in the form of a loan that must be repaid within 5 years from the time the loan agreement is signed. Erating for a maximum of 3 years or for acquisitions made with the aim of expanding and developing existing operations.

Fig III - 1

2. The SSF finances projects in the following countries in Asia, at the time of print: China, India, Indonesia, Vietnam. (Other developing countries are also eligible: see www.sofi.ch/global/seco/ for the complete list)

Financial Services	Foreign Exchange	Renminbi
Financing with Equity Instruments: Ordinary, Preferred, Cumulative Shares	yes	yes
Financing with Debt Instruments: Straight, Subordinated, Convertible Loans	yes	yes
Financing in Hybrid Forms: Guarantees, letters of support, etc.	yes	yes

3. The borrower/investor (either a company or a natural person) must reside in Switzerland. There may be co-borrowers with domicile abroad.
4. The project must have committed investors with sound reputation.
5. Investors (borrowers) should show evidence of adequate financing resources and management capacity to implement the project.
6. The project should have a positive long-term impact on the partner country's development. No harmful environmental effects or negative social consequences should result from the project.
7. Studies (preparation of private investment projects) will only be financed if there is an investor in place with a clear commitment and capacity to invest in the project. Only 20% of overall funds of the SSF are available for studies.
8. No other commercial financing sources (venture capital funds, term loans) are available to finance the project.

10.1.2.1 Standard Loan Conditions

1. The SSF covers up to 50% of the costs of the project's preparation or initial investment phase, with a maximum contribution in the amount of CHF 500'000. The other 50% is raised by the project's promoter(s).
2. Interest is paid semi-annually. The interest rate is based on the 3-year "Swiss Export Base Rate" (SEBR) plus a risk premium that is applied as follows: 1st year - SEBR + 2%; 2nd year - SEBR + 3%; 3rd year - SEBR + 4%; 4th year - SEBR + 5%; 5th year - SEBR + 6%.In addition, the SSF will charge a commitment fee of 1% on the loan amount not drawn for each year in arrears.
3. The contribution from the borrower to the project preparation or investment phase can be in cash or in kind (property, equipment, materials), but not in working hours. A third party will determine the value of a contribution in kind.
4. The SSF can be used to finance fixed assets (land, buildings, equipment and materials), costs of setting up the project and working capital, but not working hours of the borrower. The value of fixed assets should be at cost but not higher than the market price.
5. The duration of a loan cannot exceed 5 years from the date of signature to the final repayment.
6. The SSF loan must be repaid before the project company pays dividends to its shareholders or pays off any other loans from investors.
7. The formal lender is seco. All the borrowers (both Swiss and foreign residents) are jointly and severally liable.

10.1.2.2 Required Documentation

- Complete business plan for an investment project
- Preliminary business plan in case of project preparation
- Latest financial statements of borrower
- Latest financial statements of other anticipated investor(s) (if not the same as the borrower)
- A copy of latest tax declaration (applicable to natural persons - borrower or investor)

(For a business plan format suggestion, please see www.sofi.ch/pdf/documents/businessplan1.pdf)

10.1.2.3 Procedure

1. Inquiries and project proposals should be addressed to SOFI.
2. SOFI will determine if the project proposal is eligible, and if so, request a detailed business plan from the applicant.
3. Once the applicant has submitted a detailed business plan to SOFI, it will take up to 2 months for the SSF Experts' Committee to make a decision.
4. If an application is submitted to the SSF Experts' Committee, the applicant is charged an application fee of 1% of the requested loan amount (minimum CHF 1,000).
5. For more information, also see www.sofi.ch/global/seco/ or contact:
   Ms. Susanne Grossmann, SOFI Regional Head for Far East at: telephone:+41 1 249 28 88 or e-mail: susanne.grossmann@sofi.ch

10.1.3 Sino-Swiss Partnership Fund

10.1.3.1 Objective

The Sino-Swiss Partnership Fund is a direct investment-fund with the objective of fostering strong Sino-foreign partnerships, mostly joint ventures. The Fund aims at assisting small and medium sized enterprises from Switzerland and other OECD-countries to invest in China. In doing so, the Fund will also promote sustainable development in the People's Republic of China. The Swiss government has contributed CHF 25 million and the Chinese government CHF 6.25 million to the Fund. In the first phase, the Fund will invest in and give priority to Sino-Swiss partnerships. In the second phase, the Fund will also support Sino-OECD partnerships.

Financing is predominantly in the form of equity, but the product range also features shareholder loans and guarantees. At an appropriate time and in accordance with the other partners, the Fund will withdraw from the partnerships and use the proceeds to support others. The China Development Bank (CDB) manages the Fund.

10.1.3.2 Services

The Sino-Swiss Partnership Fund intends to become, for a limited period of time, an active and valuable partner alongside the foreign and Chinese sponsors of direct investment-projects. It is able to lend financial and non-financial support to various forms of partnerships. In terms of financing offered, the Fund provides a diverse range of renminbi and foreign exchange denominated equity-, debt-, and hybrid-financing. The maximum financing for any partnership is CHF 5 million.

Non-financial support is offered by the fund manager, mostly in the form of assistance to project partners. Non-financial support includes advice to both parties during negotiations, board level representation and assistance vis-à-vis external parties such as the Chinese administration.

10.1.3.3 Non-Financial Services

- Due diligence to assess project viability and structure
- Participation and mediation in negotiations between Chinese and foreign partners
- Structuring of the investment
  - Procurement of additional financing (if necessary)
  - Monitoring and controlling
  - Mediating between Chinese administration and project partners
  - Supporting project management

The above listed services are free of charge. Other services, such as information on direct investments in China and other selected countries, or search for a suitable Chinese partner are available at no cost through the Swiss Organization for Facilitating Investments (SOFI). The fund manager as well as SOFI are also able to offer additional services such as consulting or support on feasibility studies, business plans etc. Such additional services will be charged at market rates.

10.1.3.4 Conditions

To qualify for support a partnership must include at least one Chinese national and at least one partner from an OECD-country, with the latter being a small to medium sized enterprise. Each partner must be willing and able to commit its own resources to the partnership over the long run. Formation of joint ventures and other forms of partnerships, may qualify for support by the Fund. Either the foreign or the Chinese partners (or both) may request funding from the Fund.
The Fund will only invest in partnerships that have a profit potential commensurate with the risks involved in direct investment projects in China and that will be able to function independently in the medium term, after the Fund has withdrawn its support.

For application process and more details, visit: www.sofi.ch/instruments/sspf.html

For additional information, contact either of the following:

Ms. Susanne Grossmann, SOFI Regional Head for Far East at: telephone:**+41 1 249 28 88** or e-mail: susanne.grossmann@sofi.ch

Mr. Michael Lee, General Manager, Sino-Swiss Partnership Fund at: telephone: **+86 10 6621 0272** or e-mail: lee_sspf@hotmail.com

10.1.4 Insuring Export Risk

Export Risk Guarantee (e r g) insures export risk in countries that are economically and politically unstable. It advises clients who require financing and risk insurance solutions.

The Agency was founded in 1934 as an organization of the Swiss Federal Government to fight unemployment and has gradually been developed into the instrument of export promotion that it is today.

10.1.4.1 Objective

The ERG Agency relieves exporters of certain risks which are beyond their foreign customer’s control.

10.1.4.2 Services

Exporters can use the Export Risk Guarantee for both consumer goods and capital goods. Construction and engineering work as well as other services are also eligible for coverage. The following services are provided by the Swiss-ERG Agency:

- Political Risk
- Transfer Risk
- Commercial Risk
- “Unlimited” Contingent Currency Risk
- Manufacturing Risk
- Non-coverable Risks

For more information on who can benefit from the ERG, terms of payment and extent of coverage, visit the Swiss-ERG homepage at www.swiss-erg.com

10.1.5 Importing from Countries under Development and in Transition

The Swiss Import Promotion Programme (SIPPO) promotes the competitiveness of emerging countries and countries in transition. Through its trade promotion programme, SIPPO helps small and medium-sized companies in emerging countries and countries in transition to improve their market entry to Switzerland and the European Union. It also assists Swiss importers to access new products, distributors and procurement opportunities. www.sippo.ch

10.1.6 Protecting against Country Risks: The Multilateral Investment Guarantee Agency (MIGA)

MIGA was created in April 1988 as a member of the World Bank Group and began operations in 1990. The objective of MIGA is to encourage the flow of investments for productive purposes among member countries, in particular to developing member countries. To serve this objective MIGA issues guarantees against non-commercial risks for foreign direct investment (FDI) in its developing member countries that originate in any of its member countries and provides technical assistance to governments of developing member countries to improve their ability to attract FDI. Its primary means of facilitating investment is through the provision of investment guarantees against the risks of currency transfer, expropriation, and war and civil disturbance. MIGA also provides technical assistance to host governments on means to enhance their ability to attract foreign direct investment. Switzerland has been a MIGA member since the agency's inception. It holds 1,500 shares and has 1.36 per cent of the total voting power. MIGA offers guarantees to cover the following risks:

- Currency transfer restrictions that prevent investors or lenders form converting local currency into foreign exchange and/or transferring the proceeds abroad.
- Expropriation in the form of acts (direct or indirect) by a host government that reduce or
- eliminate ownership of control over or rights to the insured investment.
- War and civil disturbances (including political motivated acts of sabotage or terrorism) resulting in damage to, or destruction or disappearance of, tangible assets or interference with the ability of the foreign enterprise to operate.
- Breach of contract by a host government, provided the investor obtains an arbitration award or judicial sentence for damages and is unable to enforce it after a specified period.

MIGA covers several forms of investment, including equity, commercial bank loans, loans made or guaranteed by foreign equity holders and technical assistance and management contracts.

MIGA is mandated to assist investments that contribute to the host's country's development. The equity-related direct investments that MIGA facilitates are more stable than portfolio investments and are a necessary element of long term sustainable development.

MIGA can insure new investments originating in any member country and destined for any developing member country other than the country from which the investment originates. New investment contributions associated with the expansion, modernization or financial restructuring of existing projects are also eligible, as are acquisitions that involve the privatization of state enterprises.

An eligible investor is a national of a member country other than the country in which the investment is to be made. A corporation is eligible for coverage if it is either incorporated in and has its principal place of business in a member country or if it is majority-owned by nationals of member countries. State-owned corporations are eligible if they operate on a commercial basis.

For more details, also visit www.sofi.ch/instruments/miga.html and www.miga.org
For additional information about MIGA, contact Ms. Ariane Bauer at telephone: +41 1 249 21 63 or e-mail: ariane.bauer@sofi.ch

10.1.7 For Financing Feasibility and Post-Evaluation Studies: The Asian Development Bank (ADB) Swiss Trust Funds

The Swiss Trust Funds' objective is to finance the short-term mandates of consultants directly involved in the bank's operational activities as well as for independent studies; financing in particular of studies including preparatory studies, feasibility studies, environmental impact studies, evaluations, project follow-up studies, technical support for projects in the process of being restructured, and post-evaluations in the following countries - India, China, Pakistan, Bangladesh, Vietnam, Indonesia, the Philippines and Thailand. The financial activities are concentrated in the following four areas:

- private infrastructure projects,private investment projects
- projects designed to promote clean technology transfer
- projects to adapt the financial sector

For additional information, contact
Ms. Susanne Grossmann, SOFI Regional Head for Far East at: telephone: **+41 1 249 28 88** or e-mail: susanne.grossmann@sofi.ch

Contributed by SOFI
The Swiss Organization of Facilitating Investments SOFI is offering financial support for qualified Swiss activities in China.
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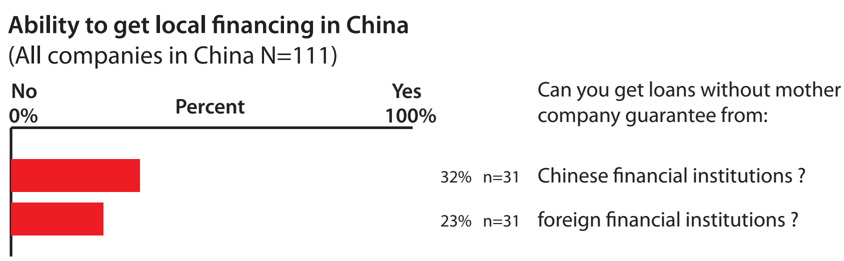
10.2 Obtaining Commercial Loans in China

by Wang Tao, Senior Consultant of a European IT company in Shanghai with CH-ina

Foreign Invested Enterprises (FIEs) can obtain commercial loans from Chinese and foreign banks in China or from abroad.

Yet, Foreign banks in China offer less financing opportunities to FIEs than local banks; at the moment, they usually do not provide loans on local assets, be they real estate, production assets or other assets. This is also confirmed by the Survey chart III-12.

Survey chart III - 12



Source: Swiss China Survey, 2005

However, the sum of accumulated RMB loans as well as foreign loans of FIEs (whether short, medium and long-term) must not exceed the difference between the total investment and the registered capital amounts .

10.2.1 Maximum loans amount

The total investment amount is fixed at the time a foreign company is registered. The table below indicates the maximum total investment permitted according to the amount of registered capital. The difference between the total investment and the registered capital provides the maximum amount of loans that a FIE can obtain, from any sources, including from the mother company.

The table below provides the permitted amount of total investment with respect to the registered capital, therefore the maximum amount of loans a foreign company registered in China can contract. **For a registered capital less than USD 2.1 million, the total amount of loans is about 41% the amount of registered capital**. For instance, a USD 1.4 million registered capital allows a maximum total investment of USD 2 million and a maximum amount of loans is USD 600'000.-.

Such regulation is enacted by the Chinese government to compensate for the fact that a foreign company can keep operating, no matter its accumulated losses over time. In other words there are no restrictions to the debt/equity ratio of a FIE in China, except in terms of total amount of loans against initially registered capital.

It is also important to note that loans may be taken by a FIE only upon formal decision of its Board of Director.

Fig III - 2

Total Amount of Investment / Registered Capital (in million USD)							
1987 SAIC Regulations							
Total amount of Investment	0-3	3-4.2	4.2-10	10-12.5	12.5-30	30-36	>36
Minimum Registered capital	70%	2.1	50%	5	40%	12	1/3
2003 M&A Regulations							
Registered Capital	0-2.1	2.1-5	5-12		>12		
Maximum Total amount of Investment	unclear	X 2	X 2.5		X 3		
= Minimum Registered capital as percentage	unclear	50%	40%		1/3		
2004 Holding Company Regulations							
Registered Capital						>30	>100
Maximum Total amount of Investment						X 5	X7
= Minimum Registered capital as percentage						20%	~14.2%

Source: CH-ina (Shanghai) Co. Ltd.

10.2.2 Loans obtained in China

FIEs which need working capital, whether foreign exchange or local currency, may obtain short-term (1 to 3 years) loans from China's state-owned commercial banks and foreign banks subsidiaries designated to engage in commercial lending.

Medium and long-term loans are available from banks in China, but mostly offered to companies with large project, such as infrastructure and real estate development or for strategic purposes.

10.2.2.1 Loans usually offered in China

Loans from banks in China are generally available:

- against bank guarantees, non-bank financial institutions or other (usually large) enterprises guarantees

- by mortgaging property rights certificates, financial bonds, negotiable securities and production assets
- by discounting accepted bank drafts
- by leasing
- on company reputation or by overdraft

However, unsecured loans (on company reputation or by overdraft) are almost exclusively reserved to state-owned companies. Additionally, leasing financing is at its very beginning and is not generally available yet.

10.2.2.2 Interest rates

China's interest rates are variable on a yearly basis and set by the People's Bank of China. (Also see Chapter II, 'China's Banking and Currency System for Foreign Invested Enterprises'.)

Rates may not be fixed for the mid-term, even for mortgages.
Besides, banks have little freedom to offer different types of loans at different rates according to different risks. As a result, loans are usually difficult to obtain for enterprises that do not fall in the categories that are pre-set by the government. Such is the case for private, medium or small companies, for example.
A liberalization of the lending interest rate policy is under way since Autumn 2004, offering more freedom to commercial banks in setting their lending rates. At the time of print it did not fundamentally changed the access of private Chinese enterprises and FIEs to capital.

In the past 5 years, the interest rate for RMB loans hovered between 5% and 6% on an annual basis. The benchmark RMB lending rate was 5.6% at the time of print.
Interest rates in foreign currency offered in China usually match international money markets with a premium. The Euro lending rate was 5.6% at the time of print.

10.2.2.3 Loans on production assets

Though local loans are generally difficult to obtain without third party guarantee, production equipment can generally be used as collateral to apply for loans. Yet, in most cases, **only 30 to 40% of the depreciated value of a production asset offered as collateral is usually provided as a loan**.

10.2.2.4 Loans to purchase tax free imported equipment

As far as loans on production assets are concerned, it is important to note that **loans can not be obtained in China to buy foreign equipment to be imported under duty and VAT exemption** (See Chapter IV, Setting-up a Production, for more details).

Indeed such equipment can be imported duty and tax free only under condition that it is part of the FIE's registered capital, that is if it is part of the own capital of the company.

10.2.3 Loans obtained abroad

FIEs are free to borrow foreign currency from foreign banks and non-bank financial institutes abroad or from their mother or group companies (though within their permitted amount of total loans).

Nevertheless, all foreign currency loans or transactions that involve foreign currency payments to foreign creditors and which are foreign debts have to be registered with the State Administration for Foreign Exchange (**SAFE**).

10.2.4 SAFE requirements for applying foreign currency loans

After signing a loan agreement, a FIE need to register the amount and the contract term with SAFE before the foreign exchange loan can be obtained. Additional documents such as board resolutions, report of utilization of foreign exchange need to be provided as well.

Afterwards, a special foreign currency loan account shall be opened. Deposits into this account can only be the foreign exchange loan in the amount as stipulated in the loan agreement.

FIEs also need approval from SAFE to make repayment of the loan's principal and interests abroad.

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Sources

i Circular on the Guidelines for Verifications and Determination of Domestic Foreign-Funded Banks' Short-term Foreign Debts issued by the SAFE (2005)

11 Preparing for an assignment abroad

11.1 Relocating expatriate personnel to China

by Nigel Crockett, Business Development Manager China, Santa Fe Relocation Services Co. Ltd.

This section focuses on the key areas that have an immediate impact on anyone moving to China. The information in some sections may change over time as regulations change and different services become available. For businesses in China, the best way to keep up to date with changes in these key areas is to establish a good relationship with a professional relocation services organization.

This texts covers immigration, personal income tax, accommodation options, domestic help, health care and health insurance, education options, orientation services, expatriate services, and an introduction to some of the help and support sources for China.

11.1.1 Visas and work & residence permits

There are four key visa types for China ("L", "F", "X" and "Z"). The purpose of a visit, and to some degree, the length of stay, will determine which visa is the most appropriate for a trip to China.

11.1.1.1 Tourist visas L

The most commonly applied visa for tourists is the "L" visa. It is normally applied for in the traveler's current home country, through the Chinese Consulate or Embassy in the home country. Normal length of stay is 30 days, although this can be extended if sufficient need is presented at the time of application, and it can be extended in China for a further 60 days (two 30 day extensions) if required. The original application should take no longer than 10 working days to process. An "L" visa does not allow a foreigner to work or study in China. If foreigners are coming through Hong Kong on their way to China, it is often easier to apply for the visa in Hong Kong – which can usually be done overnight if an 'express' fee is paid.

11.1.1.2 Business Visas F

Business people, or those that come regularly to China for business related activities should apply for a Business "F" visa. This is not a working visa, but allows the holder to support their business whilst residing temporarily in China. In practice, the holder can stay in China for up to 180 days. The holder cannot derive income in China from his stay.

There are no real restrictions on the type of work or way in which the work must be done, however the government does cross-check tax and immigration records to see if the "F" and "L" visa's are being abused. Being caught will result in back-tax, as well as fines and late payment interest.

11.1.1.3 Students visas X

For students, an "X" visa is required. Anyone wishing to come to China as a student must first pay tuition fees and receive an admittance form from the education institution. This form can then be used in the home country to apply for the X visa.

11.1.1.4 Working visas Z

The working visa (Z visa) is used for anyone coming to China to work for a period of more than 3 months with a significantly more complex application process

The working visas (also known as a Z visa) is used for anyone coming to China to work for a period of more than 3 months. The application process for a working visa is significantly more complex than for a tourist or business visa, and the applicant must have a sponsoring organization in China that is authorized to employ foreign citizens.
The process for gaining a working visa differs depending on the type of legal entity that the sponsoring organization is, the country of origin of the applicant, and the city in which the application will be made. In general though, the following process is followed:

1. Enter China on either an "F" or "L" visa, ensuring that all company documentation (business licenses, employment license, etc) are all ready.
2. Complete a medical examination
3. Apply for employment permit
4. Apply for residence permit
5. Report at a local Police Station

The total time it takes to go through this process will be 3 weeks at an extreme minimum if everything is ready on time and there are no delays. Normally though, the process is done over a 4-6 week period.

Work visa's need to be renewed on an annual basis.

There are two other options for entering and working in China:

- The newly introduced 'Chinese Green Card'. The Green Card is the Chinese equivalent of permanent residence for foreigners, and is only granted to people with special skills that have lived in China for many years.
- The last option is the APEC business travel card. The APEC Business Travel Card cuts through the red tape of business travel, and gives accredited business people pre-cleared entry to participating APEC economies. The advantages include pre-cleared short-term entry to participating economies (no need to individually apply for visas or entry permits each time you travel), and many larger airports also have a special "APEC Card" priority immigration queue. Visas to China under this program currently allow for 60 days on each entry. APEC card holders must be a citizen of the country that participates in the APEC Business Travel Card program [1]. Further information about the card can be found at www.businessmobility.org

Under no circumstances should one risk overstaying a visa in China. Overstaying a visa will result in serious fines, black-listing and interviews from immigration officials. One will also risk the ability to apply for future visas to China.

Visa Application in Switzerland

Embassy of the P.R.C. in Berne
Kalcheggweg 10, 3006 Berne

Consulate General of the P.R.C. in Zurich
Bellariastrasse 20, 8002 Zurich. Tel: 01-2011073, Fax: 01-2017712.

- Opening hours: Monday to Friday, 9-12 a.m. (Express applications need to be handed in before 10 a.m.)
- Visa applications are treated within 5 working days. Against an "express fee", visa can be granted within 1 day (L, F).
- Visa need to be paid for in cash when picking them up
- Visa fee applies per person
- A visa application per mail is not accepted

For further information visit www.china-embassy.ch

11.1.2 Personal Income Tax and Welfare

Personal income tax is a complex and constantly changing environment: the information below should be used for indicative reference only. Professional tax advice should be sought for anyone wishing to work in China, and this advice should be reconfirmed every 3 years or so, or when substantial changes to an individual's situation occurs.
Normal international practice is for countries to tax the worldwide income of foreign employees whose permanent residence is in the location abroad. Under current tax regulations in China, however, unless they have lived in China for more than 5 consecutive full years, foreigners pay tax only on their China-earned income, not on their worldwide earnings..

If a foreigner spends more than 30 consecutive days (or 90 days non-consecutively) outside of China in a calendar year, that year is not treated as a full year for this purpose. In practice, by planning long trips out of China every 5 years, it is therefore possible to perpetually avoid liability to be taxed on worldwide income in China. It is good practice to ensure that your old passports are kept, showing the dates that you left and entered China, to provide proof of your 30 or 90 days absence should it be required at any time.

For most foreigners, their China-based income (on which they must pay personal income tax in China) is their salary and other employment benefits, excluding those employment benefits which are given tax-free treatment under the China tax laws.

Personal income tax on taxable employment income is computed and paid monthly, after an allowance of RMB 4'000.-/month standard deduction for foreigners, at the following marginal tax rates (China has a graduated tax personal income tax system):

Fig III - 3

Personal Income Tax For Foreign Employees:

Applicable to Wages and Salaries Received from a Company in China

Taxable Monthly Income = **Gross Monthly Salary - Tax Free Amount**

Monthly income tax = (Taxable Monthly Income) x Tax Rate - Deduction

Notes:

1. The **Gross Monthly Salary** is the amount the employee earns before any deduction (e.g. welfare & tax)
2. In 2006 the **Tax Free Amount** is RMB 4'000 which is deducted from the **Gross Monthly Salary**
3. No income tax applies for **Gross Monthly Salary** lower than RMB 4'000.
4. For online calculation use this link "http://hrs.ciicsh.com/service/company/hr_tools.asp" (in Chinese only) and go to "税务计算"
5. No individual Social Welfare is paid by foreigners in China

Calculation base:

Level	Taxable Monthly Income (RMB)	Tax Rate %	Deduction (RMB)
1	less than or equal to 500	5	0
2	between 501 and 2000	10	25
3	between 2001 and 5000	15	125
4	between 5001 and 20'000	20	375
5	between 20'001 and 40'000	25	1375
6	between 40'001 and 60'000	30	3375
7	between 60'001 and 80'000	35	6375
8	between 80'001 and 100'000	40	10375
9	more than 100'000	45	15375

Example:

If Mr. XXX, a foreign employee, receives Gross Monthly Salary from the company in China of RMB 30'000; his taxable income is RMB 26'000 and is on Level 5. His income tax shall be calculated as:

Monthly Income Tax= (30'000-4'000) x 25% - 1'375 = RMB 5'125 (or 17.1%)

Therefore his Net Monthly Income is 30'000-5'125 = RMB 24'875

Source: CH-ina (Shanghai) Co, Ltd

No social welfare or insurance need be paid by foreigners in China, whereas foreigners are not entitled to receive any social benefits from China either. Employers and foreign individuals are free to make their own arrangements in this respect.

Under current tax regulations, housing, schooling, vehicles, and other specified employment benefits received by a foreigner qualify for tax-free concessional treatment (i.e. they are not considered as taxable income). It is extremely important to ensure that the employer is provided with official invoice (PRC tax receipts) to cover these tax-free benefit payments, otherwise the benefits will be taxable, with the employer then becoming liable to pay back tax, as well as fines and late payment interest.

The amount of these taxation concessions can be quite advantageous. For instance, an employee spending USD 5,000 per month on rent and sending two children to an International School (USD 23,000 per year per child) would save up to USD 86,700 per year in taxation obligations, based on these two concessions alone.

Another major tax-free concession for foreigners relates to 'home leave' travel. The home leave concession provides for a tax-free treatment of two home return trips each year. 'Home' for this purpose is the country where the employee has either citizenship or permanent residence, or the citizenship or permanent residence of the employee's spouse if that is different. The key considerations are that the tax-free treatment is limited to the employee only (travel by the spouse and dependents is taxable), is limited to two trips per year, and is limited to specific destinations. Sticking strictly by the rules, it is clear that a family holiday trip to Fiji in lieu of a home trip to New York, should properly be subject to full tax obligations (unless the employee or spouse has Fijian citizenship or permanent residence).

11.1.3 Available accommodation and prices in different locations

Accommodation quality and pricing varies greatly across the major cities of China. Although the quality of expatriate housing has been improving, for top class accommodation there is often higher demand than supply. This leads to rental price increases in the upper-part of the market. Wealthy Chinese are also becoming more discerning on quality of properties, which is adding to price pressures. This section focuses solely on rental prices, as the majority of expatriates in China will not purchase housing.

11.1.3.1 Shanghai, Beijing & Guangzhou Property Scene

Shanghai, Beijing, and Guangzhou all have a huge range of properties, in price ranges from USD400 per month to USD20,000 plus per month.

Shanghai is the most expensive of the three cities, followed by Beijing, and then Guangzhou. All the cities are experiencing an increase in the supply of quality apartment complexes, although this increase is still not meeting the demand for quality property in any of the cities. Additionally, as the local Chinese population becomes more wealthy, they also demand higher quality housing options, and this is putting demand-pressure on quality developments in all locations.

Most foreigners live in apartments. At the extreme luxury and convenience end are serviced apartments in established quality buildings, where a 2-level penthouse of about 250+sqm. can be rented for about USD10,000+ per month, and a 2 bedroom 130 sqm. apartment for up to USD5,000 per month. These apartments are generally furnished with quality furnishing (a selection often available), and are within easy walk of central business district (CBD) areas, western shopping and entertainment facilities. At these prices, they cost about the same as living in a 5-star hotel, but the apartments are large enough to feel at home.

Average apartments (popular area, 2 bedroom, 140sqm, quality compound) for foreigners tend to be priced between USD2'500 to USD3'000 per month.

11.1.3.2 Local Compounds

Villas have always been a sought after living option in the main cities and their pricing is a consequence of this situation. In either Beijing, Shanghai or Guangzhou, it is not possible to live in a villa in a good location for less than USD3,500 per month. Popular villa complexes in Pudong offer family living solutions, with rental prices for 3-4 bedroom villas (or semi-detached homes) in the range of USD5,000 to USD7,000 per month.

At the luxury end of the villa market are palatial properties that come complete with indoor or outdoor swimming pools, multiple garaging, large indoor and outdoor entertaining areas, and a raft of modern conveniences. These properties reach prices of over USD20,000 per month, with the most expensive in Shanghai achieving a rental of close to USD30,000 per month.

Most foreigners don't end up living in 'local' developments, but for those that are prepared for the additional stresses that this involves, the cost savings can be substantial. Building quality is lower, noise insulation between apartments is not to the same standard, and expectations of residents is much lower (residents in local buildings regularly treat hallways as an extension of their own home).

For example, a near-new, furnished, 3 bedroom 160sqm. home in Hongqiao district of Shanghai will cost around USD1,000 per month. Even though there is a wide price variation, the majority of foreigners still opt for International Standard Compounds due to the higher building quality, and building management standards.

Yet, through direct on-site research (therefore available time) and flexibility on the location, **rental costs can be significantly reduced, e.g. by moving to a local compound**. This is a matter of personal standards and choice, related to the private situation (age, with or without spouse/family) as well as a function of employment set-up: Locally employed foreigners on middle management level or entrepreneurs without housing allowances provided by the mother company are often able or even forced to find significantly cheaper solutions.

Although the quality of properties is rising, some of the standard inclusions in western countries are taking a while to catch on. Here are some tips of what to look for in a quality property:

Tips for checking property quality

- It is still common in Shanghai for new buildings to not be fitted with double glazed windows. In addition to providing poor noise insulation, given the extremes of summer and winter in Shanghai, a lack of double glazing can lead to a waste of energy. Also check to see that the windows close properly, with no gaps (rubber seals on aluminum windows are the best type).
- Neighbors can make a big difference to your living experience. If you are moving into a relatively new building (particularly 'local' buildings), check to ensure that your neighbors to the side, above, and below have all finished their renovations. There is no real enforcement of noise pollution, so better check this prior to signing a leasing contract.
- Plumbing can be a problem in some buildings (both new and old), and it is strongly suggested to check by flushing toilets, filling sinks and seeing how fast they empty. An 'open sewer' smell near buildings may occur. This is caused by the lack of u-bends in plumbing. The u-bend is designed to trap smells inside the pipes, but has not been widely adapted in Chinese building construction.
- Water Pressure can be a problem. It is always worth checking what the water pressure is like in your proposed new home prior to signing a lease.
- Security differs in different buildings. Don't necessarily expect the security guards to help with your groceries or stop anyone that wants to get in to a particular building – they are often more of a deterrent than an effective security solution. The best security involves a combination of key cards and door codes, together with security guards.
- Smells – some buildings are built in winter, and a particular setting agent is often used in the concrete. If the concrete does not set properly, there can be a strong 'chlorine like' smell (especially in the bathrooms). This usually dissipates with time, but can linger on for years in some buildings. If you are shown a home with windows open (especially in winter), you should be especially wary.
- Landlords can be your blessing, or your worst nightmare. Developers are generally much better landlords, private landlords are often difficult to deal with, and can be much less scrupulous when it comes to maintaining the property or terminating a lease.

Other areas of China outside of the key cities are growing rapidly, but all popular cities have residential areas that are of an acceptable standard for foreigners. In some more out-of-the-way cities, hotels are still the only option open to foreigners who require at least a moderate level of modern western amenities.

11.1.4 Domestic Help

One of the greatest perks about living in China is that domestic help is extraordinarily affordable. Quality of domestic help varies significantly with the experience of the maid, and hourly rates are often overpriced when first asked for.

Maids in Shanghai generally feel that they should be paid more by a western family than a Chinese family. The only real basis for this assumption appears to be that they believe Westerners earn more than Chinese, and therefore they should pay higher salaries. Tough negotiation up front will always be necessary to ensure that you are paying market rate.

In reality, the hourly rate in Shanghai for basic cooking, cleaning, ironing starts from about RMB6 per hour for at least 20 hours per week. Fewer hours will mean a slightly higher rate, but more hours generally don't translate to a much lower rate.
Some families prefer to have a live-in maid, which is less costly again. Nannies tend to be live-in, and generally will look after a child on a 24 hours basis, with perhaps 1 day off per week. Experienced Nannies will be more expensive than maids that are only expected to cook and clean.

Since Chinese maids do not speak any English, another option for domestic help is not strictly legal. Philippine domestic help are available, but cost substantially more. Usual salary expectations start from a minimum of RMB3,000 per month for a live-in position. A Philippine may also need to travel to Hong Kong periodically to renew her tourist visa. Note that it is illegal to work on a tourist visa, and although it is very convenient to have an English speaking and well-trained Philippine maid, due to legal issues, such solution should be avoided.

11.1.5 Health care

According to Chris Hughes from Healthline Asia (www.heathlineasia.com), Shanghai and Beijing have made great strides over the past few years to bring health care up to Western Standards. Joint Venture hospitals, staffed with Western and/or Western trained Chinese Doctors, such as Beijing United Family Hospital (www.bjunited.com.cn), East International Medical Centre (www.seimc.com.cn) and Worldlink Medical Centres (www.worldlink-shanghai.com) are changing the profile of health care in China's largest cities. These Hospitals and medical centers have shown great improvements in the services offered to foreigners based here.

With those major investments, Shanghai and Beijing are fast becoming some of the most expensive medical service centers in the world - and someone eventually has to pay for that.

Outside of Shanghai and Beijing the same investment has not been made other than pockets of good clinics in Tianjin, Nanjing, Xiamen, and a few other locations, and most of these are run by International SOS, an emergency evacuation specialist (SOS evacuates over 400 people per year out of China).

Hong Kong has the most advanced and capable western hospitals in the immediate region around Mainland China, and there is no shortage of quality medical care there. Average costs of evacuating a person to Hong Kong from China for further or specialist treatment runs at over USD30,000, with hospitalization and the actual treatment costs on top of it. In most cases that require a high level of specialist care the recommendation is still to be treated outside of China, which is one of the key reasons why **comprehensive travel insurance protection is strongly recommended** for both leisure and business travelers to China.
Foreign Companies generally have a kind of global insurance policy in place for their expatriate employees and family members. The benefits and coverage of the insurance can vary significantly between policies – with excesses and de-

ductibles, and coverage for some items varying greatly. It is of course possible for individuals without such generous employers to arrange their own medical insurance, of which the options are endless.
One of the biggest challenges that expatriates face in China (as with other locations in Asia), is paying for medical treatment when it is needed. To date only a small number of International Insurers have made the effort to build-up a network of 'direct billing clinics and hospitals' in China. Most have not. Unfortunately, this often means a large out-of-pocket expense for expatriates requiring medical services in China, with a lengthy 2-4 months to recoup the costs from the insurance company. This can and often does add additional stress to an already difficult situation. Avoiding this kind of sudden cash outflow can be a major concern for individuals and employers alike. Luckily, this kind of situation can easily be prevented, by selecting an insurance provider with 'direct billing links' to the clinics or hospitals that will send bills directly to the Insurer for payment.

It is important to ensure that insurance policies cover any possible medical emergency in China, with a low franchise and a high degree of service.

11.1.6 Children's education

Education in China for expatriate children rates among some of the most expensive in the world, but it is also some of the best in the world.

For many families sending their child(ren) to International Schools, this will be the biggest expense of their expatriate experience, potentially even larger than their housing rental costs.
For expatriate families, the first choice when selecting a school is the syllabus that is taught.

11.1.6.1 England & Wales National Curriculum

For Families from Australia, New Zealand, and the UK, an English syllabus ensures that their Children will not be disadvantaged in their education when they return to their home countries.
Options for the English Syllabus comprise two main schools – either The British International School (www.bisshanghai.com), or the Yew Chung International School (www.ycef.com). Both schools have excellent reputations and high academic standards. The Yew Chung International tends to place more emphasis on Chinese Language skills, and The British International School is well known for its more strict academic standards and its Arts and Sports programs.

11.1.6.2 American Curriculum

For families from the United States, there are American syllabus schools that offer a continuity of education for the children of American expatriates.
There are three large International schools that have an American syllabus; they are the Shanghai American School (www.saschina.org), the Shanghai Community International School (www.scischina.com), and The Concordia International School Shanghai (www.ciss.com.cn)

11.1.6.3 European Schools

For European expatriate families, there are French and German schools that offers a good standard of European style education as well.

The Shanghai French International School (ef.shanghai.online.fr) services the French expatriate community, and the Shanghai German International School (www.ds-shanghai.org.cn) services the German expatriate community.

11.1.6.4 Other Schools

Expatriates from Hong Kong, Singapore, or Taiwan often prefer to send their children to a school that has a teaching focus in Mandarin Language. The most respected school for this is the Shanghai Singapore International School (www.ssis.cn), which follows the Singapore National Curriculum.

An "International" curriculum is followed by the Shanghai Rego International (www.srisrego.com), although it is well attended by students from many different countries.

All the above International Schools involve tuition costs of over USD20,000 per year for high school students, and slightly less for younger children. All schools offer discounts for full year payment, and/or multiple children in the same school.

Although it was common in the recent past for companies sponsoring expatriates to pay for their children's education fees in Shanghai, this practice is becoming less predominant, which is leading to a limited number of alternative education options.

The International Division of Shanghai High School (www.shs.sh.cn) is one such alternative, however. The school is a division of a quality local school that has been established to provide services for international students, and Chinese students with an advanced level of English whose parents wish them to study an English Curriculum. The school has a predominantly American Curriculum, and naturally has a stronger focus on Chinese Language proficiency than the standard International Schools. Tuition fees are generally about half of that of the International Schools (around USD10,000 per year).

There is also a growing trend among expatriates to form small groups and hire their own teacher(s), sharing the cost among the group. There are no official websites that promote this, and it is generally the domain of long-term expatriates on local-plus packages with more than one child. This option may not necessarily be cheaper than the options above, and it certainly means a much more direct control over your children's education than what other options require.

11.1.7 Introduction seminars and tours

Orientation programs are widely used by companies in the main cities in China to quickly bring their employees up to speed with their new environment. Orientation programs vary greatly between complimentary 'city tours' that are often provided by real estate agents, to fully tailored 1 or 2 day itineraries that provide a personalized introduction to the new location.

There are a large number of companies that offer Orientation services (also referred to as Look-See and Familiarization trips) in the larger cities. Prices and quality vary greatly. Some of these companies specialize almost exclusively on the orientation programs (subcontracting for international relocation management companies is a large part of their business), and other companies have specialist divisions within their operations that offer this service (for instance, International Relocation and moving companies).

There are 'tours' of Shanghai, which can be set up through hotels on relatively short notice, these usually involved following a flag-waving guide through tourist areas, and plenty of time is provided to purchase the 'souvenirs' at local tourist shops.

11.1.8 Expatriate Associations

The majority of nationalities have set up 'Business Councils', or Chambers of Commerce in the major cities. In Shanghai, the most well regarded and well attended is the American Chamber of Commerce, which regularly puts on high quality presentations and seminars specifically aimed at improving the ability of American companies to successfully do business in Shanghai. Smaller countries also have their own networks, for instance the New Zealand community has regular networking meetings on a monthly basis, and the Swedish community welcome the newcomers to Shanghai at the Consul General residence on a 6-monthly basis. Also the Swiss Chamber of Commerce organizes regular events with different interesting topics.

For information regarding expatriate associations, the best source of information will be the Consulate or Embassy in each city. Often, registering with the Consulate or Embassy will provide you with a regular email update on what activities are planned.

11.1.9 Expatriate services

There is a multitude of translation service companies in Shanghai. Hotels often offer translation services in their business centers, and in general the level of translation from English to Chinese and vice-versa is very good.

For official translation of documents, a translation service need be recognized by the particular department of the government that will use the translation. Different departments of the Government and different cities will have different 'official' translation service agencies.

For simple translation, a service is available from China Helpline www.chinahelpline.com; their national phone number is 6100-9700. The first five calls are free as an introduction to the service, and the rate thereafter is RMB3 per minute.

11.1.9.1 Help-lines and support in case of difficulties

The number for the Police (also known as Public Security Bureau, or PSB), is 110. There is also a phone number for English spoken service for the police: it is 6357 6665 in Shanghai and 6525 5486 in Beijing. Storing this number in mobile phones is recommended for anyone staying in China for any length of time.

Foreigners are relatively safe in China, especially in big cities, the risks of criminal offense is very low compared to any other developed city.

For tourist information, each city will also have its own 'hotline'. For Shanghai, this number is (021) 6439-1818.

Your Hotel will always be a great source of help if you have any difficulties in China, but organizations such as Alcoholics Anonymous (www.aa.org), Life Line www.lifelineshanghai.com and others are also represented in China. In case of emergency, Consulate or Embassy should be the first able to provide help.

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11.2 Dealing with cross-cultural challenges

The following contributions from section 11.2.1 until 11.2.3 are written by Cross Cultural Interchange (CCI) specialists to provide an initial perspective about living and working in China.

11.2.1 What is Culture?

By K. Scott Rosenberg, CCI Consultant

When describing how different cultures live and interact with each other, we often use statements to characterize groups. For example, recently I wrote about differences between Germans and Americans and provided some insight into their ways of reacting to new ideas. Since then, I've realized that some people believe that cultural differences don't even exist. I'd like to address these skeptics and shed some light onto what culture really means and how we can build bridges across cultures.

11.2.1.1 Culture is "a group or community to which we belong"

If you ask what culture means to ten people, you may hear ten different definitions. Many say culture means language, history, art, food, and geography. While these all are an important part of culture, especially as a visible element which allows us to compare differences, I prefer to think that culture is "a group or community to which we belong."

Most people believe they only belong to one culture: the nationality on their passport. Yet my definition implies that we can be members of many different cultures at the same time. For example, my good friend is Shanghainese, while also a member of "haigui" (returning overseas Chinese) culture since she used to study in France. She works at a multinational company instead of a state-owned enterprise. Finally, as a female, her communication style is entirely different from mine as a male. Members of these various groups have specific preferences of language usage, likes and dislikes, and ways to interact with others. These are due to the deep-rooted values associated with each cultural group.

Efforts to understand cultural differences are often misguided by focusing on the "results of culture". For Chinese, this often takes the form of excessive learning of English (I know people who continue to study English even though they have studied for more than 15 years and can certainly communicate adequately with native speakers). For many expats, learning Chinese culture means studying Chinese history, calligraphy, or kung fu. While all these aspects are extremely valuable when learning about a new culture and are certainly enjoyable to explore, they may not be as useful in building the necessary skills for maintaining long-term, meaningful business relationships.

Understand the reasons behind why people behave a certain way – based on their cultural values and beliefs – and you will begin to bridge the cultural gap.

Understand the reasons behind why people behave a certain way – based on their cultural values and beliefs

Too often, people tend to define others by stereotyping them. Stereotyping means creating a false sense that every member of a particular cultural group is the same, which leaves no room for individuality. You may be guilty of this when you meet an American and expect him to be very open-minded or when you meet a Chinese and believe she will communicate very indirectly.

To avoid this trap, when you meet someone from another background and encounter differences, I advise you first to identify as many of the cultural groups to which that individual belongs. For me, that would mean looking beyond my obvious American culture and realizing other groups, for example, being a foreigner in Shanghai, working at a multinational company, being a single male, etc. Each of these communities has a significant impact on determining my core values, way of thinking and way of behaving. Finally, by understanding these different groups, you could use generalizations - or summaries of practices and beliefs found through research - to understand the values of the groups to which I belong. Adjusting your behavior and style to communicate with those different from you has a positive impact on establishing enhanced cooperation with any culture.

As Chinese cities become increasingly international, it's essential for Chinese and foreigners to recognize the importance cultural differences have in our daily life. Accepting these differences, along with identifying similarities and understanding reasons for different behaviors gives us an excellent foundation to build bridges across cultures.

11.2.2 Tip #1: Beware of Tips!

By K. Scott Rosenberg, CCI Consultant

Recently, I read an article advising foreigners on how to do business in China. Some of these points I agreed with. For example, when your Chinese business partners say, "no problem…don't worry", you shouldn't take this to mean that everything will run smoothly as planned. But as I continued reading the article, I grew more skeptical about one particular tip in which he blamed the slowness to make decisions on communism, and furthermore, labeled all Chinese as followers, not leaders.

I understand the writer's intention, to prepare inexperienced foreigners for the challenges of lack of ownership and differences in the way people participate in meetings. Yet, I find this piece of advice and its explanation extremely misleading and even offensive. From these articles, along with discussions I've had with recently arrived expatriates, I've come to realize to what degree the media and general literature for foreigners working in China portray an often negative and inaccurate picture of China.

Many foreigners, including myself, have had to cope with the speed things are done in China. On one hand impressive skyscrapers seem to be built overnight, while on the other, closing business deals with a Chinese client could take ten times longer than in the West and involve many evenings of relationship-building gatherings outside the office. Similarly, maybe a brainstorming session with your Chinese colleagues ends with no one willing to participate. Is this a sign of indecisiveness? Are all Chinese followers? Is this because of communism?
The answer is no.

Different cultures have varying rules and norms which govern the way and speed at which decisions are made. Being quiet during a meeting to Westerners often means you have nothing to say. In China, though, it's a different story. Chinese might not speak up because you haven't built a close enough relationship to permit open dialogues. Another factor could be due to a clash of levels in hierarchy (manager and subordinate) or even discomfort in participating in that occasion's setting. But when you partake in appropriate relationship-building activities, you may find that decisions are made quicker and with less hesitation.
Finally, while communism has affected many aspects of China and its population, it's not the sole influence on leadership. In fact, Chinese expectations for what it means to be a leader and follower were set more than two thousand years ago. In his teachings, Confucius and his followers promoted a sense of benevolence, morality, and loyalty among leaders – virtues which effective government and business leaders in China continue to strive for today.

It is no wonder people around the world have a distorted view of China and its people. Biased international media coverage of China and "do's and don'ts" found in guidebooks often promote an image of China that may be very outdated.

Those of us who are fortunate to be part of the "China experience" should actively educate and support those who have limited knowledge about today's China. Yet, such support has its own limits. To understand China and the Chinese, it is essential you participate first-hand and gather your own experience.

The best mindset for a successful first step in China is one of openness and tolerance to be able to understand local values and ways of behavior. In order to preserve an open and non-judgmental attitude, it is important to avoid building preconceived ideas based on simplified advice. As in any culture, behaving in a kind, honest, and polite manner, in addition, will go a long way in establishing the first relationships.

11.2.3 Identity Crisis in Shanghai: a Female Perspective

By Anna Rundshagen, CCI Senior Consultant

Walking down Huai Hai Road on a Saturday afternoon I heard people talking about me, "Wai guo ren, wai guo ren… Hen pang, hen pang …" (Foreigner, foreigner… very fat, very fat).
Walking into the shoe shop, the sales clerk took one look at me, then my feet and immediately shook her head and said "No, No, No!" and reinforced it in Chinese "Mei you! Mei you!" I did not give up immediately and tried two more shoe shops for a pair of size 10 sandals. Comments like "your feet are too fat for our shoes"… and good advice like "my sister uses Oolong tea to lose weight…" followed me. Even the beautiful sunshine did not make up for that feeling on the pit of my stomach.

I came to Shanghai all excited about the opportunities: living in an exotic place, having money to spend on things like silk and pearls, meeting exciting new people from different cultures, learning Chinese…This land seemed full of excitements and opportunities to do things I never thought I would get to do.

11.2.3.1 China was not hip

Growing up in Europe, a holiday on the Mediterranean islands and going skiing in the Alps were the super hip and exotic things to do. Speaking a bit of Spanish, knowing how to cook paella and ordering the right French wine made you a well-traveled person that others looked up to. When I decided to move to China, 10 years ago, most of my friends decided this definitely was not hip and friendships became strained because of it.

11.2.3.2 The "Golden Cat"

I did not spend too much time contemplating because as a teacher at a major Chinese university, I was a celebrity. Whenever I crossed the campus the students would whisper, "This is the teacher from Germany"…"Look at her hair! It looks like that of a golden cat…" In class, 80 eyes and ears were all attention when I spoke. After class, the students would crowd around my desk with questions of all sorts and on the next weekend, I was usually invited to some student body function: judging a speech contest, participating in ballroom dancing, giving away trophies at ping pong matches or recording some language tape for my Chinese colleagues to use in their language classes.

When I went to the wet markets to shop for food, I got the same amount of attention but in quite a different way. Children cried when they saw me with my blond hair and invisible eyebrows. They thought I was a ghost. Vendors immediately raised their prices when I approached and the local shoppers were quite disgusted, hoping I would leave soon, so they could get a better bargain. And everyone who thought that they spoke some "foreignish" shouted HELLO into my face.

11.2.3.3 Getting More Attention

Nowadays, ten years later, Shanghainese are quite used to seeing foreigners and their reactions are not as extreme. Nevertheless, wherever we go, we get a lot more attention than we would at home. Even though being "exotic" in other people's eyes can be quite fascinating, after a while, it also wears you down and out.

11.2.3.4 Who am I

Expatriate women may begin to question themselves – who they really are and why they are here. **Living in China tests our boundaries and forces us to adjust to new roles**. There is the challenge of making a new home – finding the right place, the right decorations, the right appliances and a way to keep all necessities stocked is a challenge for anyone – no matter if you are single or taking care of a family. Simple tasks that used to be under control and as natural before, such as taking your two children shopping on a Saturday (you never realized that they had such blond hair…), need to be managed with a complete new set of benchmarks.

This keeps you pretty busy during the first few weeks. During this period, you may meet your first group of new friends who can be very helpful (or not). Those who tell you to take it easy and treat you to a nice afternoon at the spa – or those who may be full of warnings against unreliable household help, outrageous overcharging vendors, unreliable property management staff or horror of medical care facilities. Even though these warnings are well meant and may have an undeniable grain of truth, they do not help much in building confidence for dealing with the challenges of living in new culture.

Identity challenges come into our lives all the time. Women may find it harder to re-establish themselves here and have to constantly seek affirmation from those around them. A treat, that on one hand enhances our emotional quotient, on the other hand, makes us vulnerable to negative feedback.

11.2.3.5 Any Feedback Has to Do

As a trailing spouse, for example, we start with our husband and children as our feedback givers. The more the work load increases for the working spouse, the less time for reflected positive feedback… So, who to turn to? People we have met in the first couple weeks of living here are usually our country mates. Without even considering whether we would normally have something in common or not, they become trusted feedback givers. Without reflection on why the feedback giver is saying what she says, we accept it at face value – just thankful someone is telling us what to do.

11.2.3.6 Unsolicited Risks

An acquaintance of mine recently came to me and asked whether she should really take an 8 weeks trip home, leaving her husband in Shanghai. I did not really know where she was going with this question until she confided that some of her new friends had warned her never to leave her husband that long, or she can expect him to find someone else. Undeniable, there are cases of infidelity among expat spouses but does that give anyone the right to give advice like that?

In any new foreign environment, dealing with cultural challenges and culture shock is hard enough without worrying about everything else. To help maintain confidence and healthy self-esteem look for friendships that provide positive support, learn more about the people and country you live and most of all, learn more about yourself.

Contributed by Cross Cultural Interchange (CCI)

CCI specializes in helping expatriate professionals and their families gain the necessary intercultural skills for adapting and thriving in China. It offers customized training solutions, monthly workshop and seminars for working expatriates, spouses and children helping address specific cross-cultural issues and challenges encountered in China.

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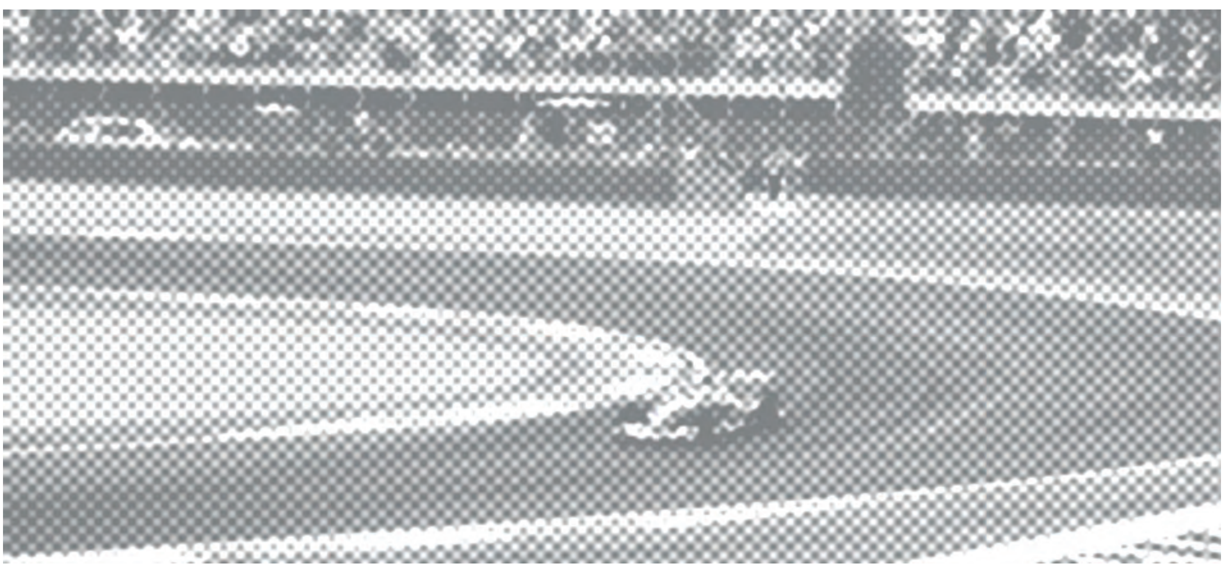


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IV Exporting & Office Set-up

China's sales opportunities have excited the imagination of business people since they are looking at international markets.

However, ever since these times as well, China's potential sales have rarely materialized in the expected ways. The fact is that the country and its people have always been able to produce for themselves at quality levels that match or surpass what is produced elsewhere.

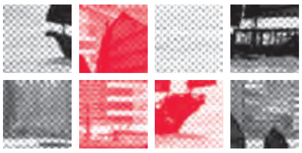
Today, China's trade balance is in her favor again worldwide. However, China has started to purchase very interesting amounts of luxury goods, machinery and chemical/pharmaceuticals from Switzerland (about CHF 7 billions, incl. Hong-Kong) creating also a very positive balance for Switzerland. This trend should amplify for Switzerland and provide more opportunities in the years to come with the development of China's middle class.

The market, however, remains the most competitive in the world, so that possible products and distribution strategies are described to deal with this situation.

Factors of success as they are rated by companies exporting to China only are listed for an understanding of what other managers selling into China consider of major importance.

Two further contributions focus on the legal aspects of imports as well on steps for the set-up of a representative office, the preferred way, up to now, to handle exports to China by foreign companies. (A description of China's customs system is provided in Chapter II Legal, tax and finances.)

A case study on Jura Elektroapparate AG's automatic coffee machines exports to China focusing on distributor selection closes this Chapter.



1 Exporting and Selling to China

by Meng Ling and CH-ina
Meng Ling is project manager and head of CH-ina legal department,
Also see chapter II, Legal, Tax & Finance, for a description of China's customs system.

Selling to the seemingly endless number of Chinese consumers has been the dream of all manufacturers, not only in the last 25 years but from the early days of the Western Industrial Revolution.

The environment, however, is ranked as the most competitive in the world and the Middle Kingdom is fast to learn and produce by itself the goods that it initially buys from other nations.

In order to export to China against local competition, unique products are of key importance. In such cases, market opportunities are growing, particularly in the machinery, instrumentation, industrial components and luxury goods sectors.

Legal restrictions to import are many and detailed, yet manageable. The most economic form of entity to be legally active in China, the Representative Office (RO), is the current vehicle of choice for Swiss companies to support their exports into China.
The registration process and check list for the set up of a RO as well as recommendations for management and operations are provided. Also included are success factors ranked by Swiss companies exporting to China offering additional insights into key elements of business in China.

Also see Chapter II, Legal, Tax & Finance, 'Customs and Bonded Areas' for related information.

1.1 China: Switzerland's Largest Asian Customer

1.1.1 Hong Kong: a major re-export hub for the Mainland

Though Hong Kong and China are part of the same political entity, the People's Republic of China, they are recognized as two different customs territories, with separate currencies, tariffs, import and export regulations and statistics.

However, a major part of Hong Kong's trade is related to China, in both directions. Hong Kong and Macau have traditionally been the gateway for foreigners to do business with China, particularly so since 1949. Around 90% of Hong Kong's exports are re-exports (imported first and then exported). Besides, when one considers imports into Hong Kong from all destinations other than the mainland, **approximately 75% of these imports are actually destined for China**. As a result, Hong Kong's figures are an important part of the overall mainland China trade picture.

1.1.2 Booming exports into China

From 1999 to 2004, Swiss exports into China have more than tripled; from less than CHF 1 billion to over CHF 3 billion. In 2004, Swiss exports to the mainland showed an increase of 25% over the previous year. When one includes Hong Kong, Swiss sales in 2004 amounted to CHF 7 billion, making a combined positive trade balance of CHF 3 billion (Hong Kong and China together exported only about CHF 4 billion to Switzerland in 2004). In 2004, Japan, Switzerland's second-largest Asian customer, imported CHF 5.8 billion worth of Swiss products, while India purchased just CHF 1 billion worth.

Mainland China and Hong Kong account for 5% of total Swiss exports, twice the exports to Mexico and Brazil combined, and close to half the exports to the US.
The main beneficiaries of this growing business with the mainland are machinery and electronics suppliers (with

CHF1.5 billion, or half of the trade), while watches, precision instruments and precious materials amount to a quarter of total Swiss exports to the mainland.

On the Hong Kong side, sales are dominated by watches, precision instruments and precious materials (CHF 3 billion, or 75%, of total exports). Swiss chemical exports rank third in sales to both destinations.

Overall **the following three aggregated categories account for over 90% of Swiss exports to Hong-Kong and the mainland**:

- **watches, jewelry and precious metals (just under 50% of total Swiss exports)**
- **machinery and instruments (just over 30%)**
- **chemicals and pharmaceuticals (just over 10%)**

Also see the first text of this guide 'China - Opportunity or Threat' for more analysis on this trend.

1.2 Export and Selling Opportunities

"So long as people of one country make goods to sell to others, so long as ships cross the oceans and international trade exists, the golden illusion of the sales which may be made to China's industrious millions will always be an intriguing one. No matter what you may be selling, **your business in China should be enormous, if the Chinese who should buy your goods would only do so**." Carl Crow, 400 million customers, 1937 (Harper: New York)

1.3 billion customers…?

Opportunities for sales into China are considerable, as trade figures certainly illustrate. Yet it is important to realize that **throughout history, the Chinese have been reluctant to buy foreign products while they have exported considerable quantities of their own. The main reason has always been the same: the Chinese were quickly able to manufacture for themselves the products that they imported.**

In the 19th Century, China was exporting so much tea and silk that the British could not afford enough gold and silver in exchange for the growing Chinese imports. To remedy this situation they started to sell opium.
Yet opium production started in China and the imports of British opium halved within 20 years of reaching their peak (1880 to 1900).
As well, Imports of British cotton peaked at the turn of the century but, by 1935, they had shrunk to just a tenth of that amount, as a direct result of China and Japan starting their own domestic manufacturing.

"1930s China is one of long receivables, rigid markets, structural inefficiency, impossible logistics and relentless, brazen copying and substitution of imported goods with cheaper fakes", says Joe Studwell[1]. For those involved with China, it sounds very familiar without being an historian...
(Also see Chapter I General Environment, 'Chinese history, business culture and psychology', for more on the history of China's trade with the West).

In **the 21st Century, the country has seen the development of a middle class** of Chinese, perhaps 80 to 120 million-strong, that purchases products of western quality levels.
Yet competition is fierce and is probably the toughest that can be experienced in any market, due to:

- the often disproportionate investments that foreign companies make in China to acquire the potential market and the ensuing battle for market share. Price wars in the local automotive industry illustrate this case well.
- the number of entrepreneurial Chinese, themselves trying to make good on the potential of their enormous market. Nowadays, many of them have access to private capital, accumulated while developing other businesses
- to avoid large numbers of workers going unemployed, Chinese State-owned companies are still supported by

the government with cheap credit and other benefits (exemption from environmental restrictions, or turning a blind eye to IP piracy, for example). As a result they can afford to produce inexpensively and compete on price.

- the low costs of production as well as the natural resourcefulness of the Chinese to cut corners and operate on a low investment basis. (Also see Chapter III, Preparing for China and Chapter V, Market Types, 'Market Competitiveness'; Swiss managers rate China as most competitive market in the world.)

1.3 Strategies: Unique Products and Dominating the Market

The solution to winning against the competition in China while exporting lies in just one direction: providing unique products, services or a combination of them and dominating the specific market.
Indeed, as soon as competitors are able to manufacture an equivalent product locally, margins drop until the cost of production in the West, transporting importing and keeping local inventory makes it impossible to compete. In such circumstances, the Chinese may only be beaten at their own game by setting up local production facilities (see Chapter VI, Setting Up Production in China).
The quality of uniqueness can comprise different aspects:

- **The product fills a niche** that Chinese producers have not tackled because the product is difficult to manufacture (the know-how is difficult to acquire) and the market is comparatively small in turnover (see Chapter V, Market Types, Precision Parts for the Telecommunication Industry, KUK Case Study)
- **The product is effectively protected by patents** (yet patents alone often do not guarantee protection, see Chapter VII, IP Protection)
- **Selling a solution**: the services to be provided with the product are the key to its sales and are difficult to set up (for an example, see Chapter V, Market Types, case studies of ABB Turbocharging and Sulzer Chemtech)
- **Brand names, image and position are established in ways that are difficult to beat** (Swiss luxury watches are the best example of this case)

To dominate the market, **the natural barriers to entry may be further built upon**:

- **Distribution is difficult to establish** and therefore exclusive in its quality (see Jura Elektroapparate AG case study below)
- **Production materials, components and tooling are specific, and a degree of control over their supply is achieved**, or their procurement needs technical support from abroad by a parent company, ensuring that local competitors will not have access to the type of materials needed to ensure quality
- **Production is sufficiently capital-intensive that the necessary large investments deter local private entrepreneurs**
- **Know-how, patents and trademarks need to be carefully protected** to avoid providing competitors with additional capacity at ones' own expense (see Chapter VI, Setting Up A Production in China and Chapter VII, Intellectual Property Protection and R&D)

Besides, **a consistent strategy towards keeping other players out of the market needs to be devised and implemented**. Eventually, three elements are crucial:

- Grow fast enough in order to achieve economies of scale and be able to lower prices and make it unattractive for a new competitor to come into the market
- Constantly innovate to remain the technology leader and be ahead of the improvements that competitors are bound to make
- Do not leave the lower market segment unattended to avoid the risk that competitors grow strong in the lower quality segments and then invest to enter the higher market segments

In most cases, combinations of unique elements, barriers and strategy provide the winning recipes.
However, acquiring and generating the resources needed to exercise a dominant strategy may be one of the main

difficulties for an SME. It can be handled by:

- leveraging assets for better financing,
- obtain financing from government supported programs to the benefit of SMEs (also see Chapter III, Preparing for China, 'financing a China business')
- establishing partnerships with equipment and materials suppliers for favorable payment terms and
- setting up alliances with distributors as well as with producers active in the lower segments to control preventively this part of the market.

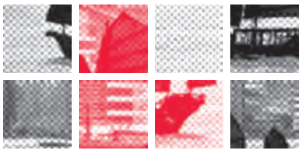
1.4 Success Factors

The full list of success factors as rated by successful Swiss companies exporting only to China (N=27) are listed below, and speak for themselves.

Yet, should a confirmation of the above be needed, **the factor 'Competitiveness of your product/service in the market' comes resolutely first with a 100% rating**. **Comprehensive understanding of the business ways** and **'Quality and qualification of the management team' come next** (second and third, yet with a statistically insignificant difference: 1.2%).

Branding and company reputation are key as well for exporters, while after sales service comes in the very top too. Indeed, case studies show that Chinese clients are used to fast and efficient service due to a cheap local labor force. In addition clients have more concerns about imported products as they know that spare parts, production and know-how reside out of the country, far away in Chinese eyes.

'Quality of distribution channels' comes in the bottom 12 of the list, perhaps surprisingly. Yet an analysis of distribution shows that Swiss companies distribute mostly by themselves. (Also see Chapter V, Market Types, 'Distribution trends'.



Survey chart IV - 1

Factors of Success: Exporting to China

(Companies selling to China, which achieved at least 50% of their objectives)

Source: Swiss China Survey, 2005

1.5 Distribution Strategies

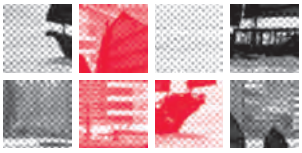
Distribution strategies vary considerably according to:

- **The type of product**
  Equipment and industrial goods are naturally distributed differently than consumer goods or services. This is the case in every market and does not specifically depend on the Chinese environment. In this section we focus on equipment and industrial goods, since consumer goods in China usually remain the field of already established multinationals or luxury brands, due to the considerable investments needed to break into the market.
  Yet, Jura's import and sales into China of coffee makers (see case study below), provide an alternative way to break in the consumer goods field in China. The services industry opportunities are highlighted in Chapter V, Market Types.
- **The complexity of the product and the amount of service that goes with it**
  Usually, the more complex the product, the more servicing it requires and the more expensive it is. In the case of complex, relatively expensive products, clients are usually easily identified and service is a key factor of success for sales. In such a case, setting up an own local service organization will help to ensure satisfactory service and good internal liaison between the sales office and the parent company's technical support division.
- **The type of potential clients**
  Their approach varies greatly depending on whether they are privately-owned, state-owned or foreign-owned. Even within foreign-owned companies, the situation is different in the case of a global client of the parent company if compared to unrelated foreign invested enterprises.
  In general foreign-owned companies are easily identified as potential clients. Besides, they can be approached in ways that are relatively similar to those used in the West, though the Chinese cultural characteristics (personal relations, for instance) do influence the dealings.
  Though potential State-owned customers are also easily identified, selling to them requires China specific skills: the build up of trustful and strong personal relationships and the deep understanding of the internal circumstances under which such institutions and their employees function, among others (also see Chapter V, Market Types, Sulzer case study for highlights on selling to state-owned companies).
  Private Chinese entrepreneurs are motivated by profit, like western privately-owned firms. However, they are at a much earlier stage in their development. Most of them are growing fast or fighting with plenty of competitors. Local banks do not easily risk providing loans to Chinese private companies, so that they are usually facing a structural lack of cash, be it because of low margins or due to the need to re-invest and grow.
- **The industry regulations and specificities**
  In certain industries, regulations may restrict or specify the distribution channels. This, however, mostly applies to the service industries (the recruitment of students for foreign schools, for example, is only allowed through government-appointed Chinese agents). Other, very specific industries, may incorporate restrictions, such as precious metals or dangerous goods
  The structure of the medical and healthcare industry, for example, indirectly generates situations where dealing through agents maybe necessary in order to avoid being exposed to requests for kickbacks. This, however, is also a special case of dealing with a state-owned/controlled market.

To provide an understanding of the variety of circumstances in which distribution may occur, different 'Market Types' are analyzed in Chapter V and illustrated with case studies.

Two main strategies are usually applied:

- **Appointing one or more distributors**
  There are a few good reasons to set up a distribution network:
  - potential clients are numerous (in the hundreds, possibly thousands) and geographically spread out. Each order per client is usually of small value (in USD hundreds or thousands). In such cases, a distribution network is needed to reach the required critical mass. Starting one from scratch is possible but may be too slow.



- there are important synergies with other products already distributed, so that it is more efficient to distribute via an existing network.
- it is essential to have a high level of relationship to sell (this is particularly the case with state-owned enterprises and those that belong directly to public services, such as railways, power bureaus and the military).
- the sector restricts distribution to Chinese companies or functions in ways that are not suitable to foreign companies (kickbacks are needed, for example).

Selecting a single distributor or multiple ones depends on the product type and positioning. The main advantage of multiple distributorship is a better geographical coverage. However, depending on products and their mobility, distributors' discipline and the efforts involved in their supervision and management, territory allocation to different distributors may not be respected, thereby generating internal competition among distributors. Such situation eventually erodes distributors' margins and reduces their motivation to provide service and to sell. The Jura case study below illustrates this aspect. (Also see Chapter V, Market Types & Logistics, 'Distribution trends' for the Survey results on Swiss companies distribution preferences.)

■ **Setting up an own representation for distribution**

In most cases of distribution of industrial goods made in Switzerland, the number of potential clients is limited and they are easily identifiable. Unless there are important synergies in distribution with other products, the advantages of an own set up are worth the efforts:

- direct contact with clients and the market, allowing better understanding of needs, better service to clients and better management of product development and upgrades
- absence of the usual conflict between local distributor looking at short term income, (since distributorship is never granted forever) and the producer, interested in setting up a long term position
- after the initial period, lower costs of distribution and better overall competitiveness (such set ups may be started with initial set up costs of USD20'000 to 30'000, including equipment and selection of suitable staff. Yearly operational costs are in the range of USD50'000 to 100'000 including local staff and local professional supervision)

In a combined strategy, the establishment of a representative office may also serve the local management and training of distributors while ensuring a direct contact with the market. Such an office may also bear the responsibility and costs of marketing, in order to guarantee the right local image and positioning. These expenses are usually of a strategic nature so that distributors are reluctant to make them and may welcome such a set up. On the negative side, the local establishment of the producer may also push the distributors towards an even shorter-term attitude, since the producer will be able to set up its own distribution even more easily.
(See the following section for details on setting up a sales Representative Office.)

1.6 Distributors Selection and Management

Should distributors be part of the distribution strategy, the selection process and criteria are important. **China as a market is not yet mature and the geographic extent of the country make it a logistics challenge for distribution. As a result, available distributors are usually less suitable than what is expected by a Swiss company**.
Swiss and other international trading companies have been setting up distribution networks in China from its opening 25 years ago, often from Hong Kong. Chinese in Hong Kong, and more recently in Taiwan, have done the same. However, the performance of good mainland companies, when available, seems to be better (see Chapter III, Preparing for China, 'Defining an entry strategy').

1.6.1 Criteria for selection

The following criteria should be considered when selecting a distributor (also see Jura Elektroapparate case study below for an analysis of the distributor selection criteria):

- Ability to understand the product and manufacturer and their needs for a successful distribution
- Ability to provide service with the product (if needed)
- Financial ability to hold inventory and spare parts and grow with the company
- Geographical coverage and structure of the network (flat or hierarchical, allowing for more or less intermediary levels)
- Synergies or competition with other products carried by the potential distributor
- Personal chemistry and ability to develop a personal relation with the decision makers. Communication, understanding and a trustful relationship are indeed important for a good cooperation since distributors have the constant threat of losing their supplier. Indeed should the distributor do a too good job, his supplier may want to take over and distribute directly.

1.6.2 Distributors management

Considerable efforts are needed to train distributors whose organizations may not be fully-fledged and whose priorities are shared among different products. Besides, building the relationship through frequent visits and technical support to generate trust on both sides is also time-intensive.

In case of multiple distributorship, managing relations among distributors, exchange of inventory and referral of potential clients for instance, may also be management-intensive. (Also see Jura case study at the end of this chapter.)

1.7 Legal and Regulatory Aspects for Importing into China

by Meng Ling, project manager and head of legal department, CH-ina

The import (and export) of goods into China is highly regulated, often in intricate ways. **The concepts and principles that are followed for China's trade regulations, though consistent, are of an unusual nature for companies used to a free trade regime** such as the one found in Switzerland. The following should help provide an understanding of particular aspects of importing into China for a foreign company.
The Chinese government has enacted laws and regulations on various aspects of importation in order to effectively manage the proper and legal execution of import activities and also to regulate foreign trade.

The major laws and regulations stipulating importation are:

- Foreign Trade Laws of the People's Republic of China (http://english.mofcom.gov.cn/aarticle/policyrelease/domesticpolicy/200406/20040600229060.html [in English])
- Regulations of the People's Republic of China on Administration of the Import and Export of Goods (http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?appId=1andlanguage=enandid=ABC00000000000004072 [in English])
- Regulations of the People's Republic of China on Administration of Import and Export of Technology (http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=CENSOFT0000000009622andappId=1 [in Chinese])
- Customs Laws of the People's Republic of China (http://search.mofcom.gov.cn/foreign/getDetail_en.jsp?site_id=englishandarticleid=20041100310994andp_keyword=law+of+customsandold_key=law+of+customs [in English])
- Regulations on Import and Export Duty of the People's Republic of China (http://search.mofcom.gov.cn/foreign/getDetail_en.jsp?site_id=englishandarticleid=20041100311020andp_keyword=regulations+import+and+export+dutiesandold_key=regulations+import+and+export+duties [in English])

1.7.1 Restrictions on the Import of Goods and Technologies

While most goods and technologies are free to be imported into China; some are forbidden or restricted.
Article 16 of the Foreign Trade Law of the People's Republic of China, amended in April 2004, stipulates the following reasons for import/export restrictions or outright prohibition:

1. to safeguard state security, public interest or public morals
2. to safeguard human health or security; animal or plant life, or the environment
3. to enforce regulatory measures relating to the movement of gold or silver
4. in the case of domestic supply shortages or the need to protect exhaustible natural resources
5. in the case of limited market capacity of the importing country or region
6. in the event of serious disorder of the export business
7. import restriction in order to establish or accelerate the establishment of a particular domestic industry
8. restrictions on the import of agricultural, animal husbandry or fishery products in any form deemed necessary
9. in order to maintain the State's international financial status and balance of international payments
10. restrictions or prohibition as laws or administrative regulations so require
11. to be in accordance with international treaties or agreements to which the state is a contracting or participating party

Article 17 of The Foreign Trade Law of the People's Republic of China also stipulates that the State may, in the case of the import or export of goods and technologies relating to fissionable materials (or the materials from which they are derived) — as well as shipments relating to arms, ammunition or implements for war — take any measures necessary to safeguard state security. In times of war, or for the protection of international peace, the State may also take any measures necessary with respect to the import or export of goods and technologies.

1.7.2 Forbidden goods and technologies

Detailed catalogues of forbidden import goods have been made by the Chinese authorities based on The Foreign Trade Law of the PRC and other relevant laws, regulations or international conventions signed by China:

- Catalogue of Forbidden Import Goods (the First Group) includes all goods and technologies that are harmful to the environment or ecology (endangered species and so on) and any chemicals considered to be a threat to the atmosphere.
- Catalogue of Forbidden Import Goods (the Second Group) involves old machinery that could threaten production security, personal safety or the environment; pressure vessels, electrical appliances and so on.
- Catalogue of Forbidden Import Goods (the Third Group), (the Fourth Group) and (the Fifth Group) are concerned with solid waste pollutants.

In addition to the above goods listed in the catalogues, certain other goods are forbidden by other laws or regulations, and furthermore, the import of other goods can be halted for other reasons. For details of all forbidden import goods and technologies, please visit the following web page: http://wms.mofcom.gov.cn/static/column/zcfb/j/z.html/1 (in Chinese).

The import of 25 different types of technology (for instance, float glass manufacturing, web-offset printing equipment) from the following 11 different industries is currently banned: steel metallurgy; non-ferrous metal metallurgy; chemical; petroleum refining; petrochemical industry; fire prevention; certain electronics and electrical engineering technologies; light industry; printing; pharmaceuticals and building materials. Please find detailed information about this Catalogue of Forbidden and Restricted Technology on this web page: http://www.mofcom.gov.cn/aarticle/b/e/200207/20020700031654.html (in Chinese).

1.7.3 Import of restricted goods and technologies

The import of goods is controlled in two ways: by qu ota restriction and by non-quota restriction. **Quota-restricted imports are managed in two ways; by import quota or by duty quota**. The import quota used to be a very effective method by which the Chinese government restricted the import of some types of goods, however, following entry into the WTO, these quotas were gradually dropped, and by 2005, the country had ceased to impose import quotas on any type of goods.

Besides the import quota, a duty quota is applied as a lever to restrict the importation of a certain range of goods (corn, cotton, vegetable oil, wool etc). See a detailed list on this web page: http://wms.mofcom.gov.cn/aarticle/ztxx/ae/200403/20040300195923.html (in Chinese). For these goods, the quota defines the maximum quantity of a certain type of goods that may be imported over a certain fixed period of time; normally a year. Within the quota, normal duty is applied (In-quota Duty); when the quota is exceeded, a higher duty will be applied (Out-quota Duty). The Out-quota Duty rate varies from 10% to 65% for MFNs (Most Favored Nations) and from 50% to 180% for other countries.

Non-quota restrictions are also imposed in the form of regulatory restrictions. **Control is exercised through the issue of permits and certificates (which may, or may not, be granted); without which, enterprises are unable to import the goods in question**. This involves a broad range of permits issued by the relevant authorities for the import of restricted goods, including:

- Standard Import Permit
- Certain Machinery & Electrical Equipment
- Endangered Species
- Recyclable Waste
- Pharmaceuticals
- Audio-visual Products
- Gold and its by-products
- Wireless Equipment
- Dynamite Equipment for Civilian use
- Registration Certificates for Special Goods (including grain, vegetable oil, pesticides, wine and colored sensitized material)
- Certificate for Carbonated Drinks
- Approval of Imported Chemicals for both Civilian and Military use (from the Ministry of Chemical Industry)
- Approval of Imported Chemicals that can be Readily Converted into Toxic Chemicals

  The China Compulsory Certificate (CCC) is also used to control the import of a range of goods for safety purposes, listed below. Import restrictions apply to 16 different types of technology (for example, transgenic technology and the minting of coins) across six different industries (bio-technology, chemical engineering, bio-chemical engineering, petroleum refining, petrochemical engineering and coin/banknote currency production). Companies that wish to import must first apply for a license, which may or may not be granted, therefore effectively restricting the import of such technologies. For a detailed list of restricted technologies, please visit: http://www.mofcom.gov.cn/aarticle/b/e/200207/20020700031654.html (in Chinese).

1.7.4 Restriction-free goods and technologies

With the exception of the above cases, all other goods and technologies may be freely imported. For technology imports, though, contracts (licensing agreements signed between technology exporter and importer) shall be registered with the Foreign Economy and Trade Committee and are effective only with the approval of that body.

1.7.5 China Compulsory Certificate (CCC) for Importation

At the time of press, 377 different types of goods required a China Compulsory Certificate for importation, including: certain synthetic polymer paints and varnishes; pneumatic rubber tires; certain ceramic products; toughened or laminated glass; cylinders and most vehicles; most electrical appliances whose voltage exceeds 36V, and medical instruments.

For a detailed list of the goods requiring CCC, please check: http://www.shciq.gov.cn/templates/common.jsp?chann

el=CCPWS1119342267493# (in Chinese)
A manufacturer, seller or importer of products requiring CCC can apply to certification organizations designated by the Certification Accreditation Administration of the PRC, an affiliate of the Chinese Administration of Quality Supervision and Inspection and Quarantine (AQSIQ, www.aqsiq.gov.cn). There are ten such certification organizations in China, all of which are licensed to certify different types of products. For a detailed list of these certification organizations, please check: http://www.cnca.gov.cn/20040420/column/524.htm (in Chinese)
The initial CCC granting process takes about 90 days, involving the following steps:

- application
- sample test
- foreign factory inspection. The certification organization will organize a delegation to visit the factory site after being mandated by the applicant
- random testing of spare parts or machine componentry (in the case of machinery imports)
- evaluation and approval of inspection results
- and lastly, supervision

The CCC is renewable over various fixed periods of time, (depending on the product) and the renewal process is much simpler than the initial CCC application.
For the following uses, certain goods normally requiring a CCC for import are granted an exemption (but this still involves certain application procedures):

- scientific research and testing purposes
- spare parts imported for entire machine processing to be exported
- spare parts needed for the testing of imported technology
- products imported for end-user maintenance, or replacement parts in the case of discontinued products
- goods for other special purposes (not clearly stipulated).

The CCC is issued in the manufacturer's name and the approval costs are borne by the applicant. **Each model requires a different certificate. Costs are mainly incurred during application, testing, factory inspection, supervision, issue of certificate, and annual certificate renewal. Other costs include application agency fees, which range from a few thousand USD upwards, depending on the complexity of the CCC application process. For more information about CCC, please see: http://www.cnca.gov.cn/20040420/column/282.htm (in Chinese)**.

1.7.6 The Import of Old Mechanical and Electrical Equipment

China exercises tight control over the importation of old mechanical and electrical equipment (old M&E equipment), with the requirement for a certain application procedure to be completed before the necessary import permits can be issued.

Firstly, application needs to be made to the local Entry-Exit Inspection and Quarantine Bureau (EEIQB), affiliated to AQSIQ, or even directly to AQSIQ if required. An Automatic Import Permit is required and shall be issued by the Mechanical and Electrical Equipment Office, a department of the Ministry of Commerce, if the commodity to be imported is listed in the Catalogue of Goods under Automatic Import Permit Management. The EEIQB will then decide whether the goods need to be inspected when they arrive in China or pre-inspected in the country of export prior to departure. In the latter case, two or three months may be needed to carry out inspection and approval.

In cases where the CCIB decides to inspect the goods upon their arrival, an inspection report must also be submitted, issued by a foreign inspection organization (for example, General Superintendence and Co, SGS, in Switzerland; www.sgs.com). In such a case, and the process of application will be much shorter. For a list of old M&E equipment that requires pre-inspection, please visit: http://www.aqsiq.gov.cn/cms/template/item.html?did=1324andcid=1324\5814 (in Chinese). **In general, mechanical and electrical equipment that is over ten years old is highly unlikely to be approved for import**.

1.7.7 Duty, VAT and Consumption Tax

Duty and VAT are the most significant taxes imposed on imported goods. Duty includes Most Favored Nation (MFN) duties, duties subject to territorial trade treaties, special preferential duties, common duties and quota duties, which apply depending on the status of the country in which the imported goods are produced. **For goods of Swiss origin, Most Favored Nation duty is applied for all goods**. Duty varies among commodities, for instance, the MFN duty rate on all goods listed under the category of lathes for the machining of metal ranges from 5% to 12%; while VAT is 17% for most goods.

VAT is paid at the lower rate of 13% on the following: grain; edible vegetable oil; tap water; gas for heating and cooling; hot water; gas extracted from coal; liquid petroleum gas, natural gas, methane gas, civilian use coal products; books; newspapers; journals; feedstuffs; fertilizers; pesticides; agricultural machinery and agricultural film.

Imported technology is not subject to duty or VAT; however, 10% of the technology exporter's contract value (which is regarded as income) shall be withheld for payment to the tax office in China prior to transfer of payment from the importer to the exporter. For detailed information about the duties and rates of VAT on specific goods, please see: http://www.china-customs.com/customs-tax/ (in Chinese).
In addition to duty and VAT, a consumption tax is imposed on the following goods:

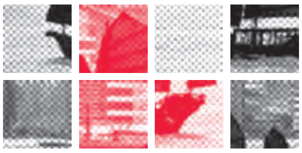
- consumer goods deemed to be harmful to human security, health, social order or the environment if consumed excessively, such as cigarettes (30% to 50%), wine (5% to 10%), alcohol (5% to 10%) or fireworks (15%)
- luxury consumer goods, such as jewelry (5% to 10%) and expensive cosmetics (30%)
- top-grade consumer goods with high energy consumption; such as automobiles (3% to 8%), motorcycles (6%) and vehicle tires (about 10%)
- non-regenerative or non-sustainable source items such as petroleum (RMB0.1-0.3 per liter)

With its entry into the WTO, China has, and will continue to, reduce its rates of duty. The following table shows the annual drop in duty rates until 2008:

Fig IV - 1
Annual decrease of China's import duty rates for industrial and agricultural commodities from 2000 to 2008

Year	General duty rate	General industrial commodity tariff	General agricultural commodity tariff
2000	15.60%	14.70%	21.30%
2001	14.00%	13.00%	19.90%
2002	12.70%	11.70%	18.50%
2003	11.50%	10.60%	17.40%
2004	10.60%	9.80%	15.80%
2005	10.10%	9.30%	15.50%
2006	10.10%	9.30%	15.50%
2007	10.10%	9.30%	15.50%
2008	10.00%	9.20%	15.10%

Source: Chinese Customs



Duty and VAT are exempted, deducted or bonded under certain import circumstances, among which, the following will mostly apply to foreign companies:

- equipment imported for own production of encouraged products by foreign-owned enterprises, with the exemption up to a limit not exceeding the total value of the company's declared investment in China. For the full list of encouraged products, please visit web page: http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000010425andappId=1 (in Chinese)
- Goods imported temporarily for sample or exhibition use; engineering machinery and vehicles; apparatus and tools for construction projects; television sets and cameras; containers for the transport of goods, and the assets of visiting performers, bands, operas etc, provided that all these goods are bonded and exported back within six months of arrival in China.
- In the export-processing trade, materials are imported to China and then exported back out as finished products. Materials or equipment supplied by the foreign buyer, and the materials for production by a processing company, are both bonded and tax-exempt
- materials imported and stored in bonded areas for production or trading
- goods in a single importation with a value lower than RMB50, USD6, and higher-value goods imported as samples are allowed to be declared at a lower value; if the declared value is less than RMB10 (USD1.25) then duty and VAT are exempted

All goods imported free of duty and VAT are under Customs supervision and may not be disposed of without Customs' approval and the payment of duty and VAT. The supervision is limited in time and varies for different kinds of goods:

- eight years for shipping, water craft, aircraft and construction materials
- six years for motor vehicles and household appliances
- five years for equipment and other goods

1.7.8 Inspection and Quarantine

All goods imported to China are inspected by the Entry-Exit Inspection and Quarantine Bureau (EEIQB). EEQIB is supposed to inspect every shipment; however it is objectively impossible to check all shipments. Instead, the bureau carries out selective inspections, while some goods must still undergo compulsory inspection and quarantine, such as: live animals; products of animal origin; live trees and plants; edible vegetables, fruit and nuts; cereals; animal furs; some chemicals and minerals and also some equipment. For information on goods required to be inspected or quarantined, please see: http://www.tdctrade.com/sme/chinese/newsflash/inspection-020927_c.htm (in Chinese).

All goods are categorized by specific detail and numbered with a tariff code. The requirements for importing all types of goods can be found through the official website: http://english.customs.gov.cn/www.customs.gov.cn (in English).

Websites for further information:

- www.mofcom.gov.cn
- www.customs.gov.cn
- www.cnca.gov.cn

All the information in this article was up to date at the time of publication. Details can be altered at any time by the Chinese authorities. Websites and pages indicated in the articles may also be updated or reconstructed by the website developers/owners.

1.7.9 Import Rights for Foreign-Invested Enterprises (FIEs)

Only legal entities that have import business rights can import commodities under their own name without hiring other import or trading agents. Import business rights are granted to WOFE and foreign-Chinese Joint Ventures (JV).

However, what **a WOFE or JV can import depends on its business scope. For instance, a WOFE or JV manufacturing company can only import equipment and facilities for use in its operations, or materials for production,**

while a trading company can import commodities according to the items allowed and described in its business scope. Services or consulting companies can import goods for their own use, for example, office facilities and cars (Also see Chapter I, General Environment, 'Foreign investment entities and corporate tax rates' for more legal aspect on Foreign Invested Enterprises).

2 Setting Up a Representative Office (RO)

by Meng Ling, project manager and head of legal department, CH-ina

ROs have a variety of purposes, most of them as liaison for their parent company for the support of:

- purchases
- market research, marketing, sales and distribution
- project management for the set up of a local company

The following focuses on the set up of a RO for the development of exports to China's local market. In many cases of exporting to China, imports should be effected directly by the client distributors or import agents. Therefore the set up of an importing, sales and distribution company is not necessarily useful to sell goods into the country.

However, most of the elements below apply also to the set up of trading companies (except for the next two sections and the approval and registration procedure). Trading and distribution companies may now be registered (see Chapter II,Legal, Tax & Finance, Registering trading, distribution, retail and franchising operations in China for details.)

2.1 General Purpose of a Representative Office

A representative office (RO) is a cost center established by the foreign parent company to be engaged in indirect business activities in China. A RO is not a company and does not have any registered capital.

The activities of the RO are limited to liaison work, product introduction, market research, marketing and promotion, technology exchange, technical services and other indirect business activities. None of these services can be charged by the RO, which cannot receive any income from its business partners. Any money going into the RO's account is from the parent company and only to be used for the RO's operations.

The RO is not an independent legal entity and does not have a limited liability. The RO is a branch of the parent company and engages the parent company's legal responsibilities for any of its activities in China.

2.2 Taxation and Exemption

Nevertheless, the RO is still subject to corporation tax and business tax levied by the PRC. ROs need to register for tax purposes and declare their financial status to the taxation bureau on a monthly basis. Tax shall be imposed on various bases, depending on the industry and activity:

2.2.1 Booked income

ROs engaged in law, tax advice, accounting, auditing and other consulting services are allowed to do direct business which is different with other ROs. They shall establish and complete account books, correctly calculate incomes and taxable amounts, and declare the business tax and income taxes.

2.2.2 Expenditure

For the purposes of tax calculation, the expenses of ROs (paid by the parent company) is deemed to be their income.

(ROs do not have a true income as such, since all their income is channeled to company headquarters overseas. For this reason, the Chinese tax bureau bases its income tax calculations on RO expenditure, which is deemed as money that comes directly from company headquarters)
This is valid for the following type of Representative Offices:

- RO of trading companies or agents that conduct agency activities (including trading parent company products and being an agent for the products of other companies)
- Advertising agency ROs
- Travel agency ROs that provide services to tourists (visa applications, collection of expenses, reservation of accommodation, booking of air tickets, supplying tour guides and so on)

A tax of approximately 9.8% is imposed on such RO's total expenditure.

2.2.3 Actual income

Actual business income including the income received by the RO and by its parent company shall be regularly declared to the tax bureau of the RO of the following entities:

- holding companies engaged in various business activities
- banking or financial institutions engaged in investment advice or other consulting services
- transportation enterprises providing service to their customers in all sectors of transportation
- other taxable business activities not included in the those mentioned above

Tax may be exempted in the following circumstances:

- The RO of a foreign government, international organization, non-profit organization or non-governmental organization. In these cases, the RO can apply to the taxation bureau for tax exemption, submitting documents provided by the home tax administration or government to certify the nature of its parent company.
- ROs that are only engaged in providing market information, liaison work and preliminary or auxiliary activities for the manufacture or sales of parent company are allowed to apply for tax exemption. Being only partially engaged in trading does not qualify the business for such tax exemption. In this case, documents certifying the nature of manufacturing by the parent company may be required by relevant taxation bureau.

After obtaining a Customs registration certificate, the RO is allowed to import limited amounts of office equipment, appliances and vehicles for its own use by paying duty and VAT in China. Before importation, the RO has to apply to the Customs office for approval to import the equipment. The RO also needs to register imported vehicles with the Public Security Bureau and apply for a license and registration plates; a 'road tax' is paid on the vehicles.
It is forbidden to sell on, or transfer, a RO's assets without the approval of the Customs office: they may only be sold to a designated shop authorized by the authorities after approval.

In terms of demonstration goods, a RO can normally import them by paying duty and VAT and use them permanently in the RO's name. It is also possible to import products for demonstration purpose duty and VAT free as temporary goods for exhibition/demonstration purposes through an import and export agent. Temporarily imported goods shall be returned to their origin within six months of their arrival in China. The goods shall be under the supervision of the Customs office during those six months; they cannot be sold, transferred or donated without Customs approval and payment of duty and VAT. If the goods are expected to be retained in China after the six-month period, the consignee shall follow an official import procedure and, of course, pay duty and VAT.

2.3 Steps for the establishment of a sales Representative Office

2.3.1 Strategy and Concept

The purpose for setting up a RO needs to be clearly established internally during the preparation phase. The RO may have an exploratory nature and conduct research by trial sales activities (on behalf of the parent company, since the RO may not act as an independent company). In such a case and considering initial set up and operation costs of a RO (USD70,000 and up for a first year), it makes sense to first ascertain that there is a sufficiently good chance of a market. Otherwise, an entry market research prior to RO set up maybe more economical.

Should the RO be set up for the marketing, sales and distribution management on the spot, steps defined in Chapter III, Preparing for China, may be followed to ensure adequate preparation.

2.3.2 Legal Registration

Activities can start with a 'virtual office', that is hired local staff whose purpose is to formally establish the RO while initiating its business mission. A period of preparatory activity during which the RO is under registration is generally accepted, however it should not go over the time reasonable for such preparatory work (a few months). Formal registration needs the following:

2.3.2.1 Searching and selecting office premises, establishment of rental contracts. Only A-grade buildings with a business license to lease the premises to foreign companies are entitled to host representative offices. (Minimum office space for lease is usually around 80sqm, unless an small instant office or desk is rented in a business center.)

2.3.2.2 Preparation of all registration documents and information for registration

- Certificate of Incorporation or the updated Commercial Registration Certificate of the parent company; or a copy of this document, notarized by a notary or legal office and attested by a consulate in its host country
- Bank certificate to confirm creditworthiness of the parent company
- Copy of Articles of Associations or Memorandum of the parent company
- Application form and application letter
- Letter of appointment of Chief Representative (CR) and other representative(s) of the RO
- Copy of passport or ID of CR and representative(s)
- Two portrait photographs of the CR and representative(s)
- Resumés of the CR and representatives
- English and Chinese Lease Agreement
- Other documents which may be required for the office registration

2.3.2.3 Upon receipt of the Approval and Registration Certificate, the following registration and procedures need to be carried out:

- Obtaining the establishment Approval and the business license
- Receiving the Enterprise Code Certificate
- Registration of the Chief Representative
- Stamp making
- Foreign exchange registration
- Bank account opening

- Tax registration
- Statistics registration
- Customs registration

2.3.2.4 Application for tax exemption for the RO may be then conducted if the RO qualifies

2.3.3 Office initial set up check list

The following steps are recommended for an initial set up. Some of them may actually be carried out in parallel or prior to the office registration (the hiring of local staff, for example):

2.3.3.1 Establishing well thought out employment contracts, searching, assessing, selecting and hiring most suitable local executive personnel and staff for the RO. (See Chapter VIII, HR Selection and Management, for a detailed approach)

2.3.3.2 Establishing a detailed action plan and budget for the initial set up and for the first year of operation; defining business processes, accounting and reporting requirements (financial as well as business). Defining payment authorizations system on behalf of the RO.

2.3.3.3 Organize training in Europe with the parent company as necessary. Training of staff may start after the probation period (usually one to three months), in order to ensure that staff and employer have found each other suitable.

2.3.3.4 Set up of the IT:

- Network: hardware, software, data security, virus and hacker protection, back up policy.
- Website
- ERP access, as needed

2.3.3.5 Physically establishing the RO

- Designing and following up the installation of the office space. (Unless selecting an already installed, instant office, Chinese office space comes raw and need to be fully installed with partitions, ceilings, floors or carpets and all necessary fixtures.)
- Purchasing of local office equipment

2.3.3.6 Import of foreign equipment, as necessary

2.4 Operations and management recommendations

Operating successfully in China requires considerable experience, below are a few points and recommendations, among many, to pay attention to:

2.4.1 HR and Business Management

- **Keep close contact with the management in order to generate trust and understanding from the beginning of the relationship**. Adequate human resources management brings efficiency and ensures keeping the local staff (also see Chapter VIII, HR Selection and Management)
- Targets and action plans need be established and regularly reviewed jointly with the local management. **Responsibility and the related competences should be delegated for best results**. (Most Swiss companies in China are autonomous profit centers, also see Chapter I, General Environment, Switzerland in China)

- Establish performance evaluation and corresponding incentive systems for the managers. (At least, one third of remuneration should depend on performance, performance need to be measured on collected money, not sales.)

2.4.2 Financial Controlling and Legal

- **Ensure adequate local supervision of accounts so that no misunderstanding on use of financial resources may occur**: mistrust can quickly be generated as misunderstandings on use of resources may be interpreted (by the mother company) as misuse of money
- Establish clear, legally valid contract with clients

2.4.3 Use support of local professionals for starting up to minimize risks and ensure best possible start. (Also see Chapter X, Support for China)

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Sources

1 Studwell, Joe. (2002). The China Dream:The Quest for the Last Untapped Market on Earth

CASE STUDY

2.5 Jura Elektroapparate AG

Home and Commercial Appliances Industry

SUMMARY

JURA Elektroapparate AG is a world leader in the premium and luxury segments of hi-tech fully automatic coffee machines for home and light commercial use. The company distributes its products through its subsidiaries in key European markets, a joint venture in the US and via exclusive distributors in all other regions.

This case explains JURA's successful market entry strategy into China focusing on:

- the choice of market segments, and
- the local distribution strategy, i.e. selection of the best distributing partner, the advantages and risks of having an exclusive distributor and distributor relationship management

Figure 1:
Jura's activities, direct and indirect customers in China
Source: Swiss China Survey 2005

		B2B				B2C	
		Components	Equipment	Raw Material	Services	Consumer Goods	Services
Producing							
Purchasing	For own China operations						
	For mother company						
	For third party						
Selling	SOE						
	POE		jura				
	FIE Global						
	FIE Local		jura				

SOE - State-owned enterprises in China
POE - Private-ownd enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of JURA in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of JURA in the global scale

GLOBAL COFFEE CONSUMER TRENDS

Through the years, coffee drinking has evolved from being a simple dining routine, predominantly in Western countries, into a global culture. Whether it is just a trend or a long-term social practice, drinking coffee today reflects a modern consumer lifestyle and sophistication that has gained substantial following around the world.

MOTHER COMPANY – JURA Elektroapparate AG

Company background and current situation

Since its establishment in Niederbuchsiten, Switzerland in 1931, JURA has been known as a pioneer in the development of innovative electrical appliances for the home. Today, the Swiss brand is recognized in Europe as a forerunner in the field of high-end fully automated household coffee machines. The company further uses its expertise and technical know-how in the development, marketing, distribution and after sales service support of semi-professional coffee machines for the office and food service sectors worldwide.

jura
www.jura.com

Outsourced manufacturing

JURA subcontracts the production of coffee machines to a partner company in Switzerland which owns three factories nearby Zurich and is one of the biggest original equipment manufacturers (OEMs) of fully automated coffee machines. This company sources some of the key components from China (Shenzhen) and Malaysia (Penang) and assembles the final product in Switzerland.

Product lines and segments

JURA's core business is centered on high-end fully automatic coffee machines for home and commercial use, with home use sales representing about 70% of the total. JURA's entire product range is characterized by exceptional design, user-friendly control functions and the ultimate coffee taste quality.

JURA establishes its products' quality as two of its Impressa models have been consecutively selected by Stiftung Warentest (Germany's leading consumer advice organization) as the "best" coffee machine in the market, "setting new standards" and "making a resounding impression with its espresso flavor and perfect "crema". Impressa F70 recently received the Stiftung award for 2005 while Impressa F50 won the same accolade in 2004.

The IMPRESSA Z, S, F and E lines are ideal for modern household kitchens while the IMPRESSA X line is distinguished by its outstanding price/performance ratio, multiple functions for varied coffee preferences and higher capacity for commercial settings like small businesses, bars, coffee shops, restaurants and offices.

Company size and turnover

In 2004, the total number of JURA employees worldwide was 434 with 255 based in Switzerland and 179 in overseas subsidiaries and representative offices. The company currently has three subsidiaries in Europe, Germany, Austria and the Netherlands, as well as a joint venture in the USA. These companies manage the distribution, marketing and after sales service of JURA machines. In addition, JURA is represented in more than 40 countries through distributors. Today, distributors account for 12% of the total unit sales; however they are growing at an annual rate of about 30%.

JURA posted CHF260m (USD199 million) consolidated revenues in 2004. Sales of fully automatic machines exceeded 180,000 units. The larger portion was contributed by international sales with CHF214.5 million (USD164 million) or 82.5% while Swiss revenues were CHF45.5 million (USD35 million) or 17.5%. Europe, with over 80% of total units, has the biggest share in worldwide sales. The US contributed 10%, while Asia's turnover accounted for 2% of the total.

Competitors and competitive advantage

Saeco is JURA's biggest direct competitor. They sell a wide range of both household fully automatic machines through retail outlets and semi-commercial machines. JURA's main international competitors in the business to business (B2B) segment are Franke and Schaerer. They also sell larger heavy duty machines with higher capacity but no home coffee makers. Solis is in the fully automatic segment with a range which competes with part of JURA's product portfolio, but not so wide in terms of the number of models.

JURA's key differentiators are:

- ability to make a variety of coffee products, including Cappuccino and Latte Macchiato at the push of a button
- minimalist styling
- quality and reliability of the machines
- user-friendly and high-tech functionalities
- first class after sales service support
- outstanding price/performance ratio in the semi-commercial segment

CASE STUDY

ASIAN COFFEE CONSUMER TREND

In Asia, following the global trend, the number of commercial establishments serving specialty type coffee has multiplied in major business and entertainment hubs. As an example, JURA observes an uptrend in Asia's general public awareness and interest in gourmet coffee and an increased knowledge and preference for specialty coffee machines. Although JURA's percentage sales in Asia is low (total of 2%), the region's sales are growing at an average of over 30% per annum. This sustained growth indicates that the region is becoming increasingly important for JURA.

JURA in CHINA

Subsidiary background and current situation

JURA has had a presence in Japan, Hong Kong, Taiwan and South East Asia (via Singapore) ever since the mid-1990s. The company partnered with a dominant Hong Kong coffee shop chain operator and coffee products retailer in 1997. This partnership ensured JURA's reach into the Hong Kong market that has a large number of foreign expatriates, international corporate offices and small to mid size commercial outlets. In 2000, JURA's Hong Kong distributor requested exclusive distributorship on Mainland China. At the end of 2000, JURA officially authorized its Hong Kong partner to distribute on the Mainland. However, after commissioning professional market inquiries in China in 2002, JURA realized that it was not efficient to distribute on the Mainland through Hong Kong. With the support of a local Swiss consulting network in Shanghai, JURA decided to appoint another distributor to manage the direct distribution in China market (excluding Hong Kong and Macau) in June 2003.

Figure 2:
Jura's milestones in China
Source: Swiss China Survey, 2005

A year after setting up direct distribution on the Mainland, JURA's sales figures in China doubled. To strengthen its market presence and improve communications with both its distribution partner and potential customers, the company intends to open a representative office in Shanghai in 2006 under the direct management of the mother company in Switzerland. The company has already appointed a Chinese manager located in Shanghai. The incumbent will work closely with the local distributor in market development and analysis, identification of new market segments and both above- and below-the-line marketing and PR activities.

Targeted market segments

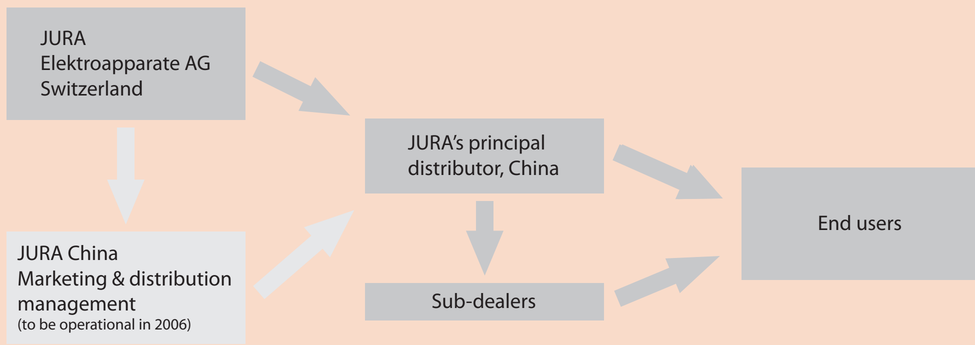
JURA targets commercial establishments and small businesses such as coffee shops, coffee product retailers or importers, small to mid-size restaurants, bars, car showrooms and offices. In the business to consumer (B2C) segment, the company concentrates on the upper-class population with the following consumer profiles: Western expatriates, high-ranking foreign and local executives and wealthy Chinese opinion leaders.

MARKET ENTRY DECISIONS and ANALYSIS

Internal value chain

JURA Elektroapparate Group in Switzerland, the mother company, supplies directly to the appointed principal distributor in China. Some of the product components are sourced from Asia by JURA's manufacturing partner, which assembles the end product in Switzerland. The coffee machines are shipped from the mother company to China. In the B2B segment, the principal distributor either distributes the products through its network of sub-dealers and appointed sales agents or sells them directly to commercial establishments and small businesses. The distributor may sign up coffee companies, coffee roasters or importers of other coffee machines as sub-dealers.

Figure 3:
Internal value chain
Source: Swiss China Survey, 2005



Location

JURA's distributor's main location is in Shanghai. It also has a branch office in Beijing and about 50 sub-dealers covering the major markets on the Mainland.

JURA is confident that Shanghai has become a major center of overseas investments in Asia with the influx of foreign companies setting up their regional offices in the city. The presence of Western culture in Shanghai is influential to the city's growing number of coffee drinkers and the middle-class consumers' modern lifestyle. In addition, Shanghai's central location makes it convenient to reach different regions and cities in China. These factors convince JURA that Shanghai is the best location for its sales and marketing headquarters. This representative office will be the company's first in Asia; therefore, it may be developed as JURA's regional headquarters in the future.

Motivation and market entry strategy

JURA became aware of the Chinese coffee market potential when its Hong Kong distributor asked for exclusive China distributorship rights. Although the company initially appointed its Hong Kong partner to distribute on the Mainland, JURA quickly recognized that it was not gaining the optimum benefits of the China market in this way due to the following reasons:

- the Hong Kong partner distributed indirectly through a network of Chinese dealers because it did not have a direct distribution branch on the Mainland, therefore only adding an intermediary
- there was no direct communication between JURA and the Mainland dealers, which would have provided JURA the necessary market intelligence
- JURA was unable to attain the best margins and competitive sales prices due to multiple layers of distribution

As a consequence, JURA commissioned an in-depth market study in China. It indicated a change in the behavior of local consumers in tier one cities towards coffee drinking based on the number of coffee shops and restaurants that serve freshly brewed coffee in cosmopolitan cities like Shanghai. The research identified in the short term a market demand for fully automated coffee machines in commercial establishments like restaurants, offices and small businesses. The study also revealed, in the long term basis, the biggest potential in the market will be with its growing local middle- and upper-class population.

In order to enter the market most efficiently, JURA decided to develop first the more promising semi-commercial segment. At the same time, efforts are being made to reach the foreign offices and expatriates, as they are one of the trend setters for the developing middle class. In a second phase JURA will put a greater emphasis in developing the retail market.

Customers / market segments

JURA's first step was to target commercial end users (coffee shops, bars, small restaurants and offices). Indeed, JURA machines satisfy the needs of these businesses to provide high-quality coffee for small consumption without the requirement to invest in fully professional machines or experienced staff. Overseas

CASE STUDY

enterprises in China offer a market of foreign expatriates, high-ranking executives and wealthy business individuals.

Additionally, local opinion leaders and Chinese executives who are associated with foreign organizations and have been exposed to Western culture, make up JURA's target retail market segment.

However, differences between Chinese and foreign customers have to be taken into account. The foreign consumers' familiarity with specialty coffee is more advanced compared to the locals, thus, their appreciation of the proper coffee making equipment. They are also more willing to invest in the long term benefits of a superior product like JURA. Affluent Chinese, on the other hand, are known to take pride in their social standing and a premium-branded espresso machine may be flaunted while entertaining guests. As a result, for the Chinese home market, brand positioning and overall quality image is a key element.

Model: IMPRESSA X9

Fully automated coffee makers are still not common household equipment in a developing, tea-drinking country. Regular coffee drinkers settle for instant coffee while brewed coffee beginners use much cheaper filter-type or manual coffee machines. For these reasons, JURA aims to become an aspirational brand that signifies sophistication and luxury and confines its market segment to the very top group rather than pursue the mass market. Though this segment is limited today, JURA is confident that the consumers' increasing interest in specialty coffee is creating a need for JURA products, not just in the local coffee shops and restaurants, but also in China's contemporary households.

JURA generally expects its China business to achieve about 5% of its global sales in five years' time.

Sales channels and distribution strategy

JURA supplies directly to its principal distributor in Shanghai which manages the distribution network in all of China. It consists mainly of appointed sub-dealers and sales agents geographically specialized and focusing on specific market segments.

JURA opted for an exclusive distributorship strategy in China, even though no one distributor is able to cover this market satisfactorily, either geographically or in terms of segment. Yet, the long term benefits of having one exclusive distributor in China were considered to outweigh faster early sales. In fact, this strategy, compared to having multiple independent channels, provides the distributor with:

- stable and generally better margins: assigning territories to distributors does not actually work as all of them have intentions for expansion and may not respect agreements

Better margins and a stable business for the distributor provide:

- higher motivation to sell the product
- the ability to deliver excellent after sales service, a key element to maintain the brand image in a country like China. (Customers take service on expensive items for granted and they have little understanding of sophisticated appliances, therefore generating more failures.)
- financial security and more resources to develop at the same pace as JURA

This exclusive distributorship strategy provides JURA with:

- the possibility to provide focused, efficient and customized technical, financial and marketing support without investing too many resources
- a long term and easier to manage relationship with the distributor and the possibility to develop joint marketing activities (promotions, fairs, etc.) without the difficulties of involving a set of partners
- the possibility to better control the end user price
- overall, the ability to maintain its global corporate image in China while minimizing resources

Yet, this distribution strategy's major risk is the quality, in all aspects, of the distributor. Should the distributor selected not understand JURA's philosophy and not make good on JURA's key advantages, results can be negative, generating a loss of image and a loss of time towards the competition. As a result, JURA went to great lengths to select the right partner in China.

Distributor selection

Selecting a partner in a specific market is a strenuous and time-consuming process particularly since JURA ensures that the local distributors are well-chosen to guarantee long term partnerships and the level of product image. JURA takes into account the following criteria in screening a new distributor:

- the size and suitability of its existing distribution coverage, in respect to geography and segments
- the absence of representation of directly competing brands and products
- the extent of its knowledge and experience in handling, developing and distributing premium branded products
- its capability and experience, manpower availability and grasp of the importance of efficient after sales services; and
- its financial stability, liquidity and capacity to cope with JURA's growth

The pre- and post-distributor selection process involved the following:

- JURA toured the new market and identified candidates
- JURA appraised the industry, market opportunities and the candidates by conferring with embassy contacts and consulting a local support network that knows the local market
- upon short selection by the local professionals, JURA met with all candidates, visited their premises, reviewed their product category and selected an exclusive distributor
- JURA invited the local partner to visit the Swiss site for an overview of JURA's business philosophy and standards

The selected distributor (a company invested from Taiwan) was considered the best for its:

Model: IMPRESSA F70, the best among its range. Winner of Stiftung Warentest Award 2005.

- specific knowledge of the coffee maker market
- General Manager and part-owner's personal qualities
- better coverage of the market
- ability to raise capital, particularly scarce in China and particularly needed due to the rapid growth of the market

Legal environment

Products sold in China command 17% VAT, while duties on imported hot beverage equipment command either 10% or 32%, depending on the product's classification. "Home use coffee machine" is subject to China Compulsory Certificate (CCC) approval and 32% import duty. Products classified as "commercial hot beverage equipment" are subject to lower import duties at 10%. Initially JURA's distributor declared the products for commercial use, which was true to the fact as most of the machines were sold to commercial customers, and managed to import them at 10%. In mid-2004, the guidelines for imported electronic equipment classification were modified. The customs authority did not approve the shipment of household machines to be declared as commercial equipment, resulting in restricting the models available for sale to only semi-commercial machines. Obtaining CCC approval was a complicated and time-consuming process. In June 2005, JURA was accorded the CCC certificate for selected household models for China.

FACTORS FOR SUCCESS, RISKS AND OPPORTUNITIES

Opportunities

JURA expects tier one cities in China (such as Shanghai) to remain potential foreign investment hubs in Asia, which will generate an increase in the number of expatriates and affluent Chinese. This presents an opportunity for JURA to improve its turnover in China since the presence of Western influence will encourage the consumers' modern lifestyle and likewise improve the middle- and upper-class population. This offers the possibility to move into the retail market with automated coffee makers for household use in the big centers.

Besides, the growing awareness of local consumers in China on specialty types of coffee due to the emergence of commercial establishments that serve the beverage also presents an opportunity for JURA to sell its semi-professional coffee machines to commercial businesses in other less developed areas in China provided the logistics on after sales can be mastered.

Risks

As JURA moves toward retail selling in China, and the need to pay 32% import duties, JURA's distributor may have to assume the expense and either reduce its margin levels or increase the end user price. If the distributor's margins are decreased, this might jeopardize the high service level JURA needs to develop its brand and distribution network.

One of the downsides of granting exclusive distributorship to a local partner in a market as vast as China is that it is geographically challenging for a single distributor to cover 100% of the market and provide after sales service, particularly needed for commercial customers. Handling sub-dealers and sales agents in key cities like Shanghai and Beijing, neighboring areas and other nearby provinces, is both a management and a logistics challenge.

On the marketing side, a fully automatic coffee machine is not a home appliance necessity in the ordinary Chinese household. This will require JURA to devise creative and extensive marketing campaigns specifically designed to target the Chinese upper class segment and to convince them of the benefits of the high-end JURA brand.

This difficulty is compounded by the necessity to train the local distributor on JURA's high-end corporate culture, particularly in its marketing campaigns.

Success factors

JURA's successful entry into China can be summarized as follows:

- Timely and well prepared market entry with the support of a local support network
  - thorough market and distribution strategy analysis
  - careful and complete distributor selection process
- Step by step entry and adjustment of the traditional entry strategy: in the first phase, capturing the semi-commercial B2B market with a very attractive price/quality ratio, then moving towards home users for which the product is today perceived as very expensive
- granting exclusive distributorship and strong support to the distributor
- ensuring a high quality and level of service

Model: IMPRESSA Z5

JURA's timely and professional entry into the Chinese market was instrumental to JURA's success in capturing an emerging niche market in China, for high quality easy-to-make coffee in small outlets.

Another key success factor was the thorough selection process and methodical approach that JURA employed in choosing its distributor in China and ensuring the best possible fit with JURA.

Finally, by recognizing the vital role that its local partner plays in the market and affording strong, on-the-spot support, JURA shows its commitment, forms a long-term partnership founded on mutual trust and loyalty and allows good management of its distributor. This in turn ensures quality of service, brand image management and further motivation for growth.

Information on JURA Elektroapparate AG courtesy of:
Yoshiko Iwata - Export Manager, JURA
Interview conducted by: *Marco Schueep and Patrick Schaufelberger*
Case Study written by: *Maria Luisa Dacera*
Approved for publication on: *August 2005*

V

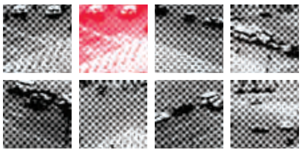
Market Types & Logistics

This chapter intends to provide framed information on selected industries relevant to Swiss enterprises as well as in-depth analysis of a set of successful companies for the reader to be able to go behind general descriptions of little value for supporting the development of strategies.

As much as available, the industry trends and success factors uncovered from the Swiss China Survey provide additional light on key market types.

The following fields and case studies are covered:

- Bien-Air
- CIBA
- ABB Turbocharging
- Sulzer Chemtech
- Saurer
- KUK
- Schindler
- Gate Gourmet

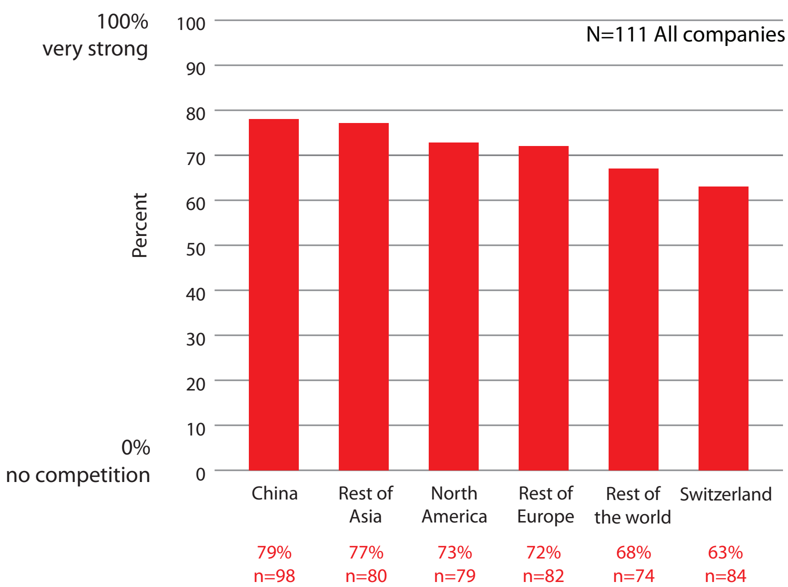


1 Market Competitiveness

China (and Asia) are rated by respondents of the survey as the most competitive market in the world (see Survey chart V - 1). Managers in China may have a biased perception towards this market due to their very location. Yet, it is generally admitted that Asia is the most competitive region in the world and it is only natural that China, the country with the largest population in the region, be perceived as the place of even greater competition.

Survey chart V - 1

Comparison of the most competitive markets in the world



How strong is the competition in the following markets?

Source: Swiss China Survey, 2005

This opinion on competitiveness is consistent with the overall rating of product (goods or services) related factors. As a group, they come of key importance for success. Survey chart V - 2 indicates the factors that have been consolidated in the 'Product Competitiveness' category of success factors.

(The category is rated by all successful respondents as No 2 with 81.8%. Yet, there is not much statistical significance in this ranking when comparing the difference with the first category, 'Human Resources Selection and Management' obtaining a score of 85.5% and the third 'Knowledge of the Environment', scoring 79.5%. The next category 'Operations' comes significantly lower with 73.5%, though. See Initial Chapter Swiss China Survey, 'Success factors and categories' for details.)

Survey chart V - 2

Factors for success of successful companies in China

Source: Swiss China Survey, 2005

1.1 Information on market types

The variety of market types in China is too big to tackle individually, although information — to be of practical value for an enterprise — need to be focused on that firm's suitable product type and even market segment. Such information can only be gathered on a case by case basis.

However, the combination of general information on industries with detailed case studies of successful companies active in these industries provide a frame and reference points in it, with which a manager can review his strategic decisions in China or evaluate a potential involvement if he is not active yet.

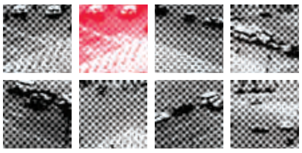
As a result, as much as possible, each industry in this chapter is described with:

- Trends as identified by the Swiss China survey (generally costs and financial returns) and success factors rated by the Swiss companies in the industry
- Expert contributions to describe the industry or a market situation within the industry
- Case studies of successful Swiss companies

Market types have been selected according to the interest they present for Swiss industries. No case or industry description has been developed for the luxury goods industry, though it is certainly a very important market for Swiss watch firms. Indeed, this specialized field should be the object of a specialized report. However, two contributions on branding are presented in Chapter I General Environment & Trends, for companies interested in this field.

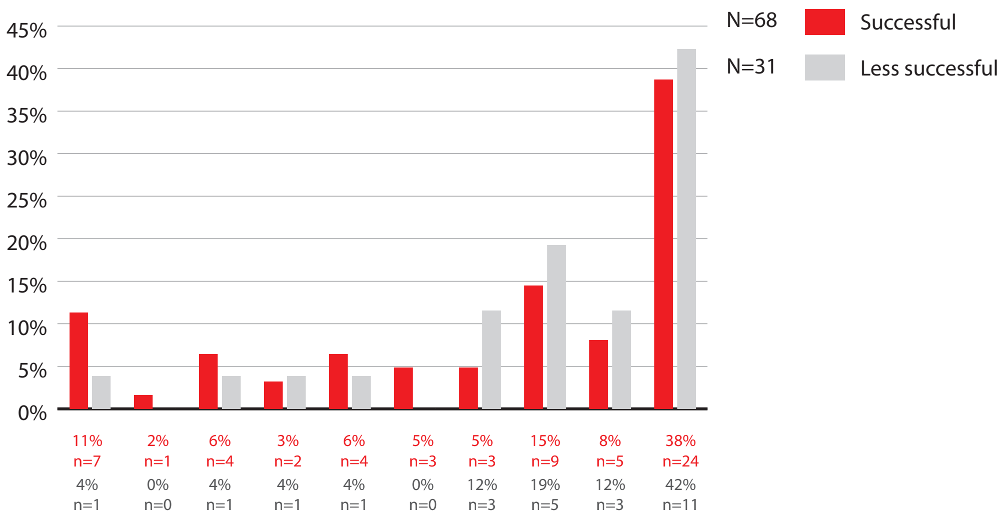
1.2 Distribution trends

Most of the Swiss respondents to the survey do a large proportion of the distribution by themselves. About two-thirds of respondents distribute 70% or more of their turnover by themselves (see Survey chart V - 3).



Survey chart V - 3

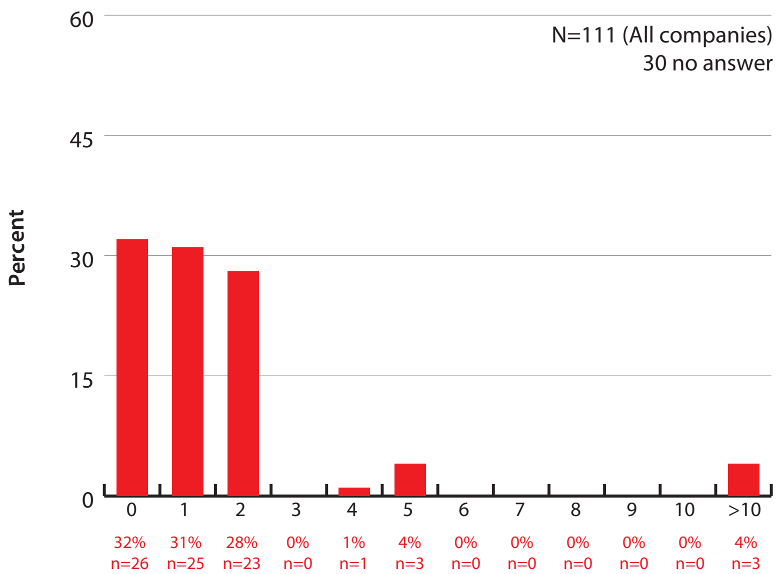
What percentage of your distribution do you handle via direct sales organized by own subsidiaries?



Source: Swiss China Survey, 2005

Besides, distribution networks are generally very flat compared to the size of the country — 32% of the respondents sell directly to end users while over 90% of respondents have no more than two distribution levels in their network.

Survey chart V - 4



How many levels of distribution are there between Chinese subsidiary and the end-users?

Source: Swiss China Survey, 2005

2 Medical Device Industry

by Anthony Ko and Diana Zhu, CBC

Anthony Ko (Anthony.Ko@cbcnow.com) works as a Senior Consultant of the CBC Hong Kong Office; Diana Zhu (diana.zhu@cbc.sh.cn) works as a Senior Consultant at the CBC Beijing Office

China is considered to be the largest potential market for medical devices in Asia. The business drivers for China's medical device industry are: increasing and aging population and the rise in living standards. These factors influence the direction of the research and development and production of the business. With a growing economy and a population of more than 1.5 billion, China presents both opportunities and challenges for international medical device manufacturers.

2.1 Medical device classification

China's administration of medical devices is based on how the product is classified. The classification principles are the same as the ones in other countries.

Medical devices are split into three categories, each with specific regulatory requirements. The classifications are as follows:

- Class I: Low risk devices, regulated by provincial government. It covers devices which safety and effectiveness are sufficiently proven through conventional management or general controls.
- Class II: Medium risk devices, regulated by provincial government. This covers devices which structure and mechanism have been acknowledged or approved for production domestically and internationally, and are mature in technique but which safety and effectiveness should be specially controlled.
- Class III: High risk devices, regulated by the SFDA (State Food and Drug Administration). This covers devices implanted into the body for life support or life sustaining purposes. They are considered to be complex in technique and structure, and could present a potential unreasonable risk of illness or injury. Their safety and effectiveness should be strictly controlled.

For the purposes of this report, medical devices are considered to be any instrument, equipment, apparatus, appliance, implant or material, along with any related equipment for the diagnosis, treatment and prevention of human illness. Such devices may also be used to modify the body's physiological functions or to aid the replacement of organs. On October 1, 1997, China introduced compulsory registration for certain medical devices and extended it in April 2000. The SFDA is responsible for the registration of all medical devices used (produced in or imported to) China.

Registration numbers for new medical devices in China in 2003 and 2004

	Class I & II	Class III	Imported products
2003	16691	3564	4742
2004	23779	5701	7595

Source: SFDA March 2005

2.2 Facts and figures

According to SFDA statistics, it issued registration certificates for 20,255 new medical devices by the end of 2003, of which 4,742 were imported products; Class III products accounted for 3,564 certificates; Class I and Class II 16,691 products. This contrasts strongly with the 2004 figures, where a total of 29,480 new medical device products were registered: 23,779 were Class I and Class II; 5,701 were Class III. Of these, 21,707 were produced locally, 7,595 were imported, and only 178 were from Hong Kong, Macau or Taiwan. **This substantial growth in registration of new products demonstrates a growing demand for medical devices in China**, according to CBC in Beijing.

2.2.1 Chinese medical device industry turnover

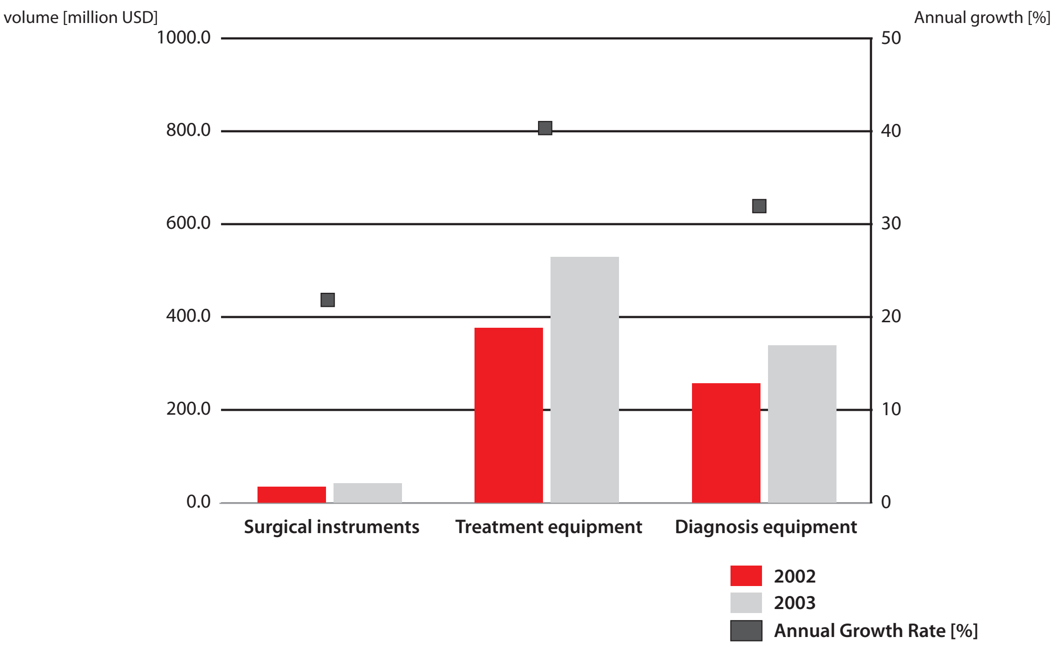
China's overall medical device market is currently worth approximately USD 3.5 billion. The turnover of the country's medical device industry represents only 2% of the total industry turnover on a global scale. Total sales in 2003 were USD 910.97 million, an increase of 25.17% over the 2002 figure (this significant growth was largely a result of the SARS crisis that broke out in 2003).

China's medical devices can be divided into three main segments:

- surgical instruments
- treatment equipment and metering devices
- diagnosis instruments and metering devices

Sales revenues across all three segments showed an upward surge in 2003, with treatment equipment and metering devices producing the highest turnover.

Comparison of the three medical device segments
(Manufacturing turnover by volume in 2002 and 2003 in USD)



Source: China Information Center, Year Book 2004

2.3 Projections and outlook

Estimates show that China's medical equipment market's growth rate is approximately 6.5% in 2004 and it is expected that the country will reach the top five largest medical equipment markets in the world by 2010. Streamlining of market entry and increasing the focus on addressing rural health care inadequacies will reveal a big number of untapped consumers which surely present plenty of opportunities for foreign business. The market is predicted to reach USD 3.3 billion by 2009, equivalent to approximately USD 2.5 per capita .

2.4 Sales revenue and profit of the medical device industry

Compared with other related industries, China's medical device industry is still young. According to the "China Medical Industry Year Book 2004", the sales revenue of medical equipment and metering devices accounts for only 34% of the total sales revenue of medical and pharmaceutical products.

Market projections 2004-2009 (USD billion)

	Market	Per capita (USD)
2004	2.4	1.9
2005	2.5	1.9
2006	2.7	2.1
2007	2.9	2.2
2008	3.1	2.3
2009	3.3	2.5

Source: Medistat Outlook: The market for medical devices and equipment in Brazil, Russia, India and China, 2005. Episcom Business Intelligence

2.4.1 Investment situation of the medical device industry

Despite its young age, China's medical device industry shows great potential and has become one of the most attractive industries for investment. According to the China Medical Industry Year Book, medical device manufacturing projects under capital construction increased 25% in 2002 and have been increasing at the average rate of 15% in recent years. China's medical device industry investments are expected to grow steadily.

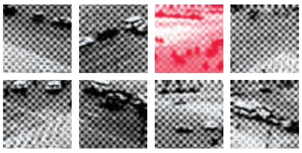
2.4.2 Market opportunities and trends

China's large expenditure on medical device products results from the following reasons:

- Alignment with international medical standards
- Village and town medical service are still developing
- Hospitals' increasing need for medical devices, driven by internal policy along with the continuous development and improvement of medical services
- In recent years, demands for rehabilitation services and related medical products has increased

2.4.3 An upgrading technology level

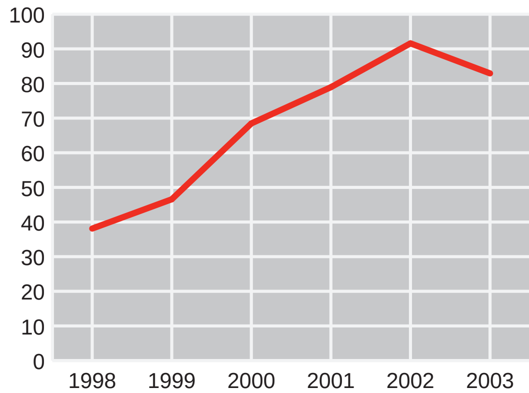
In global terms, by contrast with the medical device sales volumes of America (41%), European Union (27%) and Japan (14%), sales in China accounted for only 2% of the world market. This distribution and the relatively small share of China are due to the high technology content and high added-value of foreign medical device products from developed countries. As large multinational enterprises and the leading domestic players still largely monopolize cutting-edge technologies (such as ultrasonic focusing technology), China's medical device industry continues to lag far behind that of foreign countries.



Low level of local technology is the true bottleneck for the growth of China's medical device industry. Yet, many large-scale enterprises are still attracted by the bright prospects of the medical device industry and therefore seize the opportunity to invest considerable amounts to improve the current situation.

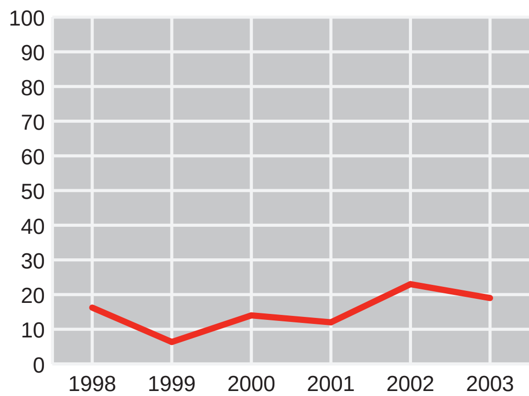
2.4.4 Expenditure on technical upgrading

The following charts cover all state- and privately-owned enterprises with annual sales exceeding USD 605,000.



Expenditure on technical renovation from 1998 to 2003 (in million USD)

Source: China New and Hi-tech Industry Year Book 2003



Expenditure on technical import from 1998 to 2003 (in million USD)

Source: China New and Hi-tech Industry Year Book, 2003

2.4.5 How the industry rates for competence on a global scale

Thanks to a comparatively open economic environment, import and export figures for medical devices can be regarded as an effective indicator, reflecting the overall competence of the whole industry.

According to the General Administration of Customs (GAC) in China, the total value of imports and exports of medical devices in 2004 was USD 6.06 billion, an increase of 28.31%. Of which the import value was USD 3.28 billion, an increase of 22.98%, and the export value was USD 2.78 billion, an increase of 35.25%, resulting in an adverse balance of trade deficit of USD 506 million.

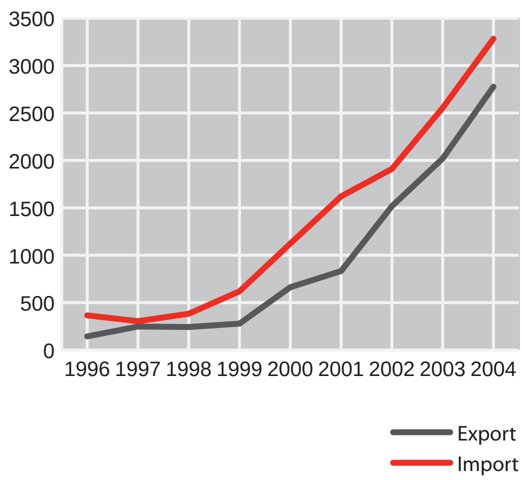
The succeeding chart indicates that the industry's competence has improved dramatically since 2000. The increasing trade of high technology, high added-value and large medical equipment (both import and export) resulted in a considerable rise in the total value of imports and exports.

Prior to 2001, as China's high technology, high added-value and large medical equipment manufacturing industry were very weak, the adverse balance of trade deficit continued to grow. With the development of China's own medical equipment manufacturing industry - reflected in the increasing number of oversized enterprises in the country since 2001 - the country's growing exports of high technology, high added-value and large medical equipment have helped to reduce the trade deficit.

2.4.6 China's market for imported medical devices

China's medical device market is currently one of the largest and fastest growing, ranked 11th in the world. Imports account for approximately 70% of China's USD 6 billion medical device market and the United States supplies approximately 35% of those imports, followed by Japan (25%), and Germany with other European countries (28%) in 2004.

China's market for imported medical devices is growing at about 15% annually during 1999 and 2002 and the sales volume of China's medical equipment market (including locally produced and imported devices) is expected to exceed USD 7 billion by end of 2005. However, although China became a member of the World Trade Organization (WTO) three years ago the uncertainty of the regulatory environment (centralized procurement regulations and pricing issues) will continue to play a negative role on profit expectations. Over the next ten years though, China should remain a good market for manufacturers of medical equipment and products.



Import and Export value volume from 1996 to 2004 (in million USD)

Source: China GAC Statistics Feb. 2005

Currently, Chinese end-users view foreign products as the most technologically advanced, and superior in quality to locally-produced equipment; China's hospitals, particularly, welcome high technology medical equipment and products. At the same time, domestic medical device companies are consolidating, improving their quality and beginning to compete in medium level technology niches.

2.5 Market entry and the industrial barriers

2.5.1 Market entry regulations

Following China's entry into WTO, the SFDA (the Chinese equivalent of the US Food and Drug Administration [USFDA]) is making greater efforts to create a better regulatory environment for medical devices. In August 2004, the SFDA implemented new registration requirements, simplifying the application and review process for such devices.

All medical devices in China are regulated by the SFDA. In addition, the General Administration of Quality, Supervision, Inspection and Quarantine (AQSIQ) regulates all medical devices that are imported into China. AQSIQ conducts mandatory safety registration, certification and inspection for certain medical devices.

a) SFDA registration

All medical devices need to undergo mandatory certification by the SFDA, a governmental agency controlled directly by China's State Council. The SFDA is in charge of comprehensive supervision of the safety of food, health care food and cosmetics and is also responsible for the regulation of drugs. On August 9, 2004 the SFDA issued new regulations for the registration of medical devices in China; regulations that have simplified and shortened the time needed for the application and dossier review process.

Companies will no longer need to apply to the SFDA for specification validation. Instead, they may use their own specifications as a basis for a testing agency to provide testing. The company then includes these test results in its completed dossier and submits it to the SFDA. The SFDA sends this dossier to the Medical Device Evaluation Center (MDEC) to review the specifications, dossier, government certificate and clinical report, if needed. The MDEC sends their conclusion to the SFDA and if everything is acceptable, the SFDA will issue the product approval license. While these new regulations have somewhat streamlined the process, they have not significantly altered the time frame (between nine to 12 months) for medical device registration in China.

Product registration is valid for four years. In order to change manufacturing location or add a new manufacturing location, a new product registration must be submitted to SFDA. To change basic information, such as the manufacturer's name, product name, or name of the manufacturing location, etc., an amendment to the product registration can be submitted. Requests for renewal of product registration must be made within six months of expiry of the initial registration. A copy of the original registration must be submitted with the renewal forms, and product quality follow-up reports must also be submitted.

Medical device import licenses approved by the SFDA

2001	2002	2003	2004	1st Qtr 2005
1104	1890	2050	4029	1200

Source: China Compulsory Certificate (CCC Mark) 2005 April

SFDA registration is required for all medical devices sold or used in China. To ensure product safety, manufacturers of the following seven medical product categories have to apply for both the SFDA and the China Compulsory Certification (CCC) which is issued by the China Quality Certification Center, simultaneously:

1. Medical diagnostic X-ray equipment
2. Haemodialysis equipment
3. Hollow fiber dialysers
4. Extra-corporeal blood circuit for blood purification equipment
5. Electrocardiographs
6. Implantable cardiac pacemakers
7. Artificial heart-lung machines

Manufacturers can apply for the CCC mark directly at an Authorized Certification Body (ACB) or through a Chinese agent. Products requiring the CCC mark that are not properly marked may be held at the border by Chinese Customs and may be subject to other penalties.

b) SFDA registration application procedures

In order to register a medical device, the following 12 documents must be collected and submitted to the SFDA in both Chinese and English, as announced by the SFDA on March 22, 2005:

1. SFDA registration form
2. Legal production qualification (for example, US FDA registration, what is the Swiss one?)
3. Business license for the Chinese agent registering the product (the agent must be located in China, have a valid license, and have a letter of commission from the manufacturer)
4. Marketing approval from the government of country of origin (Certificate to Foreign Government as well as 510(k), pre-market approval (PMA) application for US-made devices issued by FDA or Free Sale Certificate).
5. Product standards (ISO, CE, AAMI, etc.); Including an authorization letter for a Chinese agent to translate and adapt it to Chinese standard.

6. Instruction manual for the product.
7. Test report issued by SFDA-certified test center (only required for Class II and III products that have not received ISO9000 certification).
8. Clinical trial report (only required for certain types of device; the manufacturer may submit the clinical trial data that was originally used for product registration in the product's home country.
9. Quality guarantee letter (certifying that the product being registered and sold in China is identical to the product approved in the country of origin).
10. Letter of authorization from the manufacturer authorizing a Chinese agent who is responsible for reporting unfavorable practices, the agent's qualifications document and a promise letter from the agent.
11. After-sales authorization (this includes an authorization letter from the manufacturer, a promise letter from the after-sales agent, and an after-sales agent qualification document).
12. Self-guarantee declaration (to vouch for the truthfulness of submitted documents).

All documents executed in Switzerland to be used in China must first be authenticated. The Chinese Embassy and Chinese consulates provide this service. Before applying for authentication, the documents must first be signed in front of a public notary.

2.5.2 Import and export of medical devices

a) Foreign medical devices companies

Foreign companies face fewer difficulties today than in the past when registering and exporting medical devices to the China this is due to the implementation of more relaxed regulations. However, local procurement policies, testing requirements, protection of intellectual property and restrictions on the types of activities in which foreign firms can engage are all possible issues for foreign medical device companies. In recent decades, some well-known foreign medical manufacturers have set up wholly foreign owned enterprises, joint ventures and cooperative enterprises in China in order to produce locally and be more competitive. Up to now these foreign-owned manufacturers have experienced relatively successful operations: Johnson & Johnson, Agilent, Generic Electric, HP, Becton Dickinson, Siemens, Drager, Aloka, Mishawa, Shimadzu, Hanaco, JMS, Omron, Medison Korea, and GN ReSound.

The advantages of this strategy are as follows:

- Various incentives from economic and technological development areas from different province and cities
- Low cost on factory set up
- Low labor cost
- Evasion of high added-value import tax
- Being closer to market

b) Reduced tariff barrier

Following China's entry into the WTO, exporting to China is becoming easier for foreign companies, and tariffs on most medical devices were reduced from 11% to 5%-6% between 2000 and 2003. In January 2005, the tariff was further reduced to 3.9%.

c) Technical standards differences – the obstacle for Chinese export

Despite China's general WTO commitment to establish its regulations on international standards, the SFDA has yet to move toward the quality systems approach - focusing on design and manufacturing systems, processes, and procedures - to ensure quality products that is being adtopted in the rest of the world. By contrast, all Global Harmonization Task Force (GHTF) founding members (Australia, Canada, the European Union, Japan, and the United States) rely primarily on quality systems rather than type testing. In fact, when considering international standards, such as ISO quality systems standards, China has proposed country-specific requirements, thereby defeating the possibility of harmonization.

China's medical device industry lags behind international standards, and when it comes to technical innovation, the country is still lacking in many areas of expertise. Consequently the domestically produced medical devices cannot meet the technical standards of developed countries such as America, European countries and Japan. This is a technical barrier for China, and in turn, an advantage for developed countries, which are able to enter the Chinese market relatively easily thanks to their technological and high product quality advantages.

2.6 Marketing, sales and distribution

2.6.1 Defining distribution channels

Foreign medical device companies sell their products – exported to China and/or manufactured or distributed locally – via a network of distributors. Before 2005, foreign firms had no right to distribute products in China other than those manufactured in China. They could not own distribution networks, wholesaling outlets or warehouses and had to rely on Chinese distributors. Though China's accession to WTO has reduced import tariffs on most medical devices to 3.9% (as of January 1, 2005) and many distribution restrictions have been phased out, medical device exporters still face many challenges, such as test requirements and complex product registration processes. Considering these, the following three main distributor options are available for foreign medical device suppliers:-

a) **Large China state-owned distribution companies**
There are two types of state-owned distribution company: Foreign Trading Companies (FTCs) and Industrial Trading Companies (ITCs). FTCs are authorized and have established infrastructure with a broader reach in multiple provinces but are not aggressive in terms of developing new business. ITCs are smaller and monitored by their respective industrial ministries and bureaus. They have a better understanding of specific products but limited geographic focus.

b) **Privately-owned trading companies**
Compared to stated-owned companies, private-owned companies are more aggressive, entrepreneurial and market-oriented. However, they are usually not well-funded and tend to lack the expertise needed to sell western products. Few of these distributors are able to cover the entire country. Since there are very few large-scale private national medical device distributors, it is better to sign up two to four distributors to obtain wide-scale coverage.

c) **Hong Kong distributors**
They are familiar with both Western and Chinese business practices. In particular, most of them have good experience and knowledge about running a business in China. The common language (English, Cantonese and Mandarin) also contributes to effective communications.

d) **Joint Ventures/Wholly Foreign-Owned Enterprises/Foreign Investment Enterprises**
For medical device manufacturers, it is strongly recommended that they set up their representative offices – via joint ventures and/or wholly foreign-owned enterprises (WOFEs) – in large cities such as Beijing, Shanghai and Guangzhou to facilitate the marketing of products and monitor the performance of their local distributors. Also, they can offer more competitive prices as a result of using China's low cost labor and resources. Lastly, these Foreign Investment Enterprises (FIEs) are also able to recruit experienced local people from the Chinese health care system who are familiar with the market, policies and regulations.

2.6.2 Market segmentation

With a growing economy, rising per-capita incomes and increasing expectations for better health care, the market potential for the medical device industry in China is huge. In 2003, there were approximately 330,000 medical institutions in the country, including 2'000 hospitals at county level, 50,000 hospitals at township and town levels and 400 private hospitals consisting of special and Traditional Chinese Medicine (TCM) hospitals.

Public hospitals in China are classified into three categories: public hospitals, military hospitals, and corporate hospitals. Public hospitals are divided into Class I, II, or III hospitals. Class III hospitals are ranked the highest and are generally found in metropolitan areas and usually possess what the Chinese call 'the five large pieces' namely: X-ray; Computed Tomography (CT); ECT; Magnetic Resonance Imaging (MRI) and linear accelerator. Military hospitals are run by the People's Liberation Army (PLA) and are financially supported by the government. Corporate hospitals are run by large, state-owned companies but most of them have financial difficulties.

a) Market for high-end medical equipment

High-level hospitals tend to purchase advanced medical equipment and technologies such as color ultrasound to meet the rising public expectation for high quality medical equipment. They include: Class III hospitals; specialized hospitals; medical universities with subsidiary hospitals and research institutes; and private hospitals. Class III hospitals import the latest high technology products from the West such as imaging scanners and radiology equipment. Private hospitals regard high technology as a core requirement and competence, and hence represent a potential market. Foreign companies usually target Class II and III hospitals because of greater purchasing power.

They can sell their products better to these high-level hospitals, while county-level and small- to medium-sized hospitals are the major markets for domestic manufacturers. In addition, medical universities and institutions also look for imported medium- to high- priced medical devices. Geographically, sophisticated electro-medical diagnostic and imaging equipment are in demand in China, especially in large cities such as Beijing, Shanghai, and Guangzhou. Moreover, high-level hospitals - namely the top three hospitals: West China Medical University; Sichuan Provincial Hospital and Chengdu Number Three Hospital in Chengdu, Sichuan Province in south western China - are equipped with advanced imported medical equipment. However, due to the economic differences, the hospitals in inland areas are usually accustomed to purchasing medium-priced or standard medical devices.

b) SARS epidemic accelerates the demand of imaging equipment

Currently China's medical and health network covers counties, townships and villages. Of the country's 1.5 billion people, 900 million live in rural areas. They account for more than 70% of the population but only use about 20% of China's medical resources. With the outbreak of the severe acute respiratory syndrome (SARS) in 2003, the Chinese Ministry of Health signed an agreement with the WTO and the World Health Organization (WHO) to bring China's medical system up to world standards, especially in rural areas. This creates a huge potential market for medical equipment in rural China, particularly for imaging equipment such as CT, MRI and ultrasound.

2.6.3 The decision makers

The key decision-makers in a hospital are the hospital director, the purchasing director and physicians. Because of the importance of personal connections in China, decision makers are easily influenced by their relations with other people. In order to better sell to the Chinese, some foreign companies donate their medical equipment to hospitals and then provide training for their physicians and staff. Therefore, it is common for foreign companies to recruit Chinese physicians to work as sales people.

a) Public bidding

China adopted the law on governmental purchase bidding in 2002 to end kickbacks and special deals. Due to the high profit margins on medical equipment and intense hospital competition as a result of the government's move to privatize 50% of the state-owned hospitals, public bidding is deemed the best way to control costs for hospitals and keep patients' medical expenses reasonable. This is especially applied in the high cost, high technology and high-end user market; MRI equipment being a good example. Registered manufacturers with certificates are therefore required to take part in public bidding.

Before proceeding to public bidding, approval or permission is required from provincial or local medical departments. To purchase equipment priced above RMB5 million, investigation and approval by the Ministry of Health (MOH) are required. Otherwise, a permit from the local public health administrative authorities is sufficient.

b) Factors influencing decision making

In the purchase process, the following factors are influential:

- Hospital budget
- Technical requirements for the operation of the equipment
- The price and quality of the medical device
- After-sales service, maintenance cost and training provided
- Social benefits of the purchase (i.e. improved quality of life for the patients)

2.6.4 The marketing tools — PR activities and a list of the most important medical exhibitions in China

Public relations activities help to fulfill a number of functions in the medical equipment industry. They:

- strengthen the presence of a company or a product and
- provide training for medical professionals and develop stronger ties with the government

In the medical industry, PR activity usually takes the form of scientific citations, conference presentations and participation in exhibitions.

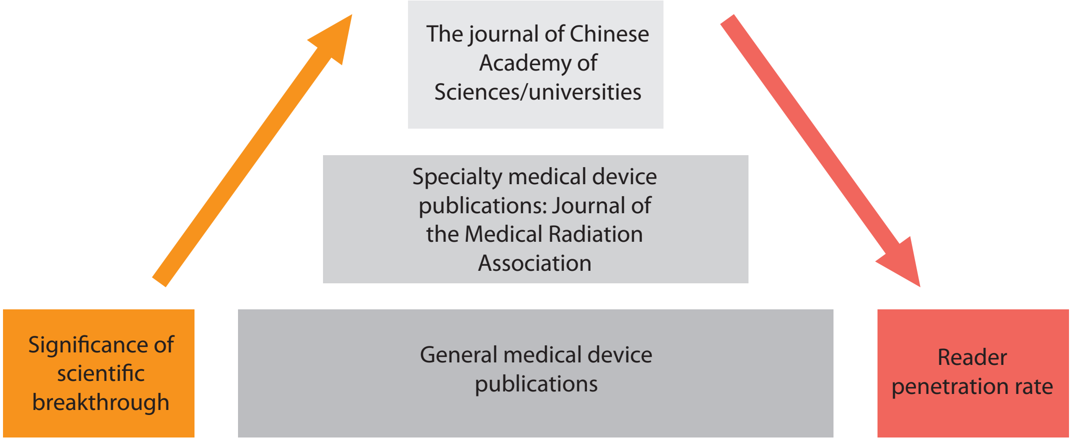
a) Citations

One useful communication channel for launching and marketing medical device product capabilities in China is through citations or publishing articles in medical magazines, periodicals and journals, such as the Chinese Medical Journal (CMJ). High technology and high-cost medical devices — especially those with a significant scientific breakthrough — tend to publish in the more professional medical publications, such as The Journal of Chinese Academy of Sciences/Universities. Scientific and medical publications is illustrated in below.

b) Conferences and seminars

Conference and seminar activities are frequently used by public relations organizations to present a company and then introduce new products and new technologies. However, some Chinese PR activities are more likely to take the form of entertainment, such as an invitation for a weekend's holiday in a nice hotel, or visiting the company's overseas headquarters.

Prestigious scientific and medical publications in China



c) Exhibitions

Exhibitions and trade fairs have been important marketing channels as they can attract thousands of medical equipment designers, buyers, manufacturers and researchers. Very often, the buyers make their purchases on site. Amongst all of the exhibitions/fairs in China, the most influential one is CMEF (China International Medical Equipment Fair) organized by: CNPGC (China National Pharmaceutical Group Corporation); CPEC (China Pharmaceutical Exhibition Corporation); CMEI (China National Medical Equipment

Industry Corporation) and the MOH. CMEF is the largest medical equipment trade fair in Asia, and it takes place bi-annually in spring and autumn. The recent CMEF Harbin 2005 attracted about 1,900 exhibitors, not only domestic, but including those from 13 other countries. The most important medical device exhibitions in China are listed below:

Important medical exhibitions in China

Exhibitions	Date	Venue
CMEF Chengdu 2005	1-5 Nov 2005 (held twice a year in Spring and Autumn)	New International Convention & Exposition Center, Chengdu, Sichuan Province, south western China
International Medical Equipment & Technology Exhibition	01-03 Mar, 2006	Shanghai Exhibition Center, Shanghai, China.
CHINA MED	11-14 Apr, 2006	China International Exhibition Center, Beijing, China.
Congress of Ophthalmology & Optometry China	14-16 Apr, 2006	Shanghai Exhibition Center, Shanghai, China.
CMEF Shenzhen 2006	25 - 29 Apr 2006 (held twice a year in Spring and Autumn)	China Hi-Tech Fair Exhibition Center, Shenzhen, Guangdong Province, southern China

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2.7 Beijing Bien-Air Medical Instruments Technology Services

Medical and Dental Equipment/Devices Industry

SUMMARY

Beijing Bien-Air Medical Instruments Technology Services Co., Ltd. manages its distribution network, marketing and promotion activities to expand its customer base for dental and surgical instruments in China. It offers after-sales services to dentists, orthodontists, oral hygienists and maxillofacial surgeons [i] as well as neuro-surgeons who are working for state-owned hospitals, specialized oral hospitals and private dental clinics throughout the country. The subsidiary provides specialized after-sales training to its local partners that manufacture dental units [ii], its authorized dealers and distributors.

This case study illustrates Bien-Air's activities and experiences in the Chinese market and highlights the following success factors:

- Partnership with local manufacturers to capture mid-range market and gain future customers
- Sound relationship with renowned hospitals and collaboration with industry opinion leaders to promote products
- Product innovation, durability, reliability and high-technology features
- Efficient after-sales service and training

Figure 1:
Bien-Air's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Medical Equipment	Raw Material	Services	Consumer Goods	Services
Producing							
Purchasing	For own China operations						
	For mother company						
	For third party						
Selling	SOE		Bien-Air		Bien-Air		
	POE		Bien-Air		Bien-Air		
	FIE Global						
	FIE Local						

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of Bien-Air in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of Bien-Air in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

The overall dental equipment and devices industry is characterized by high-end and high added value products so that the market is lucrative although relatively small in relation to that of the general medical devices market (see Figure 2 for the dental device's share of the global medical devices market). The industry has consolidated over the past five years as manufacturing companies and distributors either merged or acquired other companies to become single-source, full service providers to their customers. Even so, the entire dental equipment industry is still rather fragmented with the top ten companies having less than 50% share of the market [1]. More consolidation is expected as smaller companies find it even more difficult to compete against larger ones.

Globally, there are at least ten major international dental companies that post sales ranging from USD200 million to USD1.7 billion a year. The remaining industry players comprise of 3,500 to 4,000 smaller companies. The dental manufacturing industry employs approximately 40,000 to 60,000 people while there are about 800,000 registered dentists all over the world [2].

The global dental market (dental supplies, instruments and equipment sold worldwide) is estimated at USD 13 billion annually with the consumable product segment accounting for USD 11 billion [3] of the entire market. Dental consumable include:

- dental adhesives
- dental cements, fillings and sealants
- anesthetics
- products for cosmetic dentistry such as bleaching and whitening products, finishing and polishing, bonding agents
- disposable products such as syringe tips, dental hoses, forceps, dental needles, etc
- fixed and removable dental prosthetics [iii], crown and bridge materials, moulds or impression materials, dental implants, screws, abutments [iv] and other implant placement instruments
- small equipment such as electronic anesthesia units, carbide burs [v], dental handpieces [vi], drills and X-ray products such as film mounts and film holding instruments

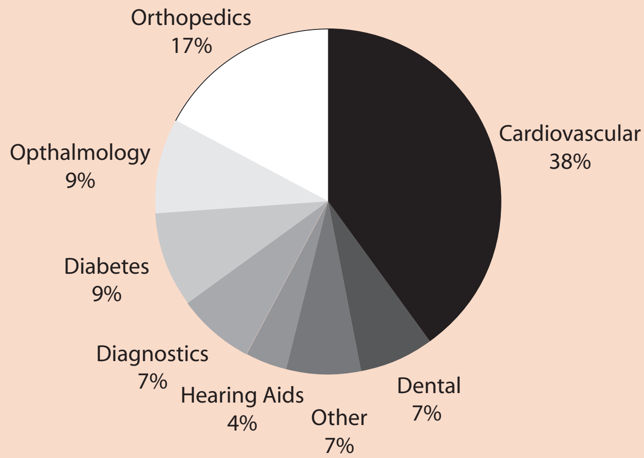


Figure 2:
Global medical device market 2004
Source: Straumann estimates; analyst reports

Estimates show that the entire market is growing 4.5% to 5.9% [4] annually on average; this denotes a yearly growth of USD 600 million to USD 700 million. The following factors are seen to be the major drivers of the industry's growth:

- Increasing demand due to:
  - limited longevity of natural teeth and longer lives
    (Natural teeth longevity is only about 50 years and the aging population (those over 65 years) in developed countries is increasing. The United Nations estimates there will be around 1.2 billion people aged over 65 years in 2025 [5]. Demand for dental services increases since older people require more of them as they age.)
  - significant growth in the aesthetic dentistry and specialty procedures
    (The demand for cosmetic dentistry has grown substantially as more and more people strive to achieve better looks and pay more attention to personal care. This benefits other areas of dentistry such as orthodontics [vii], teeth whitening, dental implants and others. The current worldwide market for dental implants alone is estimated at USD1.25 billion, growing 15% annually [6].)
  - growth in disposable income
    (Developing regions around the world are experiencing growth in gross domestic product (GDP) resulting in rising standard of living which allow for increased per capita spending on health and dental care.)
  - increasing dental plan insurance coverage
- Dentists' interest in improving practice productivity and profitability
- The development of innovative dental technologies brings about new treatments and procedures and improves existing treatments

MOTHER COMPANY – BIEN-AIR SA

Company background and current situation

Bien-Air is a family-owned enterprise founded in 1959 in Bienne by David Mosimann. The company develops and manufactures laboratory, surgical and dental instruments in Switzerland. Starting out with dental instruments and accessories, the company has progressively expanded its product range in over four decades of operation. In 2001, it has officially launched Bien-Air Surgery SA to meet the growing demand for neurosurgery, microsurgery, ENT (ears, nose and mouth), maxillofacial surgery instruments and systems. More recently, Bien-Air has also integrated instruments for dental implantology [viii] into its product catalog to supply the increasing needs of aesthetic dentistry. The company distributes its products and provides after-sales services through its eight subsidiaries and vast distribution network worldwide.

Company size, subsidiaries and structure

Of Bien-Air's two core divisions, the dental business generates 90% of its total turnover and the remaining 10% is contributed by the surgery business. The company has set up three development and production facilities; two of which are located in Le Noirmont and Saignelegier in the Canton Jura and one facility in Bienne which also houses the company's sales and marketing headquarters. Today, Bien-Air has a total of more than 300 employees in Switzerland and all over the world, 52% are assigned in production, 30% in R&D and administration and 18% in sales and after-sales services.

Bien-Air's eight subsidiaries are strategically located in Europe, the Americas and Asia. They provide the organizational support to the company's sales and distribution network, comprising of over 300 direct distributors worldwide.

- Italy
- France
- Germany
- Spain
- United Kingdom
- USA
- China
- Japan

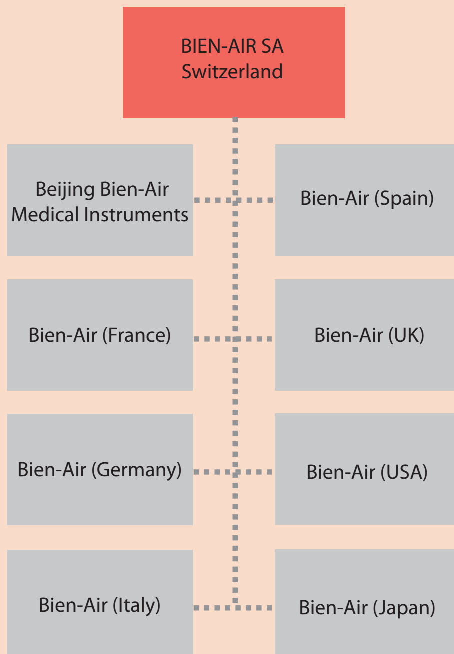


Figure 3:
Bien-Air structure
Source: Swiss China Survey, 2005

Business divisions and products

Bien-Air has two core business divisions —

- Dental division – provides instruments for laboratory and dental procedures (excluding complex surgical procedures e.g. maxillofacial surgery) such as oral implantology, amalgam polishing, caries removal, dentin and enamel reduction, root canal treatment and tooth sectioning. The products under this division include implant machines and instruments (with the exception of the actual implants, abutments and crowns), handpieces and handpiece turbines, air and electric micromotors as well as measuring instruments, adaptors, hoses and cables, accessories and maintenance products.
- Surgery division – provides instruments for maxillofacial surgery, microsurgery, ENT and neurosurgery like contra-angle handpieces, micro-saws and blades, rotary instruments and accessories.

Targeted market segment, competitors and competitive advantage

Premium products naturally command higher than average prices. Bien-Air therefore targets the high-end market segment such as:

- private dental practitioners working in privately-owned dental clinics that use modern, state-of-the-art, high-priced equipment

- large state- or government-owned hospitals with generous state funding for first-class high quality surgical and dental instruments
- orthodontists, periodontists [ix] and oral disease experts working in specialized oral hospitals

The Bien-Air brand is one of the top three high-end dental instrument brands in the world along with Sirona and KaVo. The following key factors give Bien-Air its competitive strengths:

- Unmatched reliability of Bien-Air products through the use of modern machinery, employment of specifically-trained personnel to operate numerical-controlled machines and stringent quality controls in every phase of development, manufacturing and assembly.
- Serial coding system imprinted on every Bien-Air product to serve as individual product identification enabling Bien-Air to track the product throughout its lifetime anywhere in the world, for parts/components replacement, maintenance, etc.
- Progressive and timely development of comprehensive medical and dental instruments allow Bien-Air to better serve the growing needs of its clients ahead of its competitors. For instance, with the advent of latest dental procedures like implantology, Bien-Air is one of the first few companies to develop machines for installation of dental implants.

CHINA INDUSTRY TRENDS and OUTLOOK

An overview of the Chinese dental market

The economic development achieved by China, following its reforms and open door policy, substantially enhanced people's disposable income and living standards particularly in the metropolitan areas. Consequently, the number of Chinese paying more attention to their appearance and health is increasing. These developments, together with efforts by the government and healthcare institutions to promote national health, drive up the demand for oral health care services and products.

The number of special dental hospitals and clinics emerging in the country has also grown. All new hospitals are required to be equipped with the basic if not high-end dental equipment while the older ones need to update their units to remain competitive. As a result, and as China's dental industry standards advances, the need for high-tech and up-to-date dental equipment is also growing.

Fifty percent of the adults and 70% [7] of the children of China's 1.3 billion population have decayed tooth problems and over 90% of the entire population has periodontal [x] diseases. According to the Chinese Stomatological Association (CSA) — an academic organization specializing in the field of stomatology [xi] in China — the number of oral hospitals and clinics in China has now exceeded 10,000. The Ministry of Health records also confirm that there are only approximately 38,000 registered dentists and 34 dental schools in the entire country; the proportion of dentists to the population is 1:33,000 compared to 1:4,000 in developed countries. These figures indicate that China needs to construct ten times more the current number of dental hospitals within the next 10 to 20 years to provide adequate dental health services and protection to its massive population.

According to the State Food and Drug Administration (SFDA), China's dental equipment market has experienced a steady growth in the last 20 years. Nearly all range of dental equipment, supplies and devices, from the low- to high-end models, have already made their way into the market.

The current size of China's dental market — including equipment, devices and instruments — is estimated at USD 150 million with domestic production accounting for 40% to 50% of the total volume. (Domestic output amounts to as much as 3,500 comprehensive dental treatment units annually from over 100 local dental unit manufacturers) [8].

CASE STUDY

BIEN-AIR in CHINA

Background, motivation to enter China and current situation

Bien-Air has had presence in the Chinese market for over ten years since it was already exporting and distributing surgical and dental products directly to selected and limited number of local dealers some time in the mid-1990s. In 2001, Bien-Air initiated a cooperation with a local manufacturer that imported Bien-Air turbines (a dental turbine is classified as a handpiece instrument used for various dental procedures mainly for drilling and grinding) to be bundled with their local mid-range dental units (a set of fully equipped dental chair including all instruments and accessories).

The company saw great potential to build up its customer base and activities in China. Hence, in June 2002, the wholly foreign-owned subsidiary Beijing Bien-Air Medical Instruments was set up in Beijing. The subsidiary functions primarily as an after-sales center through which it provides after-sales services (such as maintenance, repairs and replacement of old dental and surgical components and parts) directly to its customers. It also gives professional after-sales service training to its dealers and local manufacturer partners. Rather than doing direct sales and distribution, Bien-Air focuses instead on managing its above-the-line advertising, public relations, brand promotion and pricing. The company also facilitates the expansion of its distribution network in China through its partnerships with local manufacturers, marketing initiatives, evaluation and appointment of dealers for direct selling of Bien-Air products.

Subsidiary size and turnover

Bien-Air's office in Beijing consists of four key personnel: the General Manager (who also acts as the chief representative for Bien-Air SA), Administrative Assistant, Chief Accountant and the After-sales Service Manager. Currently, the subsidiary collaborates with two Chinese dental unit manufacturers and has more than ten direct distributors all over China. All in all, approximately 300 to 500 people in the country are working with Bien-Air products in the areas of sales, after-sales services and technical support through Bien-Air's local partnerships, direct dealers and sub-dealers. During the first few years of operation in China, Bien-Air has achieved 50% growth in the high-end market segment.

Value chain

Bien-Air negotiates and signs agreements directly with Chinese dental unit manufacturers and local dealers of foreign-branded medical and dental equipment. The orders coming from the dealers and the manufacturers are forwarded by Bien-Air to its mother company in Switzerland. Bien-Air headquarters then ships the products and/or components to the Chinese companies either directly or via local importing companies.

Bien-Air's dealers are generally direct distributors of imported medical and dental equipment and supplies. Like the local unit manufacturers, the dealers receive the high-range end product directly from Bien-Air Switzerland (unless they are using local importing companies instead of importing the products directly by themselves). The dealers sell the products to state-owned general medicine hospitals, specialized oral hospitals and dentists working in privately-owned dental clinics (see Figure 4).

FACTS and ANALYSIS

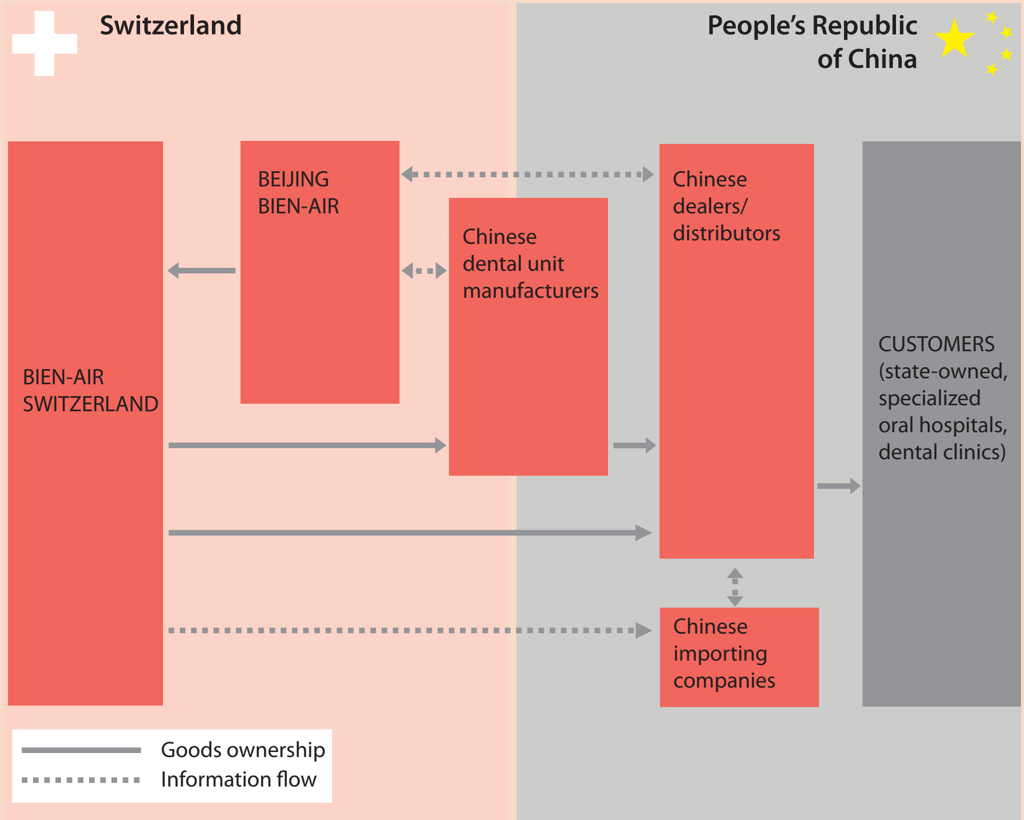
Customers/market segment served

At present, approximately more than 300 large state-owned and specialized oral hospitals are using Bien-Air products. In keeping with its global culture, Bien-Air targets the high-end market segment in China. Generally, the profile of the subsidiary's customers varies by region depending on the size and characteristic of the market. For instance:

in the northern region and the capital city Beijing, Bien-Air's customers are:

- mostly large state-owned general hospitals that receive substantial government funding for medical equipment and supplies

Figure 4:
Beijing Bien-Air value chain
Source: CH-ina (Shanghai) Co., Ltd



- some specialized oral hospitals
  (Large state-owned hospitals enjoy the benefits of government loans and government-approved budgets as the country strives to augment national health care through sufficient and better services. Therefore, they have more resources and are more willing to spend on imported high-end products.)

in the southern region and cities like Shanghai, Suzhou, Guangzhou and Shenzhen, Bien-Air's customers are:

- western-style privately-owned dental clinics that use imported dental equipment and materials (these clinics commonly serve the expatriate communities and occasionally affluent local patients)
- specialized oral hospitals dedicated to aesthetic or cosmetic dentistry like orthodontics and implantology
  (At this stage of China's oral care industry — although private clinics are seen to have more purchasing power due to less stringent government control over their service prices — the overall number and financial capability of private-owned clinics is still relatively limited compared to state-owned hospitals. Only the very advanced and western-style private clinics that cater to the more affluent local patients and the expatriate population in large cities like Shanghai and Guangzhou will invest heavily on imported dental equipment.)

The competition and Bien-Air's advantage

China's dental equipment industry is extremely competitive particularly with the advent of several Sino-foreign joint ventures and wholly foreign-owned companies as well as with the growth of local manufacturers and emerging local start-ups. China's own domestic dental industry, although generally regarded as not yet fully developed, has experienced considerable growth in the past several years. The total number of local dental product manufacturers has reached more than 100 and the vast majority is concentrated on the low to middle tier market. However, as technology rapidly develops and the number of private dental clinics in the country increases, more and more local companies are beginning to venture into manufacturing high-end dental unit models (these are computerized, fully integrated dental chairs that include small hand instruments and accessories).

Among the largest domestic players are:

- Shanghai Foshion Medical Instrument Co., Ltd.
- North Western Medical Instrument Corporation
- Suzhou Victor Dental
- Fimet Shanghai
- Shanghai Victor

Although domestic competition is not, thus far, considered as an immediate threat to the foreign-dominated higher market level, locally-made products do have a price advantage compared with the imported devices. The end user prices of one locally-produced dental unit may vary from USD 3,000 to USD 10,000 while imported ones go as high as USD 50,000 [9]. With this huge price difference, naturally the cheaper domestic products become far more attractive price-wise than the costly imports for small privately-owned local clinics with limited resources. (Even so, the data from the World Trade Atlas in Figure 5 show the figures of China's dental equipment imports still surged in recent years.)

Bien-Air does not consider local manufacturers as immediate competitors since they are still largely concentrated on the lower part of the market and they only sell to small hospitals and start-up private clinics. Foreign companies, either independently or via joint ventures have already captured the high-end, fully-computerized dental equipment market. The Bien-Air brand is ranked first among all domestic and international players in China's high-end medical and dental equipment market. Listed below are Bien-Air's major international competitors present in China:

- German Sirona Dental Systems
- German KaVo Dental Corporation
- Japanese NSK Nakanishi
- Austrian W&H Dentalwerk

The subsidiary also faces strong competition with companies that are exporting to, but not currently present in China. The amount of five key types of dental equipment (drill engines, instruments and appliances, x-ray apparatus, alpha/beta/gamma radiation apparatus, and dental chairs with equipment) imported by the country was estimated at USD 25 million in 2004 [10]. Among the top countries that export dental equipment and appliances to China are:

- Germany
- USA
- Japan
- Switzerland
- Italy
- Austria
- Finland
- Israel
- Sweden
- France
- Canada

To remain competitive, Bien-Air demonstrates the following advantages:

- Bien-Air has an extensive distribution network in China that targets key markets like Beijing, Shanghai, Shenzhen and Guangzhou. Its network is made up of carefully-selected local dealers of imported medical and dental equipment with the following strong and competitive qualities:
    - highly credible, widely recognized and have very well-regarded reputation within the industry
    - employ skilled and competent sales and after-sales service personnel
    - well-organized distribution systems and extensive coverage all over the country
    - exceptional knowledge of the medical and dental market in China, highly satisfactory sales track record and equally outstanding presence in the local medical and dental industry through media exposures and marketing

CHINA DENTAL EQUIPMENT IMPORTS FROM WORLD Jan 2001 to Oct 2003 (in USD million)				
				% change
Description	**2001**	**2002**	**2003**	**2002/2003**
Dental drill engines	3.54	2.42	2.50	3.41
Dental instruments and appliances	7.77	7.78	7.92	1.84
X-ray apparatus for dental use	1.42	2.97	2.76	-7.31
Alpha/beta/gamma radiation apparatus for medical/s	15.38	3.98	12.88	223.95
Dentist's chairs with dental equipment	5.18	5.00	7.25	44.81

Figure 5:
China dental equipment imports - Jan. 2001 to Oct. 2003 (in USD million)
Source: World Trade Atlas

- Bien-Air is the only wholly foreign-owned subsidiary in the high-end segment in China that provides professional after-sales services such as maintenance, repairs and parts replacement. The after-sales services are provided as a value added benefit to its customers without charge (except for parts/components replacement where Bien-Air charges for the cost of parts, excluding labor). Also, Bien-Air's own after-sales representative provides specialized after-sales service training to both its local partners and authorized dealers to ensure that customers can conveniently obtain the same quality servicing from the dealers' shops and/or the manufacturers.
- With the use of advanced technology, modern machinery and techniques managed by extensively trained technical personnel in its manufacturing and assembly facilities in Switzerland, Bien-Air products guarantee dependability. Bien-Air's technology-enhanced product features help dentists and surgeons alike to effectively facilitate pain management during treatment to avoid discomfort and unpleasant experiences on the part of the patient.
- Bien-Air's partnership with local dental unit manufacturers enables the subsidiary to capture a share of the mid-range market without foregoing its products' quality. This allows the subsidiary to strategically secure Bien-Air's position with the mid-range customers while this segment of the market potentially develops into high-range users in the future. This also enables the subsidiary to augment its distribution coverage in the country.

Sales channels and distribution strategies

As with all its subsidiaries all over the world, Bien-Air does not sell directly to its customers in China. However, China's immensity and diversity posed a challenge for Bien-Air to cover and reach all potential customers in the entire market in the most efficient and effective means. To gain maximum coverage and build up its customer base, Bien-Air places its products in the market via a distribution network made up of local companies specializing in selling imported dental and medical instruments directly to hospitals, medical centers and clinics throughout China.

Currently, Bien-Air has more than ten authorized dealers based all over the country which cover 80% of China's entire high-end segment. To target the most important markets of Shanghai, Beijing, Guangzhou, Shenzhen, Xi'an, Chengdu and Hong Kong, the subsidiary has assigned at least one official dealer in each of these major cities.

Bien-Air also partners with two domestic manufacturers that produce low and mid-range dental equipment units. These local companies have their own network of local dealers all over China. Through these partnerships Bien-Air further expands the extent of its distribution; although, this is primarily a strategic move for the subsidiary to establish its brand in China's mid-range market segment.

Dealer/distributor selection

As dealers play a very important role in building up and maintaining Bien-Air's client base, the subsidiary puts in considerable time and effort in selecting and appointing them. Negotiations and discussions take time and normally last around 12 up to 24 months. Upon appointment, Bien-Air will provide its dealers professional after-sales service and product training.

Following is the set of criteria that the subsidiary strictly adheres to in choosing its potential dealers:

- the business growth rate of the dealer must be suitable to match Bien-Air's own development rate and goals
- the dealer's distribution network must be extensive and the profile of the potential customers in the dealer's area of coverage must agree with Bien-Air's target market segment
- the size, skill set, market knowledge and level of education of the dealer's sales staff must be highly satisfactory to ensure that dealers are capable of promoting, presenting and explaining the functions of Bien-Air's products to customers
- the dealer must have considerable experience and duration in the business and in the industry
- the dealer must not be carrying products of Bien-Air's direct competitors to avoid differing interests

Product and brand awareness development

As China's dental industry shows every sign of development and potential growth, Bien-Air works doubly hard to establish itself as the premium Swiss-brand product in China in preparation for the future. After three years in the market, Bien-Air has noticed an increasing awareness and growing recognition of the Bien-Air brand among potential clients in China. The subsidiary concentrates on implementing marketing activities to promote its brand by:

- constant presence in the biggest medical and dental equipment exhibits and trade shows for opportunities to do product presentations and initiate contact with dealers and clients
- ensuring Bien-Air's strong presence in the industry through above-the-line advertising in all forms of media (specifically medical and dental publications) as well as hosting medical/dental forums and symposia for which it invites opinion leaders in the industry to deliver speeches and host workshops
- relationship-building with key customers (i.e. large state-owned hospitals, specialized oral/stomatological hospitals and modern private clinics) to instigate brand awareness, likewise to establish brand loyalty through personal visits from Bien-Air representative and free-of-charge after-sales services

Location

Given that one of its main target markets are large state-owned and specialized oral hospitals, Bien-Air chose to set up its subsidiary in Beijing where it can be closest to the majority of state-owned medical and dental centers. Beijing has the most number of the country's most comprehensive and largest state-owned hospitals and clinics specializing in oral health. Of China's over 10,000 oral hospitals and clinics, approximately 1,200 are located in Beijing [11].

Legal environment

China imposes stringent rules and trade barriers on all imported medical products. All foreign medical device manufacturers are required to register their products with the SFDA as well as submit necessary documentations of product and business licenses from the country of origin prior to approval for distribution in China. The product registration takes at least nine months to complete which at times hinders Bien-Air from speedily introducing new products into the market. The SFDA also demands imported products to be tested for safety and effectiveness.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Shifting market environment presents opportunities for expansion

Ensuing from China's WTO membership is the lifting of trade barriers and relaxing policies on importing dental equipment and instruments. Indeed, the tariff rates of imported international medical products will be reduced to 5.5% to 6% [12]. The country's slackening importation policies will make buying products directly from its mother company in Switzerland easier and more cost-effective for Bien-Air. Thus, similar to the distribution process carried out by other Bien-Air subsidiaries in other countries, there is an opportunity for Bien-Air to perform wholesale distribution activities where it imports from Switzerland and sell to its dealers in China directly.

Furthermore, foreign investments — in the form of Sino-foreign joint ventures or cooperative medical institutions —are now permitted (although agreements are restricted to only 20 years) in China for constructing new hospitals and health care centers (wholly foreign-owned investments are still not allowed). These foreign-invested hospitals and health care centers are required to provide international, high-tech medical technologies and equipment. Hence, there is a potential for Bien-Air to maximize its customer base as more and more western-style private clinics and specialized oral hospitals that use top-of-the-line imported surgical and dental instruments are opened in the country.

In addition to opportunities offered by the upgrading of China's health infrastructure, growth trends are also seen in the number of high-technology dental equipment imported into the country in the past five years. According to China's official customs statistics, the current actual size of imported and Sino-foreign joint venture products account for 50% to 60% of the entire Chinese dental market. The country's import figures for five key dental equipment represent a 22.95% increase in 2004 with ABG radiation apparatus, dental chairs with equipment (or dental unit) and dental drill engines as the top three fastest growing imported dental instruments (see Figure 5).

This indicates a growing demand for the more expensive high-end, technology-advanced medical and dental instruments, especially since China's domestic manufacturers primarily produce only relatively low technology, basic medical and dental products. Indeed, Bien-Air is optimistic and forecasts an annual growth rate of 20% to 50% in the high-end market segment alone.

Progressive product range development to meet new and future market demands

Many Chinese are paying closer attention to their personal appearance, are willing and can afford to spend on personal care in the wake of their enhanced living standards and increased per capita GDP especially in metropolitan cities and coastal regions where the influence of the Western culture is more apparent (i.e. Shanghai, Guangzhou and Shenzhen).

The growing awareness for oral health care will bring forth demand for ancillary dental services or dental aesthetics; for instance, opting for implants instead of the old-fashioned dentures and paying for corrective procedures for certain irregularities of the teeth like fitting in braces. There is certainly a great opportunity for Bien-Air to introduce and promote its recently developed range of implantology instruments to the Chinese dental market. This also opens doors for up-and-coming dental procedures and treatments for which Bien-Air can continue to develop innovative instruments and products.

Risks and difficulties

Ever increasing competition

Domestic output accounts for a significant portion of the total dental equipment industry in China (40% to 50%). According to the US Foreign Commercial Service, local manufacturers have begun producing integrated comprehensive treatment equipment (or dental units) and the number of the local companies venturing into the high-end segment is increasing. There are now over 20 domestic dental unit brands in the country. In fact, some of the "Made in China" dental devices are now being exported to other regions such as the Middle East.

The rapid growth of the local dental equipment output, the gradual improvement of their quality standards and their relatively cheaper prices pose a threat to Bien-Air's position in the high-end segment as local companies move towards producing high-range products. The prospect of future profits attracts more competition from the local as well as international players and with intensified competition, it may be a challenge to realize quick returns on investment and Bien-Air may need to adjust or adopt long-term and more focused strategies.

Distributor selection

Choosing the best-suited dealers that qualify Bien-Air's selection criteria is one of the biggest ordeals that the subsidiary experienced in China. Apart from the tough and lengthy selection process, there is also stiff battle among imported dental equipment manufacturers which compete for obtaining the dealer with the highest integrity, reliability and satisfactory qualities. Since Bien-Air automatically disqualifies dealers that already carry its direct competitors' products, finding a distribution agent is all the more difficult.

Distribution span in China's challenging geography

Because of China's enormous size and the different demand among its many regions, there is practically no distributor in the country that can truly claim 100% coverage of the entire Chinese market. Most distributors are compelled to provide the complete line of products to meet the varying needs of each dentist, hospital or clinic in different areas. Although Bien-Air has partly addressed this difficulty by designating one authorized dealer in key markets like Beijing in the north, Shanghai and Suzhou in the east, Shenzhen and Guangzhou in the south/south east, Chengdu in the west and Xi'an in central China; the biggest challenge is for Bien-Air to appoint big scale distributors with established branches in both major and developing cities as well as provinces all over China that also carry an excellent product mix to complement Bien-Air's own.

Success factors

Partnership with local manufacturers to capture mid-range market and gain future high-end customers

One of the key factors to Bien-Air's success in China is having the foresight to adapt to the evolving marketplace and capture a portion of the mid-range market by forging partnerships with Chinese manufacturers of dental units. The subsidiary regards its partnerships mutually beneficial for both the local companies and Bien-Air. The local manufacturers benefit from associating their mid-range locally produced dental units with Bien-Air's high-end instruments, enhancing their products' image with the help of the prestigious Swiss brand. In addition, more than getting specialized training from Bien-Air's own after-sales professional, the subsidiary also provides them repair and maintenance services when they need it. In return, Bien-Air has been successful in reaching, establishing brand recognition and laying out solid foundation for brand loyalty among the middle market customers in China. Bien-Air is confident that with the market's gradual development, today's mid-range users will mature, become more lucrative and will prefer to purchase high-end imported instruments in the future. Moreover, the local manufacturers have their own network of established distributors throughout the country and Bien-Air products are sold with the mid-range local units through these same channels.

This strategy not only aids in propagating the Bien-Air brand in the entire Chinese dental market but also ensures that Bien-Air gains new customers in the foreseeable future.

Sound relationship with renowned hospitals and collaboration with industry opinion leaders ensure product and brand awareness

Bien-Air has succeeded in overcoming one of the biggest challenges in its operations in China — how to reach potential customers in a huge market. The medical equipment industry in general is somewhat subject to the “word-of-mouth” and referrals from industry players and opinion leaders. Bien-Air employed the the following strategies to introduce its products and reach its customers:

- Bien-Air’s head representative in Beijing creates strong ties with large and prominent specialized oral or stomatological hospitals in China to help introduce its products into the market. Certain renowned state-owned hospitals have extended reach throughout the country owing to the fact they host a substantial number of surgeons, dentists and medical trainees from all over China each year. Rapport is fostered through personal visits by the Bien-Air head representative who personally calls in on these hospitals. The visits are mostly to present and give product updates especially when Bien-Air is introducing new products to the market. The visits are also to check whether the customers are in need of after-sales services. By so doing, Bien-Air is able to express to its customers that they are valuable and at the same time the company is able to deploy immediate after-sales servicing.
- Among the subsidiary’s roles is to manage above-the-line advertising and marketing initiatives to help publicize its products. One of the most effective ways to introduce new products is by hosting marketing events such as medical conferences, workshops and symposia. Bien-Air collaborates and invites opinion leaders of the industry to speak in these events which assist in endorsing Bien-Air products.

Innovation, durability and high-technology — assets of successful products

Bien-Air products are meticulously manufactured using state-of-the-art machines and modern techniques. The result is impeccably dependable, technology-advanced products. Part of Bien-Air’s success is owed to its products’ durability and inventive designs that allow for less invasive and more comfortable oral treatments and procedures on the part of the patient. Bien-Air’s computerized hand instruments offer ease of use and trouble-free cleaning and maintenance that can be performed by the users (dentists, oral hygienists and surgeons) effortlessly. These qualities distinguish Bien-Air products from its competitors; together with successful branding and marketing programs, Bien-Air has acquired a well-recognized status among the dealers and customers alike.

Immediate, convenient and efficient after-sales service

To ensure that customers can obtain timely and efficient maintenance/replacement services conveniently, Bien-Air’s after-sales service professional trains all of the company’s dealers and local manufacturing partners. Upon signing up a dealer, Bien-Air not only prepares and educates its dealers about the products; the company also invests on giving them professional after-sales service/maintenance training and workshops. Bien-Air customers are guaranteed of top service levels for maintenance and repair of their instruments and replacement of components, anytime whether they get it directly from Bien-Air or its local partners.

Information on Bien-Air courtesy of:
Michelle Huang - General Manager, Beijing Bien-Air Medical Instruments Technology Services Co., Ltd.
Interview conducted by: *Marco Schueep, Luca Bortolani and Patrick Schaufelberger*
Case Study written by: *Maria Luisa Dacera*
Approved for publication on: *December 2005*

Notes

[i] Maxillofacial surgery/surgeon – is the surgical arm of dentistry. The oral and maxillofacial surgeon is the surgical specialist who diagnoses, treats and manages the conditions, defects, injuries and the aesthetic aspects of the mouth, teeth, jaws and face.

[ii] A dental unit – is a fully equipped dental chair that includes all range of dental instruments and accessories

[iii] Dental prosthetics – artificial teeth, can either be classified as dental bridges, partial or full dentures and implants

[iv] Dental abutments – are the extension that connect the implant or metal anchor placed into the bone of the jaw and the prosthetic tooth/teeth or crown

[v] Burs - A rotary cutting instrument used in dentistry for excavating decay, shaping cavity forms, and reducing tooth structure

[vi] Dental handpieces – a dental handpiece and accessories is an AC-powered, air-powered or belt-driven hand-held device that may include a foot-controller for regulation of speed and direction of rotation or contra-angle attachment for difficult-to-reach areas intended to prepare dental cavities for restorations, such as fillings and for cleaning teeth (as defined by the Food & Drug Administration in its "Good Guidance Practices for Dental Handpieces – 1997").

[vii] Orthodontics – The dental specialty and practice of preventing and correcting irregularities of the teeth, as by the use of braces.

[viii] Implantology – is the area of dentistry concerned with the diagnosis, design and insertion of implant devices and restorations which provides adequate function, comfort and aesthetics for the edentulous (lacking teeth) or partly edentulous patient

[ix] Periodontist – a dentist specializing in the diagnosis and treatment of bacterial infections of the gums

[x] Periodontal disease – is the name for bacterial infections of the gums in the mouth

[xi] Stomatology – is the medical study of the mouth and its diseases.

Sources

[1] Gabelli & Company, Inc. (2004). Second Annual Dental Conference - June 2004. Author.

[2] International Organization for Standardization (ISO). (2005). Business Plan - ISO/TC 106 Dentistry. ISO.

[3] Ibid

[4] Ibid

[5] World Health Organization (WHO). (2005). More oral health care needed for ageing populations. WHO.

[6] Gabelli & Company, Inc. (2004). Second Annual Dental Conference - June 2004. Author.

[7] Sun, S. and Pierrepont, S. (2005). The dental equipment market overview in China. CS Market Research.

[8] Ibid

[9] Ibid

[10] Ibid.

[11] Peng, A. (2004). Dental Equipment Market in China. Industry Canada (STAT-USA Market Research Reports).

[12] Sun, S. and Pierrepont, S. (2005). The dental equipment market overview in China. CS Market Research.

3 Chemical Industry

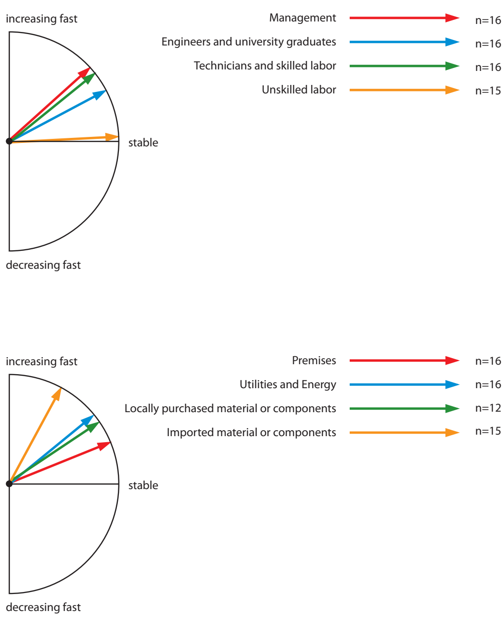
3.1 Industry trends

Below are the trends for the chemical / pharma industry as perceived by managers of Swiss subsidiaries in China.

3.1.1 Cost trends

Survey chart V - 5

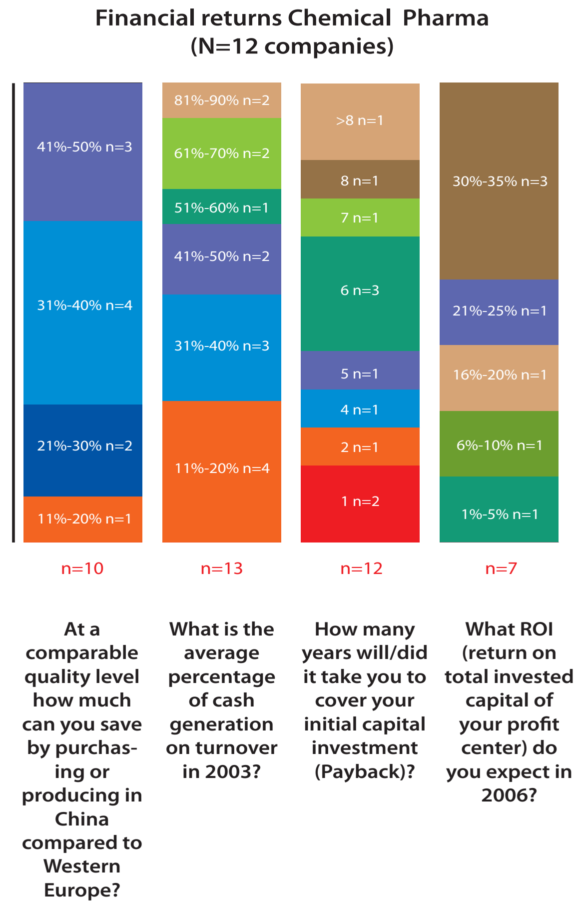
In your industry and field of activity how do you expect following costs to evolve?
Chemical / Pharma N=16



Source: Swiss China Survey, 2005

3.1.2 Factors for Success

Survey chart V - 6



Source: Swiss China Survey, 2005

3.1.3 Financial returns

Survey chart V - 7

Success Factors Chemical / Pharma

(Companies in China, which achieved at least 50% of their objectives N=16)

How important are the following strategic factors to be successful in China

Source: Swiss China Survey, 2005

3.2 CIBA SPECIALTY CHEMICALS (CHINA) LTD.

Specialty Chemicals Industry

SUMMARY

Ciba Specialty Chemicals (Ciba) has its headquarters in Basel, Switzerland and produces specialty chemicals products that, added in small quantities, improve existing or add new qualities to materials at every stage of their production processes. Additionally, Ciba's expertise enables the company to offer complete solutions serving several markets including Automotive, Textile, Packaging, Home & Personal Care, Paper & Printing, Construction, Electronics, Water Treatment and Agriculture industries.

This case study is focusing on Ciba's activity in China with particular attention to:

- China entry motivation and entry partner selection
- Environmental aspects
- Human resources selection and management
- Research & Development as a next step

Figure 1:
Ciba's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing		Ciba					
Purchasing	For own China operations			Ciba			
	For mother company			Ciba			
	For third party						
Selling	SOE	Ciba			Ciba		
	POE	Ciba			Ciba		
	FIE Global	Ciba			Ciba		
	FIE Local						

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of Ciba in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of Ciba in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

The global chemical industry is very diverse comprising hundreds of segments that make more than 70,000 products. The industry's main product segments are:

- basic or commodity chemicals
- specialty and fine chemicals derived from basic chemicals (adhesives and sealants, catalysts, coatings, electronic chemicals, plastic additives and stabilizers, etc.,)
- agrochemical and fertilizers
- industrial gases

The chemicals industry is the world's third largest industry and is also one of the most regulated among all industries. Commodity chemicals account for more than one-half of global sales with 52%, followed by specialty chemicals with 35% and agrochemicals with 9%. The remaining 4% is accounted by industrial gases.

The global chemical industry, excluding pharmaceuticals, is worth USD 1,185 billion in 2004. North America accounts for 22% of the global market, Europe's share is 45% and the Asia Pacific's is about 26%.

In the past three years, the industry has suffered a slump as volatile energy prices drove the costs of raw materials higher and governments imposed tighter environmental regulations due to increasing public pressure. In addition, the global chemical industry has also been burdened by the following factors:

- worldwide market consolidation
- globalization
- increased competition
- WTO challenges
- changing workforce environment
- generally sluggish world economy

Nonetheless, the recovery of global economy in the second-half of 2003, especially in the developing markets of North America and Asia, enhanced R&D and process improvements are seen to pick up and drive the industry's growth.

MOTHER COMPANY - CIBA SPECIALTY CHEMICALS Ltd.

Company background and current situation

The company has been spun off to be independent in January 1997, after the merger of the former Ciba-Geigy Ltd. with Sandoz Ltd. to form Novartis AG.

Ciba now employs around 19,000 people at 79 sites in 28 countries and has 24 research centers in 12 countries including China.

Value chain

Some of Ciba's main products such as antioxidants for plastics reside at the beginning of the value chain. They are produced from petrochemical raw materials like phenol, isobutylene and acrylic acid derivatives into final products. These products are essential ingredients in the production of polypropylene, polyethylene and polystyrenics where they are used to protect these plastics against oxidation.

Other products manufactured by Ciba are light stabilizers for plastics and coating systems, high quality pigments, and a wide range of water treatment chemicals.

Sales and customers

In 2004, the company generated sales of CHF 7 billion (USD 5.5 billion) and invested CHF 288 million (USD 225 million) in R&D which corresponds to about 4% of the sales. The sales are evenly balanced between the three major market areas: Europe, the Americas and the Asia Pacific region.

Figure 2 in the following page shows the distribution of Ciba's sales by the major segments served and the different EBITDA profit margins in 2004. Figure 3 gives an overview of the company's sales in different regions.

Sales growth of 4% was achieved in the Americas and Asia, but Ciba's China business experienced a growth rate of 18% in 2004, outperforming all other markets. The best performer in terms of profit margin was 'Coating Effects', while Ciba's global 'Textile Effects' business experienced the biggest difficulties. The announcement by Ciba in August 2005 to reposition its Textile Effects business has to be seen in this context.

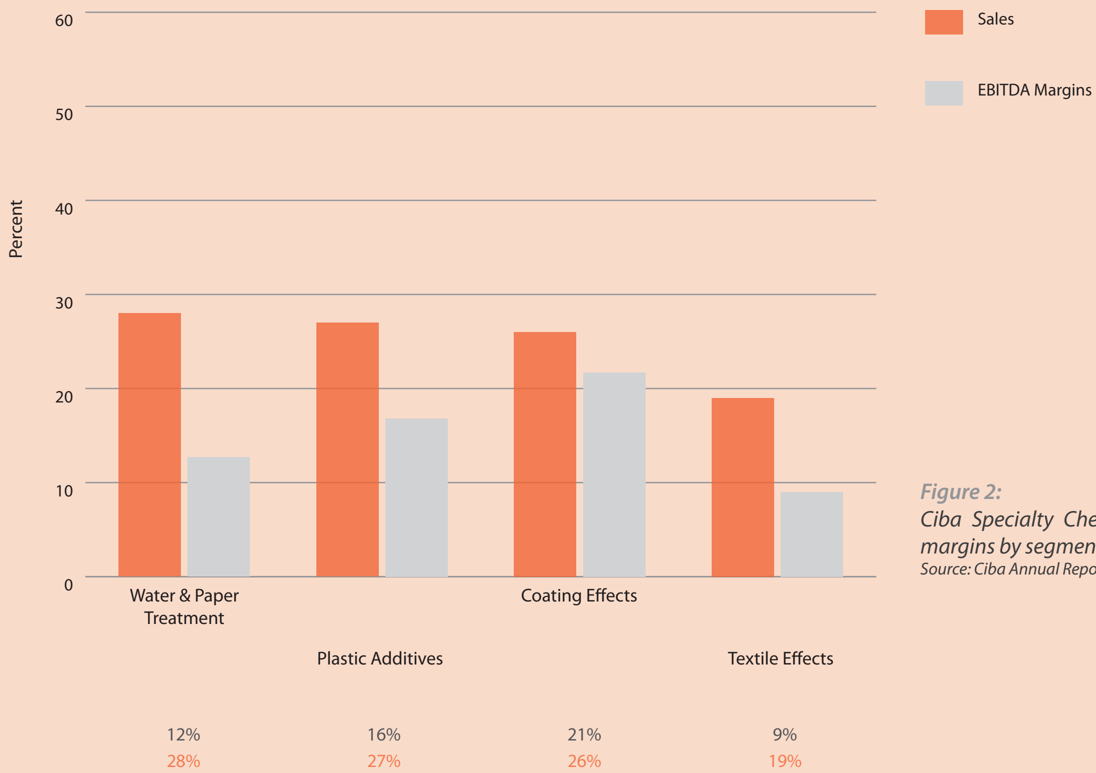


Figure 2:
Ciba Specialty Chemicals sales and profit margins by segments served in 2004
Source: Ciba Annual Report 2004

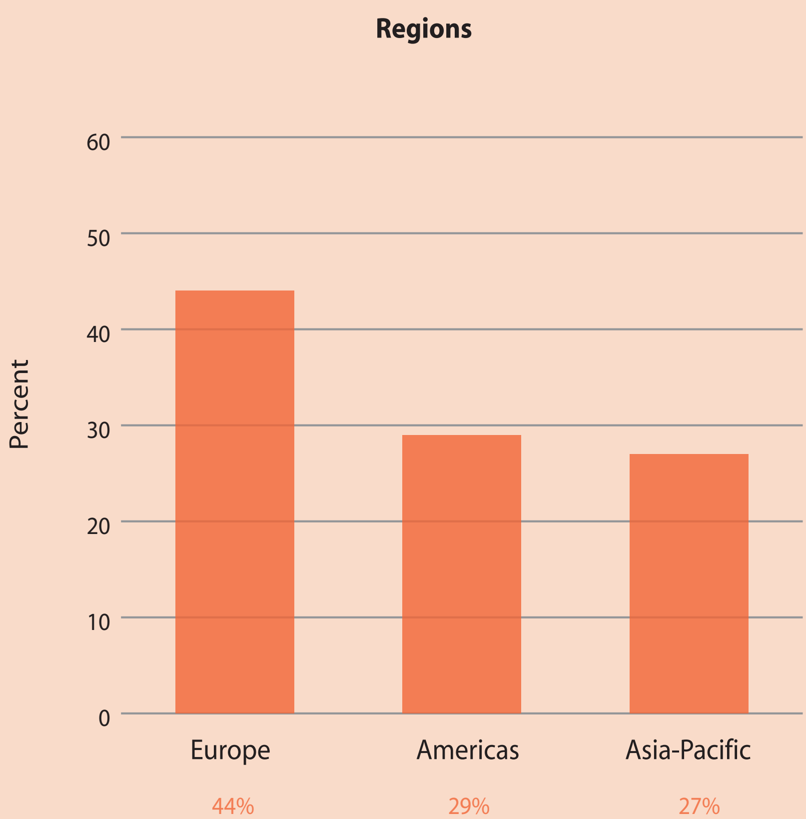


Figure 3:
Ciba Specialty Chemicals sales by region in 2004 (Europe is ranked first while the Asia Pacific region is the fastest growing)
Source: Ciba Annual Report 2004

CASE STUDY

Ciba Specialty Chemicals is a leading global company dedicated to producing high-value effects for its customers' products, adding performance, protection, color and strength to textiles, plastics, paper, automobiles, buildings, home and personal care products and much more.

Customers are mostly international enterprises located in the following industries: Imaging & Inks, Paints & Coatings, Plastics & Rubber, Textiles & Fibers Industries, Agriculture, Automotive, Construction & Pipes, Electronic Materials, Home & Fabric Care, Lubricants, Mining & Oil, Monomers & Water Soluble Polymers, Packaging, Paper Industry, Personal Care and Water Treatment. The list of technological application and the industries served by Ciba shows how broad and diversified the company's portfolio is.

CHINA INDUSTRY TRENDS and OUTLOOK

China's long term demand for chemicals is expected to grow at 6% to 8% annually compared to 2% to 3% in North America and Western Europe, making the country the most attractive market for commodity and specialty chemicals. Demand comes from both domestic consumption and exporting companies. The country's chemical consumption accounted for approximately 15% of global demand in 2002 placing it in the top two of the world's largest chemicals consumers.

In the first 11 months of 2004, China Chemical Reporter disclosed that the sales value of China's chemical industry grew by 32.8%. Goldman Sachs projects that China's chemical consumption could reach up to 20% of global demand in 2006. The majority of this demand is made up of commodity chemicals. At present, China's chemical industry is concentrated on the manufacturing of bulk and commodity chemicals.

The Chinese government however aims to increase the ratio of the fine and specialty chemicals to 45% of the country's entire chemicals industry by the end of 2005. To achieve this goal, the Chinese government has issued preferential policies, tariff reductions and investment incentives for fine and specialty chemicals. China's push to strengthen its specialty chemicals production is part of the state's drive to move Chinese manufacturing further up the value chain.

China's production and consumption of chemicals, $ billion

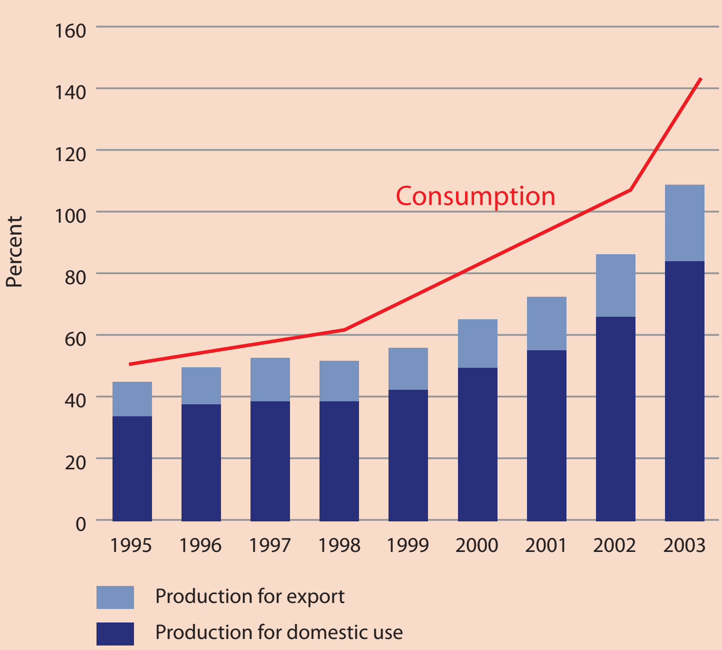


Figure 4:
China's chemicals production and consumption from 1995 to 2003 in USD million
Source: The McKinsey Quarterly (2005). Global chemicals: China remakes an industry. www.mckinseyquarterly.com

CIBA SPECIALTY CHEMICALS in CHINA

Subsidiary background and current situation

Ciba was one of the first foreign companies which was given permission by the Chinese government to set up a holding company in 1993. Subsequently, this holding company became the major shareholder of all of Ciba's subsidiaries in China, which were mostly manufacturing plants set up as joint ventures (JVs) with Chinese partners.

The current presence of Ciba Specialty Chemicals in China consists of a holding company in Shanghai, three trading companies in Shanghai, Taiwan and Hong Kong, six branch offices in Beijing, Guangzhou, Hangzhou, Xiamen, Kunming and Chengdu and 11 production sites in Shanghai, Qingdao (two plants), Panyu, Guangzhou, Shekou, Zhenjiang, Xiangtan, Shouguang, Suzhou and Kaoshiung. Ciba's business in China today represents about 7% of the company's global turnover, including sales from the plants and imports through trading companies. The map below shows how the company is set up.

Current presence in China region

Figure 5:
Ciba's geographic presence in China
Source: Swiss China Survey, 2005

Before Ciba set up a holding company structure in China, business activities were limited to trading by selling imported products directly to end users and distributors. This changed when the first local manufacturing plants were added in Qingdao and Shanghai in 1997/1998.

In the remaining part of this study we will focus on one of Ciba's most important subsidiaries in China, namely the Shanghai Ciba Gao-Qiao Chemical Company. Ciba's experience in setting up a big joint venture (JV) plant can serve as an interesting case study. However, one must always bear in mind that this joint venture was set up back in early 1994, at a time when the Chinese system was far less flexible in dealing with foreign investors. As a consequence of this, some of the information presented here may be obsolete in today's business environment.

In 1988, Ciba was approached by a chemical producer of plastic additives who wanted to license the know-how to produce anti-oxidants at their plant in Beijing. Ciba at that time was however not very interested in licensing its production know-how to a local company for two main reasons. First, such a technology transfer would have been a one time deal which would not have given Ciba a long term presence in the market. Second, licensing know-how to a local company would have created a strong local competitor who would have made it difficult for Ciba to sell its own products in the market. Since Ciba was

CASE STUDY

looking for an arrangement which would provide it with long term business prospects in China, the company opted to explore the possibility to set up a joint venture instead. The ensuing joint venture discussions did however not lead to any tangible results and Ciba's focus eventually shifted from Beijing to a new partner in Shanghai. In February 1994 Ciba signed a joint venture contract with the Gao-Qiao Petrochemical Company (GPC), a major refiner and chemical producer in Shanghai. Apart from being able to offer an attractive site, GPC had the advantage of being able to supply the main raw materials and utilities for the factory. Furthermore it was part of Sinopec which in turn was a major user of the products which the new joint venture plant was going to produce.

Construction of the plant took more than three years and the factory was eventually commissioned in late 1997 and full commercial production started in January 1998. In early 1998 the company employed 200 people which later were reduced down to 150 as the production process were optimized and efficiency increased. Today the plant produces the main range of Ciba's antioxidants and is one of the company's main global supply points for these products. The following diagram demonstrates the development of Ciba's business activities in China:

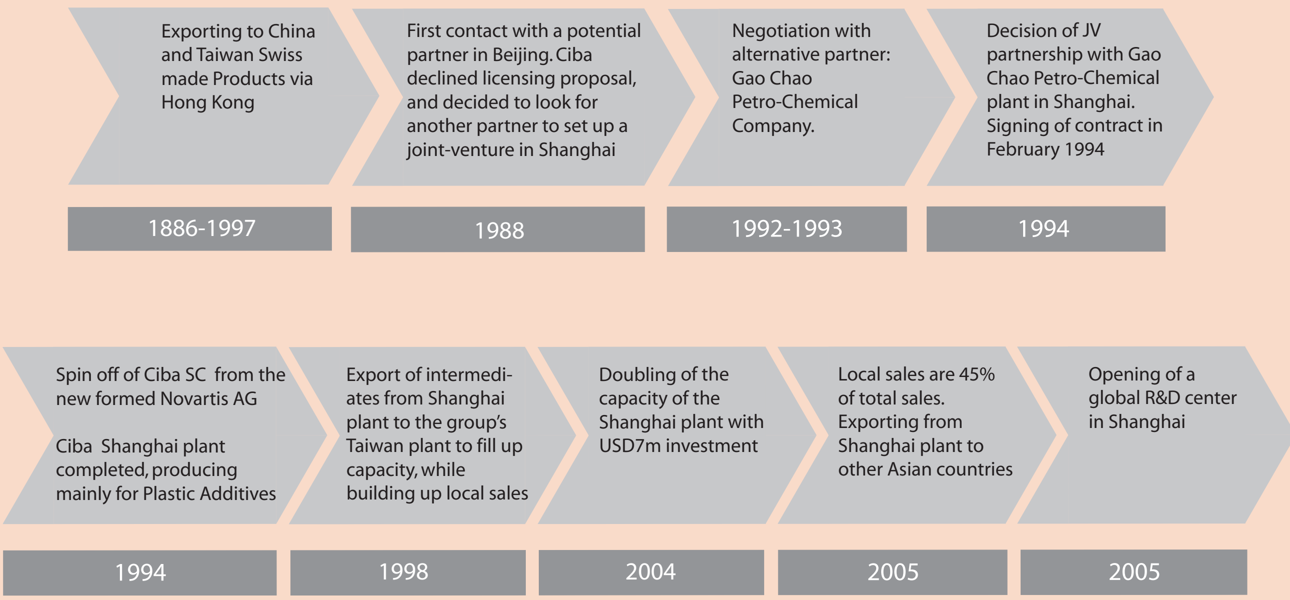


Figure 6:
Ciba Specialty Chemicals history and milestones in China
Source: Swiss China Survey, 2005

Motivation to enter

The main motivation to set up this joint venture company has always been the sales potential of the Chinese market. Being in a capital intensive business, it was never Ciba's motive to produce in China to take advantage of cheap labor. Sourcing of chemical raw materials was similarly not a reason for being in China because the cost of basic chemical raw materials are generally more expensive in China than in other countries.

R&D

Ciba believes that innovation is the key to profitable and sustainable business growth. The objectives of R&D are therefore to deliver innovative effects, and to ensure future success of the business. Accordingly, Ciba Specialty Chemicals will focus its annual research budget more on new markets and technologies, in an effort to increase sales share of new products in the portfolio. Under the new innovation initiative, the company has set a mid-term target for one-third of the products in the portfolio to be less than five years old.

Innovation comprises development of new products, new chemistries, new technologies and new services. Ciba Specialty Chemicals has set up a new research and technology center in Shanghai. The center combines expertise in organic synthesis, physical chemistry, polymer chemistry, photochemistry and analytical chemistry, as well as in application and formulation sciences, to create new products, to develop new applications, and to provide solutions with high-value effects for the chosen industries that Ciba serves. The new R&D center in China is an integral part of the global R&D of Ciba Specialty Chemicals, serving regional as well as global businesses.

Suppliers

Being at the supplier side of the value chain only a few raw materials are needed by the Shanghai joint venture. The company has relatively few suppliers and the materials purchased are mostly commodities and are purchased from the cheapest source. For example MTBE (Methyl Tertiary-Butyl Ether) is imported from Saudi Arabia or Taiwan. Phenol, the most commonly used material, is produced by the JV partner. 35% of the raw materials are sourced locally.

Customers and distribution

Customers are mostly state owned companies situated all over China, such as the major petrochemical complexes belonging to Sinopec or CNPC. The products are usually transported by road but the quality and the standard of the transportation services still pose a problem occasionally. Freight costs are expensive in Shanghai compared to other locations, but this is partially compensated by the central location of the city.

Ciba sells its products directly to end users as much as possible, using as few distributors as possible. Due to the nature of the market, the joint venture does have only a small number of customers, about 150 in all. This small number basically eliminates the need for distributors and other middlemen. Customers are being taken care of directly by the company which sustains precious relationships. The joint venture's local sales grow at a rate of 15% per year, doubling in value every five years.

Competitors and financial entry barrier

The market for antioxidants in China has gone through a phase of consolidation in recent years. In the past, there used to be many small producers at the local provincial level. After Ciba had set up their factory in Shanghai, the market started to consolidate and only a few players remained. Ciba emerged from this process as a market leader. There are practically no foreign competitors in the market in China. The main reason is that it is absolutely essential for success in China to be present in the market with products that are produced locally. Foreign competitors have so far shied away from making the big financial commitment which is needed to build a plant for antioxidants.

Generally it is quite expensive to build a chemical factory because a lot of investment into plant infrastructure is required. While smaller players are active in the Chinese market, their capacity is normally not economical and their safety and environmental standards are at a very low level which is not sustainable.

FACTS and ANALYSIS

China set up (choice of partner and location)

Shanghai has been chosen because the joint venture partner is located there. Some important criteria for the partner selection were the availability of phenol as the main raw material and the availability of a suitable site with existing chemical infrastructure nearby. By being close to the supplier of phenol, the Ciba joint venture can save transport costs and material handling.

Even though it did not have any influence on Ciba's site selection process for the joint venture, Shanghai offers the additional benefit of the free trade zone. A foreign trading company which is located in the Waigaoqiao trading zone can import and distribute products in China. The only condition is that the products are imported and cleared through customs in Shanghai. After China acceded to the WTO in 2001, the regulations on trade and distribution by foreign companies are changing slowly. It is now possible under certain circumstances for foreign companies to engage in local trading from any location in China.

One important reason for Ciba to choose the Gao Qiao Petrochemical Company as a joint venture partner was the fact that the company is part of Sinopec, the most important customer organization for the products produced by the plant. This provided Ciba with customer connection which would have been much more difficult to build, had the partner been an outsider.

A positive effect of selecting Shanghai as the location for the joint venture is the higher probability to find qualified personnel. In most cases it is very difficult to find people outside big agglomerations whose professional qualifications conform with the standards of Western companies. Furthermore, recruiting key personnel in a big city like Shanghai and then relocating these people to a remote site, is also not the answer as such an undertaking would be associated with very high costs.

After the plant became operational in 1998, the company had to make sure that the production capacity of the plant was reasonably utilized. For this reason, the plant was allowed to export its surplus capacity which could not be sold locally to a factory in Taiwan. The plant in Taiwan used these exported products as raw materials for its own production. These exports became smaller and smaller as local sales increased over the years. In 2004, new production capacity was added and the export portion increased considerably. Even though Ciba's Shanghai plant is exporting a sizable portion of its production, the fundamental concept of the plant has always been to focus on the local market. The possibility to export surplus capacity provides an additional bonus which improves the financial feasibility of the original project.

Supplier management

In the chemical industry, the quality of a material does not necessarily mean the highest purity, the highest transmission or the best possible color. More important is that the quality criteria which have been agreed upon are consistently met all the time. In the case of Ciba's joint venture plant in Shanghai, the number of quality tests of raw materials is reduced as much as possible and the plant does to a large extent rely on the quality test carried out by the suppliers of the materials. This saves time and manpower and consequently reduces costs in production. Many Chinese suppliers of chemicals today are capable to meet very high quality standards for their products. State of the art plants built with foreign know-how make this possible.

Environment and regulations

Ciba Specialty Chemicals, like most other international companies is fully committed to implement Environment, Health and Safety (EHS) standards for all Ciba operations, which is in line with its stringent standards. With that in mind, the aim was from the very beginning, to build up a highly professional EHS team. Due to the growing work force and a typically high staff turnover rate, the resources needed for ongoing training efforts are high. Ciba's operations in China have achieved a level, based on measured lost time accidents, which is well in line with its plants in Europe or the USA.

At the early stage of Ciba's investments most of the technical equipment were imported. Thanks to the build up of the required professional local know-how Ciba is now in a position to apply more and more local sourcing of technical equipment, without compromising on safety standards. The same is true for raw material supplies where local sourcing is a key success factor in today's business environment. The big challenge in this respect is on how to consistently apply Ciba's commitment to integrate EHS aspects as one of the key elements into all sourcing activities.

In recent years, local laws and regulations have been changing very fast. In many areas the legal requirements regarding EHS in China are now close to an international level or even higher. Together with other peer companies, Ciba Specialty Chemicals, strongly supports this trend towards international standards and tries to support local government to draft more practical and consistent EHS laws and regulations. This process however is still in a very early stage and companies face many areas where local laws and regulations are often conflicting with each other, are not practical and in many cases are not enforced by provincial or municipal authorities.

This situation is a major obstacle for all international companies which strives to be in full compliance with all local laws and regulations independent of local laws enforcement. Especially the extremely strict concentration limits for COD (Chemical Oxygen Demand) in discharged wastewater puts a high burden on their production plants. A more practical approach would take into account the total load of pollutants discharged, the achieved removal efficiency of the waste water treatment system and the type of operations being carried out in the plant rather than the current inflexible and purely concentration-oriented regulations. With regard to waste disposal, the preference is incineration of all hazardous wastes. For some plants, Ciba builds its own incineration capacity whereas for other plants, it has to rely on local hazardous waste incinerators approved by local authorities.

In line with the Ciba Specialty Chemicals' global EHS targets, it initiated many activities in the past two years to improve the energy efficiency of its operations. It turns out that in many areas there is a high potential to improve energy efficiency. This is to some extent surprising since energy costs in China are very high compared to other costs and so the financial incentive to increase energy efficiency in China is actually much higher compared to European plants.

Patents and Intellectual Property (IP)

Registration and government approval are pre-requisites for legal protection in China. To crack down counterfeiting of patented or trademarked products, application for trademark registration and patent right is required. For undisclosed information, legal protection requires a holder to take reasonable measures to keep its technical and commercial information confidential.

Notwithstanding the efforts that China made for the protection of intellectual property rights, know-how leakage and counterfeiting remain as a significant threat to multinationals. To pro-actively adopt preventive measures is a high priority.

Law compliance is part of the company's culture. Ciba is committed to comply with applicable laws and regulations of China; thereby demonstrating the company's regard to the governing laws and adhere to them in it's day-to-day activities. Ciba firmly believes that law compliance brings competitive advantage in the long term and ensures sustainable growth. By setting a good example on law compliance, Ciba hopes to positively influence the business behavior of it's business partners and competitors.

Human resources management

Talent sourcing, development and retention are the three major HR challenges for companies in China. In the last ten years, the supply of local talent has never been able to meet the demand of the market. Even though the situation has improved, employee turnover rates remain very high. There are always companies willing to offer better pay and more benefits to attract the talent required to run their new operations.

Development opportunities, attractiveness of the remuneration package and the company culture/image are the top three criteria considered by local talents when choosing an employer. Nowadays, more and more emphasis is given to career development opportunities — what kind of training program is offered by the company? Does the company offer overseas on-the-job training? What management education system is in place? How far and how quick can the company's employee move up? By aiming at higher positions early in their career, local staff expects financial rewards to follow quickly. In such an environment, loyalty is rare as opportunities are widely available to skilled people.

Influenced by the parental perception, local employees often believe it is the company's or the managers' responsibility to fully look after them. Hence, the staff expects to be led in terms of their development needs. Superiors must take a much more proactive approach in coaching, target setting and performance management.

Managing employees' expectations and clear communication regarding career progression is vital as the risk to train and develop the staff just for the competition is high. Finally, the development initiatives must be clearly aligned with business needs, China is not different in this matter from other markets.

CASE STUDY

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Global R&D center

Many multinational companies follow a general sequence in getting involved in China: First, set up a sales force and then go into local manufacturing. As they further deepen their involvement in China, research & development capabilities are then built up.

Ciba's decision to set up a new R&D center in China was a strategic one. Clearly due to market size and growth, the chemical industry in China is of grave importance to Ciba Specialty Chemicals. Resources must follow the market and Ciba's innovation competence needs to be extended to all strategic markets.

China offers also a ready supply of scientists for industrial companies. There are a number of universities and research institutes of high standard. Each year, China as a whole generates about three million undergraduate degree holders and 300,000 with postgraduate degrees. More recently, there are about 1,000 Chinese returning to China annually after having obtained a degree from various prestigious universities overseas.

The issue of intellectual property is still a concern among many companies. In reality, China has put in place legal protection of intellectual properties and the legal environment has been improving, but risks do exist in practice due to the weak law enforcement. It is an issue for any company involved in research to manage and minimize these risks. In Ciba Specialty Chemicals' opinion, educating employees about the importance of intellectual property rights and to make them fully aware of them is critical. While it is essential to have protective measures in place, one should not overlook however the importance of building up a working environment which is founded on trust and loyalty.

Local presence

Building up a strong local presence in China is a key factor for success in this market. It is Ciba's strong belief that the company's success in China over the past ten years is to a large extent attributable to the fact that many production joint ventures were set up. This enabled the company to become a true insider in China by developing the know-how and expertise which is required to successfully operate and run a chemical business in this country. The fact that the company had committed large financial resources also prompted Ciba to commit the necessary management capacity to China. This resulted in the development of valuable know-how from which the company will continue to benefit for a long time to come.

The success which Ciba has obtained by doing business in China during the last decade would never have been achieved by simply exporting finished products to China from Europe and the United States.

Costs considerations

It is estimated that about 70% of all foreign direct investment which flows into China each year is directed to the local market whereas only about 30% are invested into export-oriented businesses. Ciba's investments in China are no exception as most of the company's plants have been set up to produce primarily for the local market. Labor costs were never a consideration for Ciba when investment decisions were made to produce in China. The chemical business is not a labor intensive industry and any cost advantages gained from lower labor costs in China are therefore minimal.

Furthermore, given an annual escalation of salaries in major cities which is in the order of 8% to 10% per year, China is bound to lose its reputation as a low wage destination in the not too distant future.

On the other hand, purchasing equipment in China for chemical production can be relatively cheap. However, it usually takes a long learning period for foreign companies to take advantage of this fact. The quality of locally purchased equipment is normally acceptable, provided that one does not expect European standards. The quality gap is however closing fast because many foreign equipment manufacturers have set up their own production facilities in China and are offering their products at reasonable prices. Apart from being significantly cheaper, the major advantage of sourcing equipment locally is that maintenance services are readily available and fast. Ciba's policy in China therefore has always been to use as much local equipment as possible.

Risks

Raw material prices

Prices of basic chemical raw materials are generally higher in China than outside the country. This is not surprising given the increasing dependence of China on imported crude oil and the fact that basic chemicals are produced in large petrochemical plants which are capital intensive and require very little labor input. As a consequence of this, manufacturing certain chemicals in China may actually be more expensive, at least as far as raw material costs are concerned.

Joint venture

Regardless of the level of equity participation, one of the key learning points for Ciba is the importance of building a joint venture relationship with Chinese partners based on sound and sustainable strategic fit. Without this, there will be times when the objectives and priorities of the parties do not match resulting in draining of management resources and failure to achieve business targets. It is therefore worthwhile to spend enough time to identify the right partner and analyze thoroughly to ensure a good strategic fit.

Difficulties

Location selection

Going in it alone is becoming easier with the proliferation of industrial parks across the country. Keen competition among the industrial parks and municipalities to attract investments is driving rapid improvements in infrastructure and utilities services offered to the chemical industry. However, at the same time, it is driving a fierce competition, which sometimes leads to the development of industrial parks before proper governmental approvals are granted. Also, local incentives including tax benefits and discounted land value, etc., are offered illegally to potential investors. For Ciba Specialty Chemicals' investment projects, approvals for industrial land use from the provincial government, at the minimum, is a pre-requisite for site selection. As well, questionable incentives are not accepted and excluded from economic evaluations.

Legal environment

Significant efforts by China were witnessed over the past decades in establishing the rule of law, yet a transparent and consistent legal system is still under development. The business practice, especially of private entrepreneurs, is another key reason for the risks faced by multinationals. Little attention is still given by many companies to law compliance and the strong desire for personal enrichment leads to infringement of legitimate rights (e.g. intellectual property rights). Therefore, to protect the business against legal risks in this growing market environment is challenging for any multinational in China.

Business opportunities and legal risks co-exist in China. While certain risk taking may be necessary based on down to earth assessment, preventive measures as an internal policy shall be the most efficient and cost effective way for risk management in the business climate of China today.

Success factors

JV partner selection

For most foreign companies setting up a joint venture is not the preferred option to enter the China market anymore. In those cases where a joint venture is still required, careful consideration must be given to the selection of the partner. In the case of the Ciba joint venture in Shanghai, the following rules were applied:

1. Choose a strong partner. Only a strong partner will be able to contribute to the common goals of the company. A weak partner is only an obstacle to progress. Many joint ventures have failed because a Chinese partner was not willing and able to participate in a much needed capital increase.

2. The partner must be able to offer something which a foreign company does not have and which is critical for success. Experience has shown that market access is usually something that a Chinese partner never has, despite all assertions to the opposite.

3. The interests of the partners must be closely aligned and should not diverge too much as time progresses. This is normally difficult to achieve and is a reason why many joint ventures fail eventually. Ciba addressed this issue by taking clear majority stakes in most of its joint ventures. By doing so, full operational control was secured and any ambiguities as to who was in charge were removed. One should however always keep in mind that by law, a Chinese joint venture partner can always veto any decision of strategic importance.

In the case of Ciba's Shanghai joint venture, these conditions were all met very well. With the Gao-Qiao Petrochemical Company, Ciba chose a subsidiary of Sinopec which is a financially strong and powerful company. Ciba's JV partner is the leading producer of phenol in China which is the main raw material which the joint venture needs for the production of its antioxidants. Furthermore, the management control of the company is clearly in Ciba's hands, who owns 75% of the equity.

HR selection and management

There are several important points that companies must follow when operating in China. First of all, priority must be given to identify the right candidate during the selection process. Good English language skills are still hard to find but one must beware of not choosing candidates solely on their abilities to communicate in English. Education and the previous employment track records are also important. Moreover, since a lot of resources are usually spent on management development activities after the person has been hired, the personality traits such as attitude, values and the candidate's expectations must also be taken into consideration.

Compliance with environmental regulations

In order to comply with the Chinese regulations on waste emission, Ciba followed the same strict standards in Shanghai which are applied in other parts of the world. This required substantial investments into environmental protection facilities such as a waste water treatment plant and an incinerator for chemicals. Even though local competitors usually are not yet required to make such investments, Ciba does consider it an advantage to have proper waste treatment facilities in place.

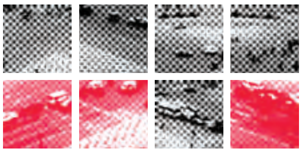
As China's industry develops further, the enforcement of proper EHS standards will more and more become the norm. This will force many of Ciba's competitors to invest into waste treatment facilities which will add to their production costs, thereby making their products more expensive.

Continuous improvement of efficiency

It is essential for the long term success of any plant that production efficiency is continuously improved. Over the years, Ciba therefore has taken various measures to increase the productivity at its plant in Shanghai. Among others, the following measures were taken to achieve this objective:

- Using exports as a temporary measure to keep the utilization of the production capacity at a high level.
- Reduction of number of regular employees from 200 to 150 during the period from 1998 to 2001. This measure helped to keep rising personnel costs under control for several years despite annual salary increases of 8%.
- Increase production capacity through de-bottlenecking and installation of new production lines at relatively small additional costs while leaving fixed costs unchanged.

Information on Ciba Specialty Chemicals courtesy of: *Robert Heiniger - General Manager, Ciba Specialty Chemicals (China) Ltd.*
Interview conducted by: *Marco Schueep, Luca Bortolani and Patrick Schaufelberger*
Case Study written by: *Patrick Schaufelberger*
Approved for publication on: *December 2005*



4 Machinery & engineering

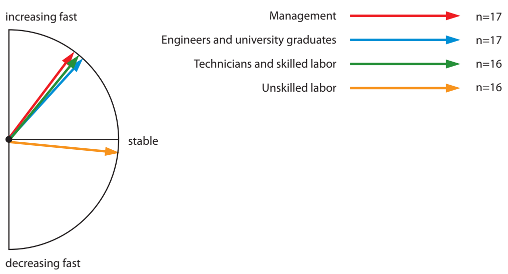
4.1 Industry trends

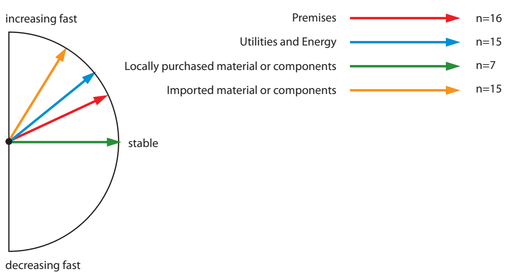
Below are the trends for the machinery & engineering industry as perceived by Managers of Swiss subsidiaries in China.

4.1.1 Cost trends

Survey chart V - 8

In your industry and field of activity how do you expect following costs to evolve?
Equipments / Machinery N=17

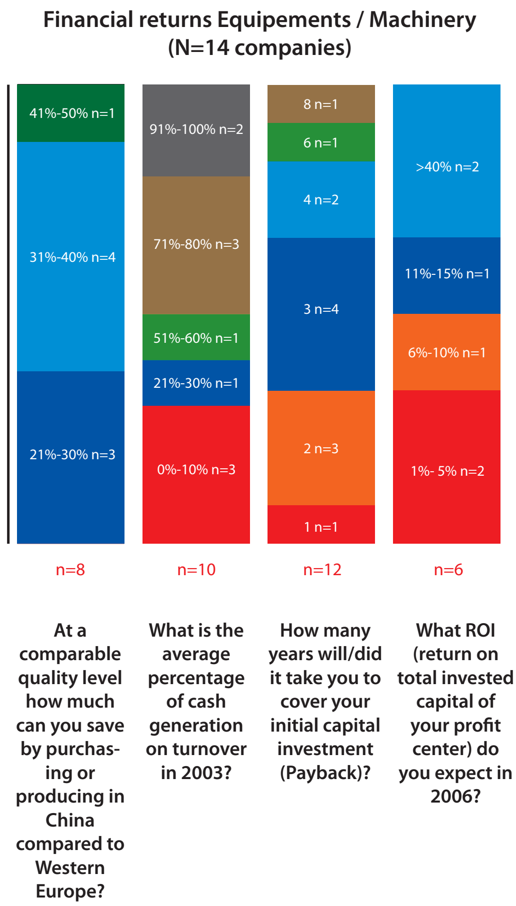




Source: Swiss China Survey, 2005

4.1.2 Financial returns

Survey chart V - 9



Source: Swiss China Survey, 2005

4.1.3 Factors for success

Survey chart V - 10

Success Factors Equipments / Machinery
(Companies in China, which achieved at least 50% of their objectives N=17)

Source: Swiss China Survey, 2005

4.1.4 Trends in adapting machinery to China

The particular situation of China renders machinery made in Western countries not always suitable. These elements are important to take into consideration when selling machinery to China.

4.1.4.1 Loss of competitiveness through automation

Products made in China with European imported machinery generally cost more than if made by hand. Experience shows that this is valid across a wide range of industries. As a result, the main purpose for Chinese to use foreign equipment is to achieve quality, reliability and precision or meet special standards (hygiene for medical production, for example) rather than lower production costs.

Another important consequence is that the increased automation of processes of foreign made machines does not translate into a cost advantage in China. On the contrary, equipment that costs less and enables to effect more of the production processes by hand while maintaining the required quality allows the production of cheaper goods.

4.1.4.2 Cheaper, less sophisticated machinery

With the development of production management methods and a workforce that acquires more and more skills and discipline, the need for less automated, 'no frills' machines providing suitable quality is growing and creating a cost pressure on the Western equipment manufacturers for all machinery for which part of the functionality can be replaced by handwork.

This trend is unlikely to change in the short term, since the cost of unskilled labor remains very stable (also see Chapter I, General Environment, 'Trends' and Chapter VIII, Sourcing & Purchasing, 'Are China low costs here to stay?). As a result, we may see a reversal in machinery production, where China and low labor costs countries generate the development of less rather than more sophisticated machinery.

The case of textiles machinery is extreme, since 70% of the demand for most of textiles machinery comes from China: manufacturers are faced with the alternative to produce equipment specifically for the Chinese market or to lose the main world market, to foreign competitors adjusting their products or to Chinese equipment manufacturers developing alternatives. In other fields where China becomes globally dominant (consumer electronics, for example), a similar situation is developing.

4.1.4.3 Strategies for foreign machinery producers

Not to serve China's needs means the short or long term loss of this market. Considering the fact that China is becoming the world's main production base and is already the world's biggest importer and consumer of machine, giving up such a market is not a good option (also see the report on the Chinese machinery industry in the following section).

From this realization two strategies can be imagined:

- Engineering and producing equipment specifically for China and the low costs markets. The difficulty usually lies in bringing a European R&D department to develop 'cheap' products. The know-how is actually missing in most companies.
- Instead, the producer may consider to set-up a 'no frills' line of products that would be produced in Asia or China. Development obviously would have to be conducted in cooperation with local R&D engineers to acquire the knowledge of the local supply base and of low costs solutions. The advantage of such a solution is to develop equipment close to the market that will eventually be most competitive due to the low production costs.

Indeed more and more foreign machinery producers are following such a strategy and setting-up a second line with production in China, specifically for the low cost countries.

4.2 Machinery industry in China

by Franc Kaiser, Senior Consultant Fiducia Management Consultants

4.2.1 Overview of the machinery industry

By the end of 2004, China's machinery industry was comprised of roughly 14,900 companies employing over three million workers. Major centres of machinery production are located in the provinces of Zhejiang (3,204 firms), Jiangsu (2,656 firms) and Shandong (1,550 firms).

In 2004, China's machinery industry had a combined production value of USD360 billion, with a year on year growth rate of 27.4%. During the first five months of 2004, output growth rate was increasing steadily, with a slight decrease in growth beginning in June of the same year.

Imports of the total machinery sector amounted to USD137 billion, up by almost 50% year on year. Exports accounted for USD85.79 billion, up 42.77% on 2003. This made for a trade deficit in the sector of USD51.2 billion.

According to the standard classification of this industry, the term machinery comprises 11 (for some statistical purposes 13) categories:

1. Agricultural Machinery Industry
2. Construction Machinery Industry
3. Instrument & Meter Industry
4. Petrochemical & General Machinery Industry
5. Heavy & Mining Machinery Industry
6. Machine-tool & Tool Industry
7. Electrical Machinery & Apparatus Industry
8. Mechanical Basic Parts Industry
9. Food & Packaging Machinery Industry
10. Automotive Industry
11. Other Civil Machinery Industry
12. (Internal Combustion Engines Industry)
13. (Cultural & Office Machinery Industry)

In 2004, the sectors of Agricultural Machinery, Electrical Machinery and Machine Tools experienced the fastest growth in profits. Enhanced governmental support for rural areas boosted the Agricultural Machinery sector and shortages in power supply were responsible for increases in demand for the Electrical Machinery and Apparatus sector.

Macro-economic control regulations were responsible for a decline in profits in the Engineering Machinery sector. The profits of the Automotive sector declined due to price increases in raw materials (especially steel) and a sharp drop in vehicle sales prices over the past year.

Forecasts indicate that production for the entire machinery industry will grow from 15 to 20% year on year in 2005. Profits are predicted to grow at roughly 10%. Fast growth is expected for the Electrical Equipment and Chemical Industries, but slowing growth will affect the Engineering and Automotive sector.

China's Top 100 Machinery Producers' sales incomes accounted for 20% of their profit and for 22% of the national total. These figures are based on sales income compiled by the National Bureau of Statistics (NBS), the China Machinery Industry Federation and the China Association of Automobile Manufacturers. Below you will find a list of the Top 20 Chinese Machinery Companies in 2004 ranked by their sales income.

Top 20 Chinese machinery companies

Rankings	Company	Main Products	Sales Income (in RMB billion)
1	Shanghai Electric Group	Power equipment, machinery, electrical appliances, household appliances	60.08
2	Chunlan (Group) Corporation	Air conditioners, washing machines, automobiles and motorcycles	20.29
3	Xuzhou Construction Machinery Group Co., Ltd	Mobiles cranes, compaction machinery and loading machinery	16.47
4	Harbin Power Equipment Corporation	Power equipment	13.11
5	Guangxi Yuchai Machinery Corporation	Diesel engines	12.94
6	Dongfang Electric Corporation	Power equipment	12.18
7	Shifeng Group	Agricultural vehicles and tractors	10.95
8	Dalian Bingshan Group Co., Ltd (DBGC)	Refrigeration equipment	9.71
9	Canon Zhuhai, Incorporated	Cameras, laser printers, fax machines.	9.69
10	Holley Share Holding	Instruments, medicine and information technologies (IT)	9.12
11	Shanghai Zhenhua Port Machinery Co., Ltd	Lifting equipment	8.59
12	Shekou CIMC	Containers	7.99
13	First Tractor Co., Ltd	Tractors, etc.	7.85
14	Dalian Machine Tool Group Corp. (DMTG)	Metal cutting machine tools	7.12
15	Chint Group Corporation	Low-voltage appliances, meters and instruments	6.95
16	Otis Elevator (China) Investment Co., Ltd	Elevators, escalators, moving walkways	6.58
17	Kodak Electronic Products (Shanghai) Co., Ltd	Digital and traditional cameras	6.28
18	XJ Group Corporation	Relays, automation equipment,	6.28
19	Zoomlian Holding Group	Concrete, hoist and road machinery	6.20
20	Jiangsu Etern Co., Ltd	Electric wires and cables, and optical fiber cables	6.07

4.2.2 Machine tools

4.2.2.1 Overview of Chinese companies: An introduction

According to the definition, a machine tool is a powered mechanical device typically used to fabricate metal components of machines by the selective removal of metal. This report understands the term "machine tool" as being comprised of metal-cutting machine tools, forging equipment, foundry machines, machine tools and fittings, measuring and cutting tools, abrasive and grinding tools and electrical appliances.

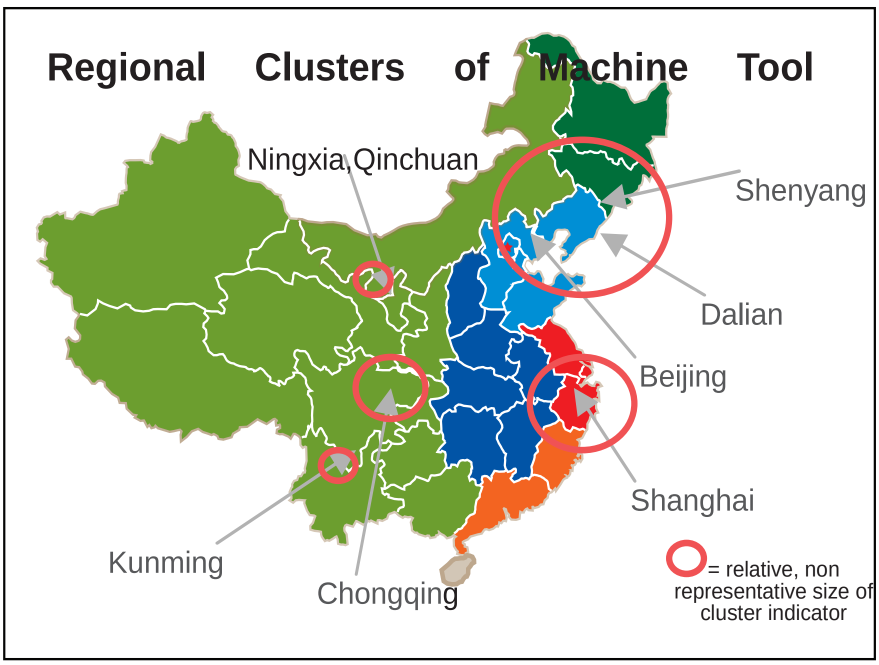
The World Machine Tool Survey 2005, an annual report carried out since 1965 dealing with world machine-tool production, trade and consumption, revealed that China, as well as being the biggest consumer of machine tools, is also the biggest importer of these products. China is also among the largest producers, claiming fourth place.

Major end-users in the Chinese machine tool industry are the automotive, space / aviation, railway / locomotive, ship building, power generation and construction sectors. Fuelled by state-financed investments in infrastructure, demand for machine tools has risen sharply since the year 2000. The construction of a modern railway network, airports, natural gas pipelines, and projects for electricity generation (Three Gorges Dam Project) have opened up a huge market for the machinery industry and for machine tools in particular.

4.2.2.2 Market size

China's total consumption of machine tools amounted to USD9.4 billion in 2004. Its total domestic production reached approximately USD4 billion, a growth rate of 35% year on year and accounting for 8.8% of total global production. China purchased and imported 20% of the total machine tool output worldwide. Was your company able to sell 20% of its output in the Chinese market?

Five machine tool enterprise clusters have developed in China:



Source: Fiducia Management Consultants

According to recently published figures, the industry is comprised of approximately 3,130 companies each having sales revenues greater than USD500,000. Of these, approximately 470 are foreign invested firms. The distribution of "key enterprises" in the industry is as follows:

Distribution of key enterprises

Category	of Key Enterprises
Abrasives	606
Metal cutting	415
Measuring and cutting tools	327
Metal forming	216
Foundry	142
Machine tool parts	102
Woodworking	59
Electric apparatus	21

4.2.2.3 Top machine tool domestic players

a) Dalian Machine Tool Group Corporation

Founded in 1948, Dalian Machine Tool Group Corp. (DTMG) is the largest machine tool producer in China. For five consecutive years (2000-2004) the company has been the leading tool manufacturer in terms of sales revenue. In 2002, DTMG ranked number 436 out of China's top 500 industrial enterprises. DTMG entered into various international co-operations and joint ventures with companies from Germany, Japan, Hong Kong, Korea and UK among others. According to DTMG, at the end of 2003 it had a total of 5,688 employees. However, this number recently increased to approximately 6,230 employees. Of these, 815 are engineering and technical staff.

b) Shenyang Machine Tool Co., Ltd.

Shenyang Machine Tool Co., Ltd. was incorporated as a joint stock limited company in May 1993 and debuted its 'A' shares in 1996 on the Shenzhen Stock Exchange. It is a state-owned enterprise (SOE) with a majority of 54.42% being held by the Shenyang State-Owned Management Co., Ltd. During the ninth "five year plan" period (1996–2000), the company was reformed and restructured with the help of a World Bank loan. The group is comprised of 14 enterprises which include three companies under China-Czech cooperation. It also hosts the National Special Research Institute for Lathe, Drilling and Boring Machine Industries. The company's goals for the future are:

- The creation and development of a Chinese production base with global marketing
- Improvement of the possession ratio of CNC (Computer Numerically Controlled) machines in the domestic market
- Enlargement of export sales

c) Beijing No. 1 Machine Tool Factory

Beijing No. 1 Machine Tool Factory has over 50 years of experience in the manufacture of machine tools. It is China's largest NC (Numerically Controlled) and CNC (Computer Numerically Controlled) machines producer and is engaged in the production of small, medium, large, heavy and extra heavy machinery. Beijing No. 1 exports to over 50 countries. Their products range from NC milling machines and lathes to more than 20 types of geological engineering drills. In 1997, Beijing No. 1 Machine Tool Factory passed the ISO9001 quality certification. By the end of 2003 it employed a total of 2,044 workers of which about 700 were trained specialists.

d) Shanghai Machine Tool Works

Established in 1946, Shanghai Machine Tool Works is now the largest Chinese manufacturer specializing in precision grinders and measuring instruments. After restructuring the enterprise with a loan from the World Bank during the seventh "five-year-plan" period (1992-1997), the company became a state-owned sole limited liability company subordinate to Shanghai Electric (Group) Co. This group is comprised of five national enterprises and two international firms (Singapore, USA). The company is in one of China's export bases of electro-mechanical products with direct export operation rights. By the end of 2003 the company employed around 970 people. Of these, approximately 750 were technical personnel.

In the future, the company aims at:

- Developing medium to high grade CNC products
- Improvement of production scale
- Expanding market share

Comparison of major Chinese machine tool manufacturers (figures are representing the results of 2003)

Company	Province	Employees	Revenue in USD m	Net Profit In USD m	Main Products
DMTG	Liaoning	6,230	412.61	13.84	■ Special Purpose Machines ■ Lathe (CNC, Universal) ■ Forging and Pressing Equipment ■ Specialized Machine Tool ■ Machine Tool Accessories ■ Machine Tool Parts
SMTC	Liaoning	7,802	212.61	2.71	■ CNC ■ Conventional Machine Tools ■ CNC Special Machines
BJ No.1	Beijing	2,044	28.87	0.35	■ NC/CNC
SMTW	Shanghai	968	46.62	0.12	■ Precision Grinders ■ Precision Measuring Instruments

4.2.2.4 Other important players

a) Chongqing Machine Tool Works

Starting with production in the early 1950's, Chongqing Machine Tool Works is currently a major industry player in the market, having an engineering staff of roughly 400 people. The company is engaged in the production of gearing machinery, ranging from gear hobbing machines, gear grinders, gear shavers, and gear honing machines to gear tooth chamfering, rounding machines and gear testers. Its gear hobbers have a domestic market share in excess of 60%. The company exports to 48 countries, mainly to the Americas and other Asian countries. International standards are assured through the ISO9001 certification, which was obtained in 1995. In recent years the NC/CNC market was also a target for the company with the R&D and production of CNC gear hobbers and CNC gear shavers. The company's aims for the years lying ahead include the future development of the NC/CNC market.

b) Qinchuan Machine Tool Group Co., Ltd.

In 1965, Qinchuan Machine Tool Group split from Shanghai Machine Tool Works and moved to Baoji in Shaanxi Province. There it emerged as an important industry player in the field of machine tools.It employs around 2600 employees with about 940 technical personnel, including one with a doctorate and 40 others with a master's degree. Product ranges (seven product lines in total) are focused on grinding machines with an emphasis on various types of manual and CNC grinding machines. Qinchuan Machine Tool Group exports to 20 countries including the USA, Japan and several south-east Asian countries. It has also passed the ISO9001 quality certification. In the coming years, the company has plans to enlarge their research and development and their manufacturing base for precision machine tools and plastic machinery.

4.2.3 Import and export

China's machine tool imports and exports in 2004 amounted to USD 8.93 billion and USD 2.25 billion respectively, resulting in a trade deficit in the machine tools sector of USD 6.68 billion. The most significant amount of the deficit is attributed to metal processing machine tools (metal cutting and metal forming), which contributed approximately USD 5.38 billion, or roughly 80.5% of the total deficit.

China is clearly the number one importer and consumer of machine tools worldwide. According to the World Machine Tool Survey 2005, China has outpaced the US, Taiwan and Germany in terms of imports. In terms of consumption, China holds the number one position, followed by Japan, Germany and the United States. In the same survey, China takes 12th place in exports, following the lead of Germany, Japan and Italy.

The main factors leading to a negative trade balance in the sector are China's strong demand for high-tech machine tools and its insufficient domestic supply of the same products. Furthermore, China's machine tool exports mainly consist of manual or low grade NC machine tools.

The total export volume of Chinese machine tools, USD 2.25 billion, accounts for only about 20% of China's total import volume.

The majority of imports were in the machine tools for metal cutting sector – USD 4.4 billion The largest exports were in the fields of abrasives and grinding tools with a value of USD 0.54 billion

Import and export of machine tools according to sectors

Product Category	Import			Export			
	Amount[1]	% increase[2]	Proportion[3]	Amount1	% increase[2]	Proportion[3]	Trade Deficit[1]
All Categories of machine tools	8.93	45.00	19.80	2.25	33.50	100.00	6.68
Incl.: Machine tools for metal cutting	4.37	4.20	48.90	0.45	40.10	19.80	3.92
Machine tools for metal forming	1.55	1.20	17.40	0.09	54.90	4.20	1.46
Die casting machines	0.22	13.80	2.50	0.03	47.70	1.20	0.19
Machine tools for woodworking	0.59	3.50	6.60	0.31	34.90	13.80	0.28
Fixtures for machine tools	0.17	9.00	1.90	0.08	-13.10	3.50	0.09
Parts and components for machine tools	0.44	5.10	5.00	0.2	27.80	9.00	0.24

NC devices	0.72	17.00	8.10	0.12	30.90	5.10	0.50
Cutting tools	0.56	2.40	6.40	0.38	39.50	17.00	0.18
Measuring tools and instruments	0.02	24.00	0.30	0.06	26.90	2.40	-0.06
Abrasives and grinding tools	0.25	36.60	2.90	0.54	33.70	24.00	-0.29

4.2.4 Outlook and trends

For 2005, forecasters still predict an overwhelming growth rate in the machine tool industry of 11 to 15%, but this will slow due to the effects of declining growth in automobile output and consumer purchases. **The effects of macro-economic control measures implemented by the Chinese government will also become more apparent and will affect the status of future product orders in the Chinese machine tool industry.**

Experts suggest that possible solutions to the forecasted market downturn include a stronger focus on the export market or a reshuffling of the current output. Presently, the machine tool market is divided into a low to middle-end and a high-end market. Chinese companies are mainly to be found in the lower end; the high-end is dominated by foreign companies. Production of high quality products would be preferable to lowering prices, as competition is fierce in the low-end segment of the market. Better products would also trigger international demand and increase export volume, as high quality products are needed in the domestic as well as foreign markets. It is expected that exports in machine tools will be about 20% higher than the growth rate of imports, which are expected to increase about 15%.

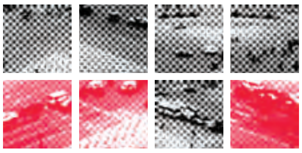
Following demand from industries, such as the automotive industry's need for high precision tools, China's machine tool market is currently shifting from manual machine tools to numeric control ones. According to experts' opinions, NC and CNC machines will gain more and more importance during the next few years.In 2003, roughly 55,000 CNC machine tools were purchased, or approximately one quarter of the total amount of manual machine tools produced. Currently there is a shortage of operators for numeric control machines (a likely number is about 6,000), but this gap should be closed in the near future.

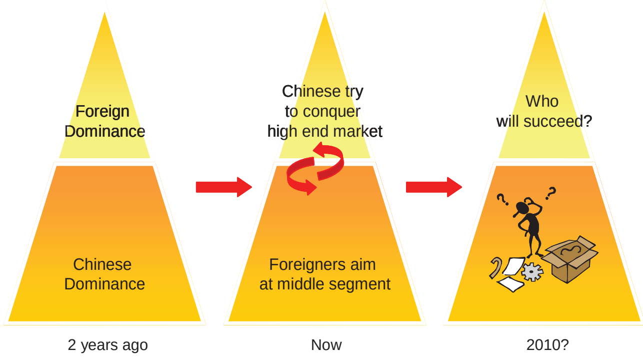
4.2.5 Mergers and acquisitions

There has been a rising trend in the past few years of Chinese machine tool companies acquiring other international players. In the final months of 2004, Shenyang Machine Tool Co., Ltd. and Dalian Machine Tool Group Corporation both made major investments by acquiring German machine tool manufacturers.

In August 2004, Shenyang Machine Tool Co. purchased 100% of the net assets of Schiess AG for the estimated amount of USD10m. Schiess GmbH will be used as an overseas base for research and development, training, and marketing and is planning to serve as a springboard for Shenyang's products to enter the European market.

Dalian Machine Tool Group Corporation (DMTG) purchased a majority stake of 70% in F. Zimmermann GmbH, a German producer of milling machines. Now DMTG is also in possession of a springboard into the European market, but the inverse could also be true. Some speculate that F. Zimmermann GmbH has enhanced their export capabilities into the Chinese market. For DMTG, this was the second big investment on an international level after the acquisition of Ingersoll CM Systems LLC and Ingersoll Production Systems LLC (USA) two years ago.





Outlook:
China's Machine Tool Market Players

	Chinese Players	Foreign Players
Advantages	Domestic Advantage	Brand at affordable price
	Cost Advantage	Higher quality perception
	Knowledge Transfer via JV	New market (segment)
	Know their customers/ the market	Brand Buffer against Chinese
Disadvantages	Quality	Global Strategy
	Expenses (R&D, services)	Loss of quality perception
	Competition on global scale	Loss of Brand Buffer
	...	...

Source: Fiducia Management Consultant

In addition to these transactions, the Chinese machine tool manufacturers Qinchuan Machine Tool Group Co., Ltd. and Shanghai Mingjing Machine Tool Co., Ltd. have engaged in their own international acquisitions. Qinchuan took over 60% of the shares in UAI (USA), and Shanghai Minjing purchased 53.6 % of the shares in German Wohlenberg and a 65% stake of the Japanese firm IKEGAI. In October of last year, Shanggong Co. bought the German firm Duerkopp Adler AG. Earlier this year, Harbin Measuring & Cutting Tool Group took over the German machinery manufacturer Kelch.

In May 2005, Qingdao Hidun Garment Group acquired Grosse Jac Webereimaschinen GmbH, one of the world's leading garment machine producers. This buyout is a perfect example of the Chinese tactic of acquiring small, unacquainted companies active in market niches with highly developed products. The textile machinery sector is an especially strong target for M&A given China's efforts to become a global leader in this market.

For companies that are in financial trouble or for which no immediate successor can be found, Chinese companies can appear as saviors. **Chinese machinery producers see the acquisition of international industry players as a way to incorporate well-known names into their portfolio and contribute to their overall strategy of international diversification.** For them, a distribution base or new market can be developed into a springboard for continental markets like Europe or North America.

Furthermore, Chinese producers see these acquisitions as a way to fill technology shortfalls and knowledge gaps. Most importantly, these acquisitions serve as a way to increase the transfer of knowledge.

4.2.5.1 Hike in steel and iron ore prices

Increases in the price of steel and iron ore during 2004 will have an effect on China's machine tool producers. In February of this year, prices were successfully negotiated between Chinese Baosteel Group and the two raw materials giants Australian Rio Tinto and Brazilian Companhia de Vale do Rio Doce. This agreement covers the approximately 35.4 million tons of iron ore to be delivered between April 2005 and March 2006.

This will further increase raw materials costs for heavy steel users such as the automobile, shipbuilding and construction industries, as well as end-users in the machine tool industry. The machinery industry as a whole is a steel consumer and will have to cope with the price increases. Manufacturers of products with low technical content, such as ordinary machine tools (non-CNC/NC tools), will not be able to pass the price increases on to their customers due to fierce competition in this segment of the market.

4.2.6 Regulatory issues

4.2.6.1 CoCom/Wassenaar agreement

The term CoCom stands for Coordinating Committee for Multilateral Export Controls. CoCom was a NATO sub-committee founded during the Cold War to put an embargo on exports of Western military technologies to the Eastern Bloc, of which China was considered a member. After CoCom's dissolution, the Wassenaar Agreement took its place, covering many similar points.

The Wassenaar Agreement was co-founded by 33 countries, among them Japan, Germany, the USA, Italy, France and the UK — six out of nine major machine tool importers to China. This agreement is of great importance, as it requires member states to thoroughly test and verify that certain dual usage machine tools are, if exported, not used for military, astronautic or marine purposes.

In order for machine tools to pass inspection, certain documents (export licenses) have to be obtained and investigations will take place in order to assure that the usage of the machine is limited to commercial purposes. Also, special conditions might be imposed on the buyer, like disclosure of the specific location for the use of the delivered machines and an announcement of any future relocation – all with the possibility of denial. This could result in higher costs and prolonged delivery times – time the customer may not be willing to wait.

4.2.6.2 Macro-economic control policy

In 2004, China increased efforts to implement its macro-economic control measures. GDP has climbed steadily since 2000 and in 2004 GDP growth reached 9.5% year on year. China's fear of an over-heating economy led to controls being placed on fast-growing fixed asset investments and on some of the more unreasonable investments going on in some industries. This continued policy is expected to have an influence on the development of the machine tool sector.

The total growth rate of the machine tool sector is predicted to fall, but demand for high-tech machine tools (NC and CNC) is still predicted to increase. The position of the machine tool sector, especially NC and CNC tools, will also be strengthened by certain Chinese governmental policies.

In early March 2005, the National People's Congress received the "2005 Draft Plan for National Economic and Social Development." In it was the statement that China's "ability to design, develop and produce complete sets of basic technical equipment such as digitally controlled machine tools and automatic control systems" will be improved. This was heralded by many as one more step for China toward meeting the requirements of industrialization.

Contributed by Fiducia
Fiducia is an independent firm with offices in Beijing, Hong Kong, Shanghai and Shenzhen to support international companies with a multinational, multilingual team of business and management consultants.

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4.3 ABB Engineering (Shanghai) Ltd. - Turbocharging Business Unit

Engineering and Construction Industry

SUMMARY

ABB Turbocharging imports turbochargers and components for oceangoing vessels' gas and diesel engines from its manufacturing headquarters in Switzerland and sells them to engine builders, shipbuilders and ship repair yards in China. It also provides repair, maintenance and after-sales services to both local and foreign shipping companies through its service stations on the mainland. ABB Turbocharging is the turbocharger market leader in China with 50% of the market share for new products and 35% for after-sales services.

This study describes ABB Turbocharging's experiences in China, focusing on the company's success factors:

- logistics and speedy after-sales services
- choice of location and timely expansion
- customer management
- maintaining competitive advantage through R&D
- employee training and people management

Figure 1:
ABB Turbocharging activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing							
Purchasing	For own China operations						
	For mother company						
	For third party						
Selling	SOE				ABB		
	POE	ABB			ABB		
	FIE Global	ABB			ABB		
	FIE Local				ABB		

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of ABB Group in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of ABB Group in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

Shipbuilding and repair

The shipbuilding industry is a worldwide enterprise that is fiercely competitive and extremely complex. Approximately 75% [1] of all new ship construction is centered in Asia between South Korea, Japan and China. Estimates show that European nations hold 15% of the market share, leaving the rest of the world's nations to compete for 10% of the global market [2].

Shipyards worldwide delivered a total of 1,147 new vessels (24.3 million cgt [i]) in 2004. The South Korean yards are in the lead with 268 completed vessels (8.3 million cgt), equivalent to 34.2% share of the world market. Japan produced 32.9% of the newbuilding tonnage, followed by China 10.7%, Germany 3.7%, Italy 3.3% and Poland 2.1%. Incoming orders received in 2004 also reflect the growing dominance of Asian shipbuilders. China is the fastest growing of all, capturing 14% of new orders in 2004 while completing 10.7% of ships produced in 2004 [3].

Figure 2:
New orders during 2004 by country
Source: Clarkson Research . (2005). World shipbuilding: still beating records. www. hamburg-messe.de : Shipbuilding, Machinery & Marine (SMM) News .

New orders during 2004 by country

country	mio.cgt	share
Korea	17.3	36.7%
Japan	12.2	25.9%
China	6.6	14.0%
Germany	1.6	3.4%
Italy	1.2	2.5%
Poland	1.1	2.3%
Taiwan	0.9	1.9%
Croatia	0.8	1.7%
Other Asian countries	1.5	3.2%
Other European countries	3.7	7.9%

Figure 3:
Completed ships during 2004 by country
Source: Clarkson Research . (2005). World shipbuilding: still beating records. www. hamburg-messe.de : Shipbuilding, Machinery & Marine (SMM) News .

Completions during 2004 by country

country	mio.cgt	share
Korea	8.3	34.2%
Japan	8.0	32.9%
China	2.6	10.7%
Germany	0.9	3.7%
Italy	0.8	3.3%
Poland	0.5	2.1%
Croatia	0.4	1.6%
Taiwan	0.4	1.6%
Other Asian countries	0.3	1.2%
Other European countries	1.7	7.0%

While the competition for the building of new ships is considerable, the battle for repair and overhaul contracts is no less so. The age of the world fleet (58.6% of the world's merchant ships is in excess of 15 years old as of January 2005 [4]) continues to create a growing market for repair and maintenance services especially as regulations become tougher and port state inspections get stricter.

Marine diesel engines

Following the global shipbuilding boom (orders received in 2004 are twice the number of ships completed in the same year); orders for marine engines have also hit record levels especially for the largest oceangoing vessels.

In terms of geographic location of the engines at the shipbuilder's site, the Far East (includes South Korea, Japan and China) again saw the largest increase in activity. The Far East is responsible for the biggest share of the largest two-stroke engine orders. The table below shows that unit orders and engine output for three types of marine engines (for 500kW and above output range) have increased in 2004.

Figure 4:
Marine propulsion orders, June 2003 - May 2004
Source: McNeely, M. (2004). Marine Propulsion Order Survey (Vol. 11)

		No. of Engines (Units)	Increase%	Total Engine Output (Megawatts)	Increase%	Western Europe	Eastern Europe & Russia	Middle East	Far East	Southeast Asia/ Australasia	Central Asia	North America	Central America	South America
Mechanical Drive Diesel Marine Propulsion	2003	6765	3.5%	21386	82.7%	2175	123	200	1682	966	120	1355	1	61
	2004	7003		39065		2244	138	157	2153	1127	34	1029	36	75
Marine Auxiliary Generating Set	2003	2974	38.0%	3431	46.5%	599	40	31	2095	86	36	65	3	13
	2004	4104		5027		963	125	215	2470	125	54	94	5	41
Diesel-electric Marine Propulsion	2003	181	28.7%	607	54.5%	82	1	0	26	20	5	43	4	0
	2004	233		938		100	7	7	13	38	8	31	14	15

**Geographic location is at the shipbuilding site*

MOTHER COMPANY - ABB Group (ABB Turbo Systems Ltd)

Company background and current situation

Asea AB (founded 1883 in Stockholm, Sweden) and Brown Boveri & Cie (founded 1891 in Baden, Switzerland) merged in 1988 to form ABB (Asea Brown Boveri) — one of the largest electrical engineering companies in the world that engineers and installs networks, facilities and plants with emphasis on efficiency and productivity enhancement.

ABB Turbo Systems is one of ABB Group's several business units under the Automation Technologies Division and is the world's premier supplier of turbochargers for diesel and gas engines in the 500kW to 25,000kW power range. Today, there are over 180,000 ABB turbochargers in operation in container ships and cruise ships, tankers and ice breakers, high-speed ferries and river ships, mining vehicles and diesel locomotives and in stationary installations such as diesel- or gas-driven power plants, mobile power generators or emergency power plants.

Company size and structure

ABB Group comprises 415 subsidiaries and operates in approximately 100 countries in Europe, the Americas, Asia and the Middle East & Africa (MEA). By the end of 2004, the Group employed 102,500 people; around 800 of which work under ABB Turbo Systems in Baden.

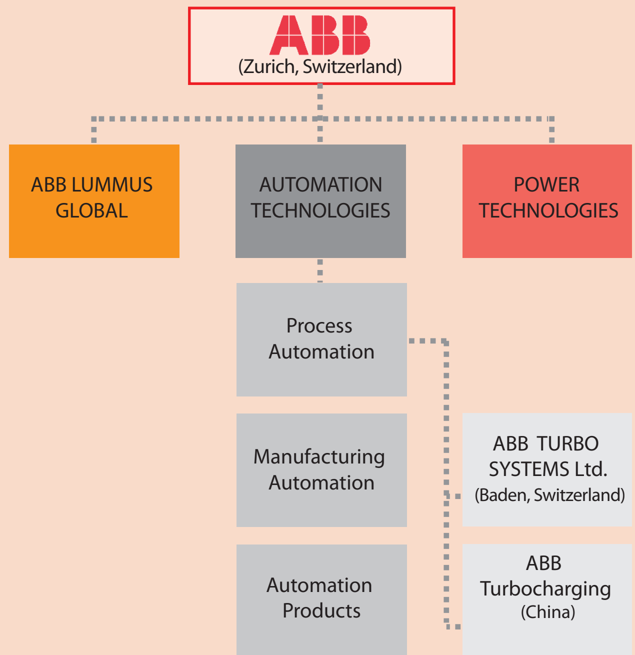
Core business divisions / units and products

ABB Group's core business consists of two major business divisions:

- Power Technologies – serves electric, gas and water utilities as well as industrial and commercial customers with a broad range of product, systems and services for power transmission, distribution and power plant automation.
- Automation Technologies – provides customer-tailored and standard products, software, systems and services for the automation and optimization of industrial and commercial processes.

The business areas under Automation Technologies are:

Figure 5:
ABB Group structure
Source: Swiss China Survey, 2005.



Automation Products – include low- and high-voltage motors used in the building automation, marine, transportation, manufacturing and process industries as well as power electronics systems and low-voltage devices for power quality and wire management. This business area also sells instrumentation products, analytical and measurement devices.

- Manufacturing Automation — has a base of approximately 90,000 industrial robots as well as related equipment and software. This area also develops standard manufacturing cells for machine handling, welding, cutting, painting and finishing and provides packaged systems to automobile manufacturers for press and paint process automation.
- Process Automation — ABB's turbocharging solutions fall under this business area. It includes systems for control and plant optimization in the process and utility industries as well as systems for electric marine propulsion, power generation and distribution, automation, heating, ventilation and air conditioning aboard cruise, cargo and other offshore vessels. The turbochargers sold by this unit add performance, environmental and fuel efficiency to large gasoline and diesel engines.

ABB Group's global revenues were USD20.72 billion as of year ending December 2004. Contributions to ABB's overall revenues per region are broken down as follows: Europe 52%; the Americas 17%; Asia 21%; and MEA 10%. The core division revenues are USD8.76 billion from Power Technologies and USD11.03 billion from Automation Technologies. The orders received by ABB Turbo Systems in 2004 increased by approximately 16% from the previous year due largely to the continuing demand growth of new turbocharger generations, strong market and successful introduction of new products. ABB Turbo Systems posted USD322.3 million (CHF399.2 million) total revenues for the business year 2004, an increase of 9% over the year before [5].

Competitive advantage

ABB Turbo Systems competes in the international turbocharging market with the following strengths:

- Large and continuously growing product portfolio featuring a wide range of turbochargers (from small turbochargers for very high pressure ratios to large products made for the world's most powerful engines; from the latest generation of turbochargers for two-stroke applications to the development of the latest products for high-speed gas engines).

- Highly efficient processes involved in the entire production chain — from suppliers for materials procurement to final assembly — ensure high availability of turbochargers in the company's global network of service stations.
- Ever growing and strengthening service infrastructure covering the world's major markets as well as its increasing presence in the smaller markets (ABB Turbo Systems has opened additional stations in Brazil, Sri Lanka, India and Vietnam in 2004 and new stations are scheduled to open in Norway, China, Japan, Yemen and Russia in 2005).

CHINA INDUSTRY TRENDS and OUTLOOK

Asian nations achieved an advantage in the global shipbuilding marketplace by minimized costs, thereby enabling them to become the pre-eminent commercial shipbuilders during the last quarter of the twentieth century.

China is the new Asian shipbuilding tiger; analysts predict that it will further seize significant market share away from other Asian shipbuilding nations within the next decade. There are over 800 shipyards in China; the largest are located in Dalian and Shanghai. The country presently builds about 15% of the world's total tonnage of ships and holds 17% of global-wide orders making it the third largest shipbuilding nation in the world in terms of gross tonnage [6]. China's leading shipbuilding company, China State Shipbuilding Corp. (CSSC), for instance, built 3.57 million tons of ships in 2004, up 64.5% over the previous year. CSSC expects to build 4.36 million tons of ship and receive 4 million tons of new orders by the end of 2005 [7].

Moreover, the country is one of the cheapest places for shipbuilding and ship repair. **Ship repair is a growing sector in which Chinese yards are increasingly becoming recognized not just for their low-priced steelworks repairs, but also for their growing competence in the full range of repair activities**. China has recently replaced Singapore as the favored ship repair hub in the region. Due to low labor costs China's shipyards can do the same repair work 30% cheaper than it would cost in Singapore [8].

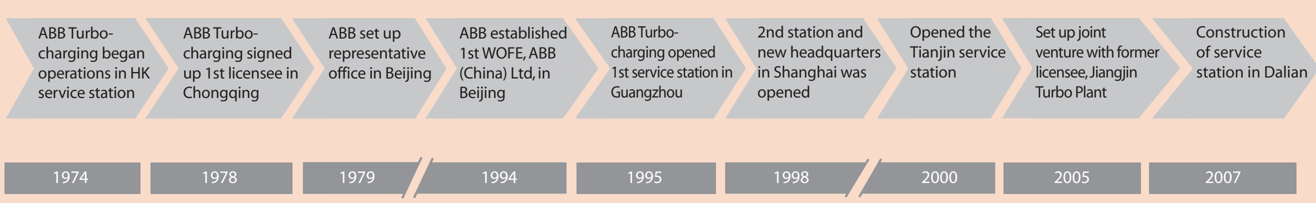
ABB TURBOCHARGING in CHINA

Subsidiary background and current situation

ABB Turbocharging started selling turbochargers and after-sales services in their first service station [ii] in Hong Kong in 1974. Prior to setting up the first ABB representative office in Beijing in 1979, ABB Turbocharging signed a licensing agreement with Jiangjin Turbocharger Plant (JTP) in Chongqing province in 1978. The company also signed up a second licensee called Xinzhong but their agreement was terminated in 1999. ABB has just recently signed a new agreement with JTP to set up a joint venture (JV) for the production, sales and servicing of ABB turbochargers in the Chinese market. The new company is scheduled to begin operations in January 2006.

Before the country's economic reforms, wholly foreign-owned companies were not allowed to provide services on mainland China, therefore ABB Turbocharging partnered with four of the biggest shipyards in China at that time to sell turbochargers and to service both its local and foreign customers.

Figure 6:
ABB Turbocharging history and milestones in China
Source: Swiss China Survey, 2005



However, ABB Turbocharging aims to provide the ABB-standard service work directly to its customers on the mainland instead of going through its local partners. At this point, ABB moved its China headquarters to Beijing permanently and established its first wholly foreign-owned subsidiary, ABB (China) Ltd, there in 1994. The following year, ABB Turbocharging opened its first service station in Guangzhou and began selling and directly servicing the many diesel power plants and other customers in South China. The second service station was launched in Shanghai in 1998, immediately followed by the third in Tianjin in 2000. ABB is currently constructing its service station in Dalian which is also seen to become Turbocharging's main headquarters in the north.

Subsidiary size and turnover

ABB Turbocharging's four service stations country-wide (including Hong Kong) currently have a total of 85 employees and cover the major areas in China where the shipbuilding and repair industry is flourishing: Guangzhou and Hong Kong (south), Shanghai (east/central), Tianjin and soon Dalian (north). ABB Turbocharging has captured a market share of approximately 50% in the new sales business and 35% in the after-sales service making the company the market leader in China for all turbocharger applications.

ABB Turbocharging currently generates about 20% of the overall worldwide turbocharging revenues from its service network in China both in new sales and after-sales service segments.

Figure 7:
ABB's turbocharger service station network in China, including Hong Kong, and its joint venture partner's location in Chongqing province
Source: ABB Group (2002). Turbo Magazine (Vol. 02). ABB Turbo Systems Ltd.

Targeted market segments

ABB Turbocharging supplies to two main types of customer in the marine market segment in China:

- In the **new sales sector,** the customers are engine builders and their licensees that use turbochargers as one of the key components for gas and diesel engines. The primary customers of ABB Turbocharging in the new sales segment are two of the biggest international manufacturers of two-stroke engines and their Chinese licensees:
  - MAN-B&W Group (German-Danish)
  - Wärtsilä-Sulzer Group (Finnish-Swiss)

  Additionally, ABB Turbocharging, through the former licensing agreement which is now a joint venture with JTP, produces and assembles around 1,200 turbochargers annually; about 50% of which are a smaller range of turbochargers. ABB Turbocharging also produces a majority of turbochargers for the local locomotive industry.

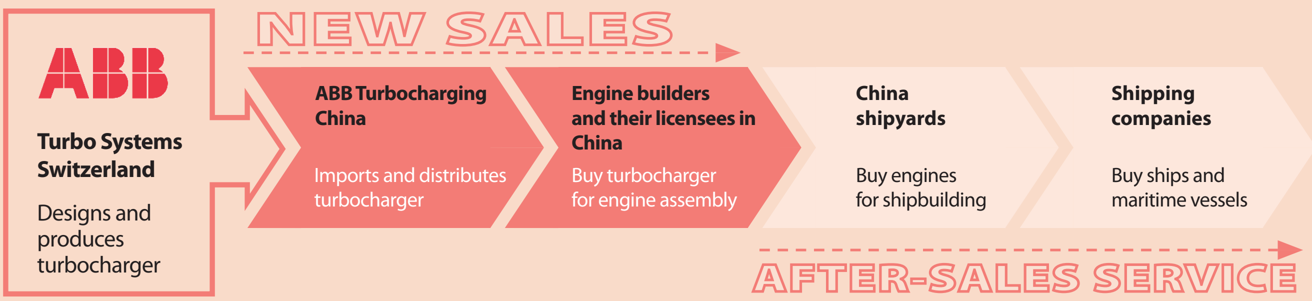
- The **after-sales service** is provided to shipping companies that own fleets of ocean-going vessels and manage the engines on board their ships.

Value chain

ABB Turbo Systems in Switzerland manufactures and exports approximately 6,500 units of turbochargers for all sizes of engine per year for its global service network.

ABB Turbocharging sells turbochargers to engine builders and/or their local licensees in China. To illustrate, both MAN-B&W and Wärtsilä-Sulzer's engines for the Chinese market are manufactured by Hudong Heavy Machinery (HHM), their common local licensee in Shanghai. Although ABB Turbocharging designs its products according to MAN-B&W and Wärtsilä's specifications, it sells the turbochargers directly to HMM. This licensee then produces and delivers the engine to the shipyards where the vessels are constructed based on the provisions of the ship owners. ABB Turbocharging provides after-sales services mostly to the shipping companies who require either to have their ships' turbochargers repaired, maintained or replaced.

Figure 8:
ABB Turbocharging value chain
Source: Swiss China Survey, 2005



Local competitors and competitive advantages

The following factors make ABB Turbocharging the market and technology leader in China:

- Efficient and reliable turbochargers that require lower fuel consumption and guarantee less unforeseen outages.
- A set of related services that ensure efficient operation and maintenance of ABB's equipment, therefore maximizing power generation and use of ABB's equipment:
  - A global network of 75 strategically-located service stations that offer trustworthy original ABB products and the standard ABB quality service.
  - High availability and timely delivery of turbocharger spare parts from Switzerland to ABB's global service network: ABB Turbocharging is able to deliver 98% of turbocharger spare parts within 24 hours to any station in its service network.
  - A technology that monitors turbocharger units and components sold by ABB Turbocharging and its licensee. This enables ABB Turbocharging to track a product's history and notify customers when it requires servicing or when a unit is in need of replacement.
  - ABB's global training service that aids its partners and customers to optimize operations and minimize down time and maintenance costs through specialized ABB trainings offered to engine builders (i.e. training for installation) and customers (i.e. training on how to operate the turbocharger).
- Close contact with end users through the service station network, allowing for better understanding of market needs and improving products through clients and maintenance staff feedback.

In the new sales business, ABB Turbocharging's two main competitors are MAN Turbo (Shanghai) and Mitsubishi. ABB Turbocharging's market share in the field of two-stroke engine turbochargers in China is around 42-49% while MAN and Mitsubishi compete for the remaining 50-58%. Unlike ABB, Mitsubishi does not have a service network and MAN offers some servicing in authorized workshops only.

ABB Turbocharging is also facing some competition in the after-sales service sector from other spare parts and service providers that offer below-standard service and low-quality parts for old turbocharger models at prices as low as 10-15% of the cost of original ABB products. However, ABB Turbocharging believes that these providers serve the lower market segment that represents customers who purchase parts based wholly on the cheapest price. Since ABB Turbocharging targets the upper market segment that pays for original quality parts, it does not put much effort into winning the lower market segment; instead, it concentrates on acquiring as much upper market share as possible.

FACTS and ANALYSIS

Supply and technical support

All new equipment, spare parts and the whole range of new generation turbochargers are imported by ABB Tubocharging from ABB Turbo Systems in Switzerland. The fact that ABB Turbo Systems functions as ABB Turbocharging's principal supplier puts the subsidiary in a secure position in terms of the high availability, quality and timely delivery of supplies. ABB Turbocharging's service stations in China also benefit from the particularly strong support afforded by ABB Turbo Systems that includes technical assistance for after-sales service.

Recruitment, training and people management

ABB Turbocharging believes that finding and keeping the right people is more challenging in China than in Europe, particularly for the position of engineers. Although there is ample supply of capable and skilled technical engineers in most of China's shipyards and construction workshops, a majority of them have minimal business experience or lack the academic business knowledge essential for writing proficient service reports (particularly in English) and for communicating with ABB's international headquarters and other service stations.

ABB Turbocharging selects maritime university graduates or experienced engineers with marine engineering background who have worked on board a ship for at least five years as the best candidates for technical positions. This helps ABB Turbocharging cut down the new-hire training period from six to seven months to two to three months since these candidates are already familiar with turbochargers. The training needs of ABB Turbocharging's growing workforce involves either flying in ABB experts from Switzerland to train engineers and after-sales service staff in China or sending the staff to ABB's training center in Baden. The training facility in Switzerland caters to training engineers on the technical aspects of turbocharging, as well as sales and service business training for sales and service support staff.

Customers and customer management

A majority of China's major shipping companies today are evolving from local companies into international players that expect higher standards in quality and service. It has been observed that these companies increasingly prefer original ABB spare parts over locally-produced or copied parts regardless of the higher prices. The same is evident in the ship repair business. The market is changing fast which forces the ship repairers to adapt to these changes at the same pace. Most of the local shipyards' clientele in the past were Chinese companies that put cost before quality. Today, 80-90% of their customers are foreign ship owners that require top quality components.

The various players (shipyards, engine builders and ship owners) in the entire shipbuilding process have conflicting priorities. Costs take precedence for the shipyards; therefore, they cut expenses by using cheap parts. Meanwhile, the engine builders prefer to use the turbocharger that guarantees their engines' performance. Lastly, ship owners aim to lower their long-term operational costs; hence, they invest in quality brands like ABB's to cut down on fuel costs and maintenance expenses.

Since a considerable part of ABB Turbocharging's business originates from after-sales services, ABB keeps in contact with ship owners in the earlier stages of a project to ensure that ABB turbochargers are used in engine building. This is done through constant communication between ABB Turbocharging, other ABB subsidiaries all over the world and the mother company in Switzerland; to the engine builders, the shipyards and finally the ship owners.

For example, when a European shipping company goes to a Chinese shipyard to purchase ships with licensee-produced Wärtsilä-Sulzer engines, ABB Turbocharging will get in touch first with Wärtsilä-Sulzer, then the mother company or another ABB Turbo Systems subsidiary in Europe where the ship owner's headquarters are located. The European ABB subsidiary will then notify the shipping company of ABB Turbocharging China's interest in the project in China.

Through this initiative, ABB Turbocharging ensures that the international ship owner will require the engine builders and shipyards in China to use globally-recognized ABB turbochargers and parts. Moreover, ABB Turbocharging also secures the after-sales service business with the ship owner who would naturally go to an ABB service station for maintenance and repair in the future.

Product and R&D

Being the technology leader in the turbocharging industry gives ABB Turbocharging a competitive advantage in the market. This edge naturally drives the company's competitors to catch up. Indeed, it is becoming noticeable that the latest products of MAN and Mitsubishi look nearly identical to ABB's. In order to sustain its lead, the bulk of ABB Turbocharging's revenues are invested back into ABB Turbo Systems' research and development in Baden to build the next generation of innovative turbochargers. As technical demands in this industry constantly increase, ABB Turbocharging believes that investing in extensive research and innovation will pay off and be a key success factor in the future.

ABB Turbocharging confines its research and development activities in Baden due to its proximity to the factories and production facilities in Switzerland. For ABB it is foremost that the R&D center is set up close to the production sites to allow for immediate feedback and product testing.

Legal and special industry regulations

China's complex import taxation and foreign exchange limitations are the biggest challenges that ABB Turbocharging deals with in administering both new sales business and after-sales services. In China, imported spare parts are subject to 17% VAT (Vale Added Tax) plus a variable amount of import duties determined by the type of equipment or spare parts. VAT is also charged if the end user (buyer) of the merchandise is a shipping company with an international fleet, regardless of whether it is a domestic or foreign company. Services sold are subject to 5% service tax. To address this matter, ABB Turbocharging issues two invoices to shipping companies (both domestic and foreign) involved in international trading and/or firms that are VAT exempt:

- A local invoice with 5% labor tax is issued for service jobs
- A separate invoice for imported spare parts (imported from Hong Kong) is issued from Hong Kong

However, this process makes transacting business with ABB Turbocharging in China strenuous and often confusing to customers. Aside from the complicated invoicing, it is also a big inconvenience for domestic companies to make payments to Hong Kong in foreign currency due to stringent laws on foreign exchange payments.

Location, logistics and regulatory frame

Establishing the service station in Shanghai proved to be most complex for ABB Turbocharging among all its current stations because most of the shipyards in Shanghai are located far from the city. The subsidiary was registered in the Waigaoqiao Free Trade Zone which, despite the zone's many advantages, proved to be a minor drawback. For instance, by Free Trade Zone policies, all goods (including tools and equipment) are required to be declared at customs every time service engineers enter and exit the zone. The company, however, managed to resolve this by conferring with the authorities of the Free Trade Zone and securing a special agreement that allows ABB engineers to go through the zone without declaring goods and tools every time. As of press time, ABB Turbocharging has moved its Shanghai headquarters from the Free Trade Zone to its service station which will soon become the hub and hold the stock of turbocharger spare parts for all its service stations in China.

ABB Turbocharging is presently building a new station in Dalian and is projected to be completed by 2007. The subsidiary's decision to set up its North China center in Dalian is supported by the following developments observed in the city over the last few years:

- Tremendous growth of the shipbuilding industry
- Increased new sales and after-sales service demand from small shipping companies that have very modern fleets
- Rising number of ship repair yards
- Fewer logistics restrictions compared to seven or eight years ago

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Maturing of the Chinese shipbuilding industry

New opportunities arise for ABB Turbocharging as the biggest players in China shipbuilding (i.e. COSCO and China Shipping Group) gradually mature into international shipping companies that adopt international standards and favor quality and reliability over price. As shipping companies shift their priorities, they also drive ship repairers and engine builders to adjust their standards and use quality original parts for their vessel engines. This creates better new sales business opportunities for ABB Turbocharging which has been receiving partnership offers from repair yards that are interested in carrying and selling original ABB spare parts. Such deals also allow ABB to have its own engineers supervise these yards to ensure that all ABB products are marketed and sold efficiently.

Chinese growth and acquiring global market share

China expects to reach world leadership in shipbuilding by 2015 and the Korean Shipbuilders Association, together with Lloyd's Register, predicts that China may reach 40% of the world market share by 2012. By catering to China's need ABB Turbocharging is also making sure to acquire global market share.

To take advantage of this opportunity, ABB Turbocharging presently focuses on its next service station on mainland China. Dalian is becoming increasingly famous for its budding shipbuilding industry — on top of it being a hub for trains and locomotives. Setting up its fourth service station in Dalian will clearly afford ABB Turbocharging an opportunity to expand its customer base and overall activity in the North.

Risks and difficulties

Potential global shipbuilding overcapacity

Since 2003, the global shipbuilding demand has gone up strongly. A large number of new shipbuilding and repair centers with large construction facilities have emerged all over the world. However, the most notable aspect is the increase in numbers and capacity of ships being built and ordered followed the fall in prices (around 25%) from the end of 1997 to the end of 2002[9]. This factor is considered as the overall driver of growth, along with the boom in trade to and from China and the need to replace and upgrade ships in order to meet improved industry standards. Shipbuilding is a very cyclical industry with short peak periods; as a result, it often suffers from overcapacity, depressed prices and low profit margins. In fact, the fall in prices in the late 1990s was a reflection of a surge in new capacity.

Estimates by the Association of European Shipbuilders and Ship Repairers (AWES) suggest that global shipbuilding capacity is likely to increase by another 20% or so over the next five years. In its latest report, AWES points out that although there may be a certain upward revision of the forecast on future newbuilding requirements, nothing suggests that the demand for new ships in the future could match the capacity of yards to supply. On the contrary, it is most likely that surplus of shipbuilding capacity will grow substantially [10] . This means that fluctuations (prices, profit margins, etc.) in the short term in the entire shipbuilding and repair industry are expected along with even fiercer global competition among all major players.

ABB Turbocharging's position versus its competitors in terms of pricing

Despite ABB Turbocharging's competitive edge in service and technology over MAN and Mitsubishi, ABB believes that these competitors are in a better position in terms of price flexibility because they are both engine builders — more than just turbocharger manufacturers. A turbocharger is, after all, merely a component of the entire ship engine unit. This factor allows both MAN and Mitsubishi the flexibility to present more attractive package terms to customers unlike ABB which is more restricted in terms of the turbocharger prices it offers.

Competition with local producers and service providers

There is always the risk that local manufacturers and service providers will soon catch up and reproduce good copies of turbocharger parts (particularly as ABB Turbocharging prepares to introduce its latest generation of turbochargers to the market) and sell them at extremely low prices. This threatens ABB Turbocharging's market share on parts and services. Even so, ABB acknowledges the presence of such competitors that serve the lower market today and believes that there will always be a segment of the market that will purchase cheaper parts.

However, ABB Turbocharging's intended primary customers are companies that give precedence to quality over price. As China moves toward globalization, so do a large number of local companies adapting to international standards. This particular segment of the market is where ABB Turbocharging aims to focus most of its efforts and compete strongly.

China VAT taxation on shipbuilding products and services

ABB Turbocharging believes that it will be necessary for China to drop its VAT rules in the near future lest it will be unable to maintain its global competitiveness. China's advancing role in the global shipping industry convinces ABB Turbocharging that the country will have to do away with VAT on shipping products and services like most European countries.

Bureaucracy

In order to comply with China's stiff import taxation policies and restrictions on foreign exchange, ABB Turbocharging issues separate invoices for its spare parts and services. This, as a result, makes purchasing original parts from ABB Turbocharging and employing its services complicated, lengthy and inconvenient for the company — more so for its customers in China.

Success factors

Training and people management

ABB's considerable investment in manpower training has enabled the company to strengthen its products and services' key selling points to its customers through its well-trained sales engineers. The staff's first-hand knowledge has contributed to ABB Turbocharging's success in China since Chinese sales engineers who went and trained in Switzerland are effective, confident, motivated and more able to clearly present to clients a highly credible account of the long term advantages and cost-effectiveness of ABB Turbocharging products.

Spare parts logistics and speedy after-sales services

One of ABB Turbocharging's biggest advantages over its competitors is its guaranteed facility to deliver original ABB turbocharger parts to its service stations in China within 24 hours. The high availability of spare parts — by maintaining minimum quantity of parts in stock in individual service stations in China — minimizes the down time of maritime vessels which consequently cuts down losses. This proves ultimately beneficial to ABB Turbocharging clients. Also ABB is able to give its clients the most efficient and speedy after-sales service quality that complies with ABB Group's international standard level.

The convenience of obtaining original ABB parts in a short period of time will soon be further improved as ABB Turbocharging sets up a spare parts center in Shanghai. This will streamline the company's importing logistics where product orders to either the factory in Baden (Switzerland) and in Jiangjing (China) for mainland China will only originate from the spare parts center in Shanghai. The company also aims to apply for trading rights following the joint venture agreement with its long-time licensee partner. Obtaining trading rights will eliminate the company's need for local import agents every time it imports turbocharger components from Switzerland or Hong Kong.

Location and timely expansion strategy

ABB Turbocharging's early presence in China (as early as 1978 even prior to the country's economic reforms) and its prime industrial and shipping centers — spanning the southern, eastern/central and northern parts of the country — as well as the outstanding and consistent service it provides in all these stations, have made key contributions to the company's success in the country. With Dalian as the latest addition to its four-station network on the mainland, ABB's strategic expansion scheme has undoubtedly secured it a definite position in China's booming shipbuilding and repair industry.

End user management

ABB Turbocharging invests more time and attention to corresponding with all the major shipbuilding players in the early stages of a project, seeing as ship owners are increasingly improving in the management of their long-term operational costs. By making an early move and communicating with the engine builders, the shipyards and the ship owners, ABB Turbocharging increases the possibility that owners will direct shipyards and engine builders to use original ABB turbochargers and parts. Likewise, this guarantees ABB Turbocharging the after-sales business as shipping companies will prefer to go to an ABB service station when their turbochargers need servicing or maintenance in the future.

R&D and world leadership in a niche product

ABB Turbocharging actively pursues extensive research and development to produce new generations of turbochargers. This approach enables the company to quickly adjust to the constantly shifting demands of the market — including the dynamic market of China — securing ABB Turbocharging's strong stance as the market and technology leader. This also ensures that ABB's products are selected by their global clients that have begun operations in China.

Information on ABB Turbocharging courtesy of:
Andreas Wagner - General Manager, ABB Turbocharging China
Interview conducted by: *Marco Schueep, Luca Bortolani and Patrick Schaufelberger*
Case Study written by: *Maria Luisa Dacera*
Approved for publication on: *October 2005*

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4.4 Sulzer Shanghai Ltd. – Chemtech Division

Chemical, Petrochemical Engineering and Equipment Industry

SUMMARY

Sulzer Chemtech Ltd is a member of the Sulzer Group based in Winterthur, Switzerland. The company's turnover is close to USD 900m and has around 10,000 employees around the world. The Chemtech Division is active in the engineering and production of equipment for separation and mixing of chemical components, particularly in the petrochemical field. In addition, Chemtech supports the engineering of plant processes and maintains refinery towers. Chemtech employs about 1,200 people worldwide with revenues of about USD 150 million. Sulzer Chemtech is represented in all important industrial countries and is the technology leader in its field.

The Sulzer Chemtech Division is active in China as illustrated in the activity chart. In 2004, the subsidiary has 120 employees and its total sales amounted to about USD 10 million.

Figure 1:
Sulzer Chemtech's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing			SULZER				
Purchasing	For own China operations			SULZER			
	For mother company						
	For third party						
Selling	SOE		SULZER		SULZER		
	POE						
	FIE Global		SULZER		SULZER		
	FIE Local						

SOE - State-owned enterprises in China
POE - Private-ownd enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of SULZER in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of SULZER in the global scale

This study describes Sulzer Chemtech's experiences in China and the company's key success factors:

- maintaining competitive advantage through its product's superior reliability and efficiency
- early entry and step-by-step development through a multifunctional workshop and shared facilities (a group incubator)
- adjustment to local business ways and handling relations, management and customer selection

GLOBAL INDUSTRY TRENDS and OUTLOOK

Throughout the world, the demand for petroleum products, particularly power fuels (diesel and gasoline) and petrochemical materials derived from oil (aromatics and olefins), is increasing. Demand in mature markets such as Europe and North America is increasing moderately, whereas emerging Asian markets such as China and India are witnessing rapid growth. Existing refineries are trying to meet the high demand by upgrading their technologies to optimize efficiency and output, while meeting environmental standards.

MOTHER COMPANY - SULZER Group

Company background and current situation

Sulzer Corporation was founded in 1834 in Winterthur, Switzerland and is active in 123 locations around the world in the machinery and equipment, as well as, in the surfacing [i] technologies.

Today, the Group's core divisions are leading suppliers in their respective customer segments globally with 9,661 employees worldwide.

Core business divisons / units and products

- Sulzer Pumps: Pumping solutions and services
- Sulzer Metco: Surface technology solutions and services
- Sulzer Turbo Services: Service and repair of thermal turbo machinery
- Sulzer Hexis: Fuel cell systems for residential applications (venture division to tap into new growth markets)
- Sulzer Chemtech: Components and services for separation columns and static mixing

Apart from these five divisions, the development center, Sulzer Innotec, offers contract research and specialized technical services.

In the first half of 2005, Sulzer Group continued to grow profitably. Sales were up 18.4% year-on-year at USD892m. Its operating income (EBITA) rose by 25.4% to USD59.2m and its net income amounted to USD45.4m (see also Figure 2 and 3 for the sales contribution by region and division).

Figure 2:
Net sales for January - June 2005 by business division
Source: Sulzer mid-year report 2005

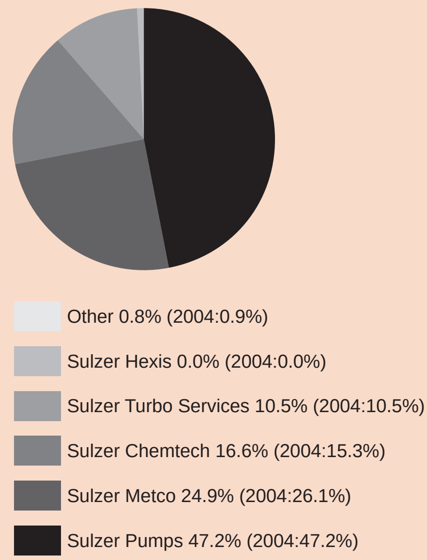
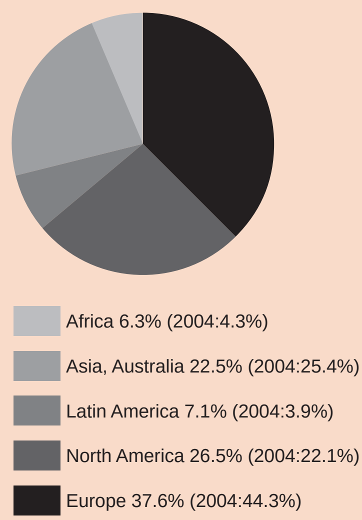


Figure 3
Net sales for January - June 2005 by region
Source: Sulzer mid-year report 2005



SULZER in CHINA

In the mid 50's, Sulzer Group negotiated a licensee agreement for large low-speed diesel engines [1], which remained, to a large extent a paper project. Sulzer's involvement after 1972 included negotiations for the supply of large blast furnace blowers (steel industry) and a 300 MW steam boiler for power generation.

In the early 1980's, the subsidiary's selling activities increased in the textile machinery business and in almost all of its other products, especially the power generation (pump, valves, etc) and the Hydrocarbon Power Industry (HPI) equipment. In the second half of the 1980's a new licensee agreement was formed with three Chinese shipyards for large low-speed diesel engines. It covered power stations, valves, pumps, mixing technology — all combined with technology transfer and intensive training in China as well as in Switzerland.

In 1989, Sulzer reached an agreement with the Chinese government to build a wholly owned Sulzer facility in Shanghai for various products, particularly for HPI Industry equipment. In 1991, the Sulzer Group set up a multifunctional platform with offices and a workshop to be used by all its divisions. The Chemtech division made best use of the platform and eventually took over the entire facility. Meanwhile, in 1999, the Sulzer Pumps division strengthened its position in the Chinese market by founding a joint venture with Dalian Pumps of China.

Figure 4:
Sulzer Group's history and milestones in China
Source: Swiss China Survey, 2005

1950s	1972	early 1980s	mid 1980s	1989
licensee agreement for large low-speed diesel engines (tentative)	negotiations for the supply of large blast furnace blowers and monotube steam boiler for power generation.	activities intensification in all other products of the Group, especially: textile machinery, equipment for power generation and hydro carbonic power	new licensee agreement for large low-speed diesel engines with three Chinese shipyards	agreement to build a "wholly owned" Sulzer facility (workshop) for various products/divisions near Shanghai

Today, Sulzer is present in China through Sulzer Chemtech and Sulzer Pumps (former divisions of Sulzer that have been divested or spun-off, such as diesel engines and weaving machines are also still active in China).

Sulzer Chemtech Division

Sulzer Chemtech is a global market leader for separation column (Figure 5) and static mixing technologies. It is present in all important markets with sales, engineering, fabrication and customer support sites. Its product and service portfolio consists of:

- process components such as trays, structured and random packings, internals for separation columns (or distillation towers) and reaction technology
- engineering services for chemical separation [ii] and reaction [iii] technology such as optimizing energy consumption, plant optimization studies, pre-engineering for governmental approval and basic engineering
- separation and purification of organic chemicals by means of crystallization and membranes
- mixing and reaction technology with static mixers (commonly used to realize division and twist processes in a pipe flow without additional power)

Figure 5:
Separation column
Source: Sulzer Chemtech (Shanghai) Ltd.

Chemtech's figures

In 2004, Sulzer Chemtech posted record results; orders received were up 19.3% from the previous year at USD154.2 million while sales rose by 28.7% to USD147.9 million. Operating income (EBITA) of USD15.1m was achieved due to high volume and increases in efficiency, while return on sales was 10.2%. Furthermore, large orders are expected in the coming months and the outlook for Sulzer Chemtech remains positive. Sulzer Chemtech employs about 1,200 staffs worldwide.

Customers, competitors and competitive advantages

Sulzer Chemtech offers solutions primarily intended to optimize the performance of industrial processes and refineries, petrochemicals, chemicals and gas plants through innovation, lower energy demand, higher product reliability, higher efficiency and increased capacity.

The mother company's customers are multinational companies in the oil and gas, petrochemical, chemical and plastics industries like BASF, Shell, Fluor, ExxonMobil, BP, Foster Wheeler, 3M and Hilti. For these customers, Chemtech is mostly providing engineering solutions and high-end (high reliability/high efficiency) equipment.

The global market size for separation columns is estimated at about USD 800 million, while the market for static mixers is valued at approximately USD 400 million.

Sulzer Chemtech's biggest international competitor is Koch-Glitsch, challenging Chemtech in most of the segments, followed by Chemineer, Mixpac and TAH in selected segments.

Figure 6:
China's oil production and consumption, 1980 – 2005 (thousand barrels per day)
Source: Energy Information Administration (official statistics of the U.S. Government)

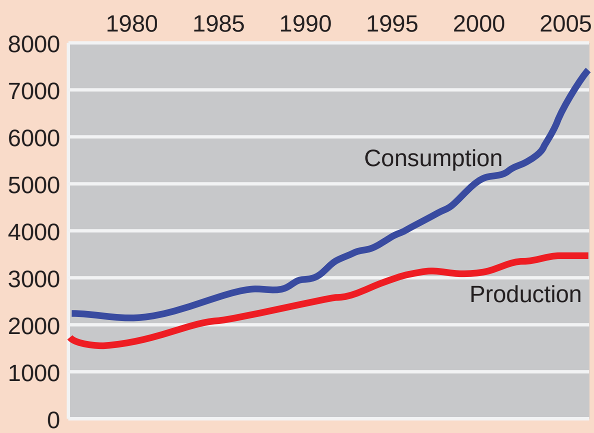
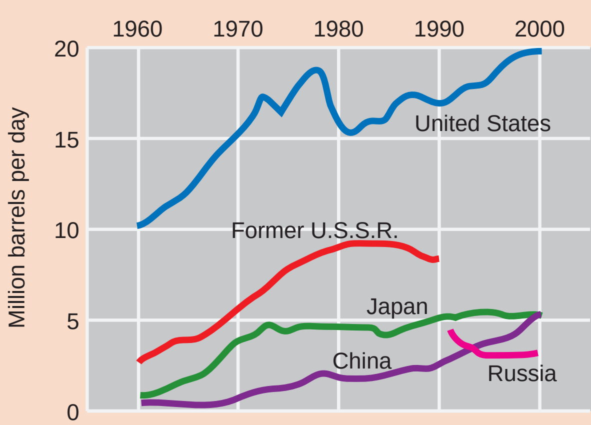


Figure 7:
Leading petroleum consumers
Source: Energy Information Administration (official statistics of the U.S. Government)



CHINA OIL INDUSTRY TRENDS and OUTLOOK

Petrochemical and refinery industry in China [2]

China's demand for oil is growing steadily (see Figure 6), and for the first time, surpassed Japan in 2003. In 2004, China is the world's second largest consumer of petroleum products, with a total demand of 6.5 million barrels per day (bbl/d). Although Chinese oil demand is growing, it is still far behind the 20 million bbl/d requirement of the United States (see Figure 7), showing the huge potential of this market. The Energy Information Administration of the U.S. Government (EIA) projected China's oil demand to reach 14.2 million bbl/d by 2025, with net imports of 10.9 million bbl/d. Asia is expected to be the region with the biggest refining capacity in the world by 2025 (see Figure 8). Chinese oil demand is a key factor in world oil markets and is often cited to be one of the main drivers of recent price increases.

Three major corporations are active in China: China National Petroleum Corporation (CNPC) in the north and west, Sinopec in the south and the China National Offshore Oil Corporation (CNOOC). CNPC is more focused on crude oil production whereas Sinopec is towards refining. The CNOOC handles offshore exploration and production and accounts for more than 10% of China's domestic crude oil production. Regulatory oversight of the industry now is the responsibility of the State Energy Administration (SEA) which was established in early 2003.

To meet the growing demand, major Chinese oil companies are striving to increase capacity. Planned projects include:

- CNOOC has a 240,000 bbl/d refinery project under development (Huizhou, Guangdong province), to become operational in early 2008
- USD3.5 billion expansion of the Quongang refinery in Fujian which will raise its capacity from 80,000 bbl/d to 240,000 bbl/d.
- CNPC is planning a major expansion of the Dushanzi refinery in Xinjiang

Another major issue for the Chinese downstream sector is the lack of adequate refining capacity suitable for heavier crude oil, which will become a necessity as Chinese import demand rises in the mid-term future and light crude availability is limited. Several existing refineries are being upgraded to handle heavier and more sour grades of crude oil.

Finally, with the rapid increase of petroleum products consumption, interests are being rekindled in the construction of greener field refineries that also values international environmental standards. Overall, the refinery sector is growing at an average of 30% per year.

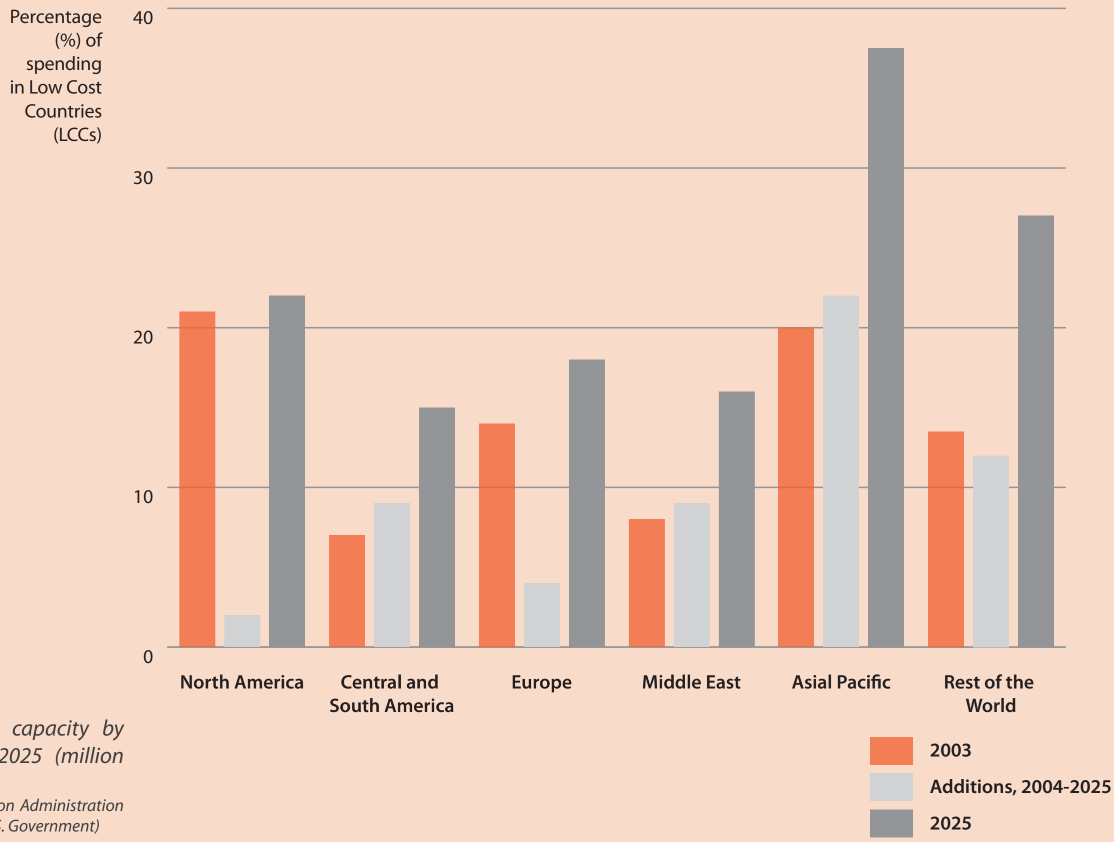


Figure 8:
Worldwide refining capacity by region, 2003 and 2025 (million barrels per day)
Source: Energy Information Administration (official statistics of the U.S. Government)

Sulzer Chemtech's China operations

Sulzer Chemtech entered China in 1989 because the company management believed early on in the importance of the development of the China market, even though Chemtech's equipment sales in China were low. The development process can be divided into two phases:

- In as early as 1991, Chemtech started production in Sulzer's cross-divisional workshop/office platform. Initial business volumes were expectedly low as Chemtech's decision to move in was strategic.
- From 2001, the Sulzer Chemtech's business took off due to the economic boom and the steady investments of foreign players. In 2003, sales more than doubled compared to 2000. This growth is expected to further continue.

In 2003, Sulzer companies in China reached altogether an annual turnover exceeding USD 20 million with more than 500 employees. Business grew at an average rate of +30% per year.

Targeted market segments

Thirty percent of Sulzer Chemtech Shanghai's customers are subsidiaries of global clients in China. Sulzer Chemtech Shanghai deals directly with the local subsidiaries, which often includes employees from the mother company. The remaining 70% are state-owned enterprises like Sinopec. The main drivers of business are a combination of large foreign joint venture investments and local oil companies investing in grassroots plants.

Figure 9:
Sulzer Chemtech's history and milestones in China
Source: Swiss China Survey, 2005

1950s	1972	early 1980s	mid 1980s	1989
licensee agreement for large low-speed diesel engines (tentative)	negotiations for the supply of large blast furnace blowers and monotube steam boiler for power generation.	activities intensification in all other products of the Group, especially: textile machinery, equipment for power generation and hydro carbonic power	new licensee agreement for large low-speed diesel engines with three Chinese shipyards	agreement to build a "wholly owned"Sulzer facility (workshop) for various products/divisions near Shanghai

Maintaining a premium in the value chain

Research and development for new products is done mainly in Switzerland, maintaining Chemtech's technology leadership. Chemtech's competitive advantages allow the company to obtain a premium on its products for the high-end market compared to competitors.

Supply side of Sulzer Chemtech

Sulzer Chemtech has about 20 locally-established suppliers of materials, mostly stainless steel plates, coils and similar materials. About one-third of Sulzer Chemtech's suppliers are foreign-invested, the remaining two-third is half state-owned and half privately-owned local suppliers.

Steel is a major portion of the material being purchased by Sulzer Chemtech in China. Approximately 50% of the steel supply is indirectly imported in the form of ingots and processed into production materials locally as local steel production is not able to cover the demand. Increasing steel prices in the recent past [3] has made the management of supply at predictable prices a difficult, although important, element to ensure profitability margins.

FACTS and ANALYSIS

Strategic vision for early, step-by-step entry

Sulzer's vision and strategy for China using a 'trial and error' approach to the market since the mid 50s allowed the Group to obtain a better understanding of the country's needs and development and favored the development of their China relations at the time when few foreign multinationals were making big investments in China. Sulzer's opening of a wholly owned enterprise in 1991 after an approval in 1989 is a pioneering step since wholly owned foreign enterprises' registration became a possibility and easily available to all foreign investors in 1995. The concept of a multifunctional workshop at the disposal of the divisions was a precursor to similar projects years later (the German Center, for instance, was not established until 1994, likewise the Swiss Center, which has a similar industrial component, was only set up in 2003).

This start-up configuration enabled the corporation to test the products and markets and select the ones with the most promising future. Sulzer Chemtech benefited from Sulzer China's incubator during its initial step into the market. Once the difficult, early years were over, the division had the opportunity to take over the facility and expand as needed.

Selling to state-owned clients

Although in technical terms the approach to all clients is similar, a different sales approach to state-owned customers and foreign-owned ones is usually needed. For example, purchasers of a state-owned company will expect big discounts on stated prices; therefore sales strategies need to factor such elements in.

Moreover, cultural understanding and specific experience with state-owned Chinese companies' business practices are also essential to develop the right negotiation strategies for every project. To acquire such project, it is important to establish a strong personal relationship with the technical personnel and negotiators. The organization of trips to the European factories, for example, helps in this aspect and provides opportunities for the client's staff to improve their understanding of the Swiss mother company's environment, concepts and technologies.

Foreign-managed companies are clearly more focused on technical aspects and the future cost advantages of the solution. Nevertheless, the cultural aspects mentioned above and the development of personal relations with the local staff of the foreign-invested client remains important.

Specifying contracts with state-owned companies

Different ways of doing business result in different styles of contracts when selling to a Chinese company. While in Western countries, much time is spent on developing a contract that specifies all possible elements and takes into account every aspect of non-performance, Sulzer Chemtech's state-owned clients only provide their own standard contracts on one page.

Specifications of the equipment to be purchased are added, but not in details, leaving room for changes. In some cases, this reduces the time needed to establish technical specifications and allows the buyer to specify details while the project is already contracted. However, the flexibility also plays in favor of Sulzer since Sulzer Chemtech can also re-negotiate to its advantage. Overall, this flexibility plays favorably for both parties as it allows immediate reaction to the fast changing environment and therefore provides further chances for the buyer to be profitable and Sulzer Chemtech to have a long term, successful client.

However, trust is very important for such specification process to offer the flexibility without misunderstandings or one of the parties attempting to take advantage of the grey zones against the other. Considering that China's legal system does not offer the same level of support for the execution of contracts as in Western systems, trust is indeed needed. Flexibility comes naturally as an additional advantage. This also explains the efforts that Sulzer is putting in to maintaining close contact with clients on the business as well as personal level.

Management selection and Human Resources

To facilitate the proper approach towards Chinese state-owned companies, Sulzer Chemtech's management was recruited from local companies and universities. This allowed immediate understanding of the local business ways and culture. Since personal relationship is important for Sulzer Chemtech's business in China, the company selected a team that has strong interpersonal skills to deal with customers and suppliers. In a fast growing environment managing the recruitment of human resources is a must and a challenge in itself. As a result, employees are going through extensive training in terms of product, service quality and company culture.

Supply management

The scarcity of steel and resulting price hikes necessitated paying particular attention to the management of supply and suppliers. It is also important to maintain supplier loyalty so that they do not decide to allocate their production to others or unduly raise prices at times when Chemtech is most in need of their materials.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Acquiring low-end market share and early client loyalty

Sulzer Chemtech is active mostly in the international customers and high-end segment in China; yet, a big potential lies in the lower-end segment which is currently dominated by local competitors. Operating with local cost level and more efficient production methods, Sulzer Chemtech is able to produce lower-end equipment at a competitive price by increasing volumes.

The name that Sulzer Chemtech built for itself through its professionalism and client solution-oriented approach also made it easy for Chemtech to enter into the market. More importantly, in addition to achieving turnover growth and profitability by venturing in to the lower-end market, Sulzer makes certain that it acquires the best clients.

Risks and difficulties

Investment in new project, payments collection

Taking into account the value of investing free engineering work to acquire new clients and projects, it is imperative to select valuable and trustworthy clients. Besides, it is common among local companies to fall behind payment schedules. This increases the business risks.

Establishing strong relationships through personal contacts

Strong personal relationships may create conflict of interests and make the company dependent on its staff. Should they leave, part of the client relationship is lost. To manage this situation, strong emphasis is brought on code of ethics and human resources management.

Success factors

Technology leadership, superior reliability and efficiency of the products

In a refinery there could be 40 columns and out of these, around ten are the heart of the system which must be ensured against failures. The main success factor for Sulzer Chemtech lies in its capability to produce highly reliable critical components. Failure of the critical components can result to the shutdown of the plant, which will cause losses far bigger than the equipment's cost.

The capability to offer a product with the entire range of service — from engineering and installation to maintenance — is necessary to provide the customer with the needed security and the convenience of having a single service provider for all needs. Chemtech's technical advantage also enables the production of more efficient components, creating with less input the same output, hence lowering customer's costs. The payback time for the customer's investment, due to reduced operational costs, is around 96 days.

The know-how of Sulzer, with a group division entirely dedicated to contractual research and development, allows Sulzer Chemtech to bring innovations to China with less effort than the local competitors. Sulzer's technology leadership allows Chemtech to be steadily one step ahead of the growing competition.

Adjustment of business ways and management selection

Sulzer Chemtech Division management has been able to respond to the differences of China's unpredictable and culturally different state-owned business environment to its own advantage. The selection of culturally-aware management with strong interpersonal skills has been essential to build the trust and relationships with clients, suppliers and staff which are essential in dealing with an environment such as China. The staff is localized as much as possible and gets motivated through job rotation programs and overseas training. The key positions can count on managers that are with Sulzer Chemtech since the beginning.

Timing and step-by-step approach, support from the Group

An early market entry and the mother company's pioneering support to its divisions by setting up a group incubator has provided Chemtech with an early mover advantage while minimizing risks through a step-by-step approach. This pragmatic method has proven to be very effective in choosing the right market and direction while at the same time reducing start-up costs for the Group's divisions.

Information on Sulzer Shanghai courtesy of:
Victor Chiam - General Manager, Sulzer Shanghai, China
Interview conducted by: *Nicolas Musy and Patrick Schaufelberger*
Case Study written by: *Patrick Schaufelberger*
Approved for publication on: *October 2005*

Notes

[i] Material forming or used to form a surface

[ii] Separation - is a process that transforms a mixture of substances into two or more compositionally-distinct products.

[iii] Chemical reaction - is a process involving one, two or more substances (called reactants), characterized by a chemical change and yielding one or more product(s) which are different from the reactants.

Sources

[1] Marina de Senarclens. (n.d.). Director of Engineer Shape our Futures. Senarclens, Leu & Partner AG. http://r0.unctad.org/gcandswissbusiness/presentations/deSenarclens.pdf

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[3] China.org.cn. (2005). Sharp Steel Price Increase Expected to Continue. Author. http://www.china.org.cn

5 Textiles & Equipment

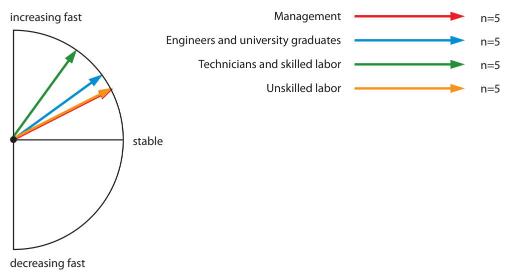
5.1 Industry trends

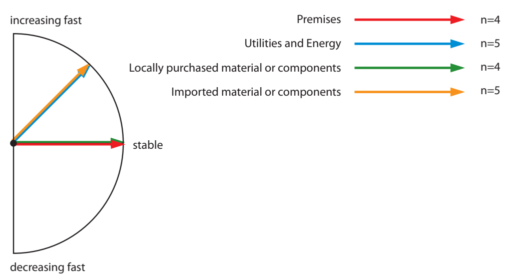
Below are the trends for the textiles & equipment industry as perceived by managers of Swiss subsidiaries in China.

5.1.1 Cost trends

Survey chart V - 11

In your industry and field of activity how do you expect following costs to evolve?
Textiles N=5

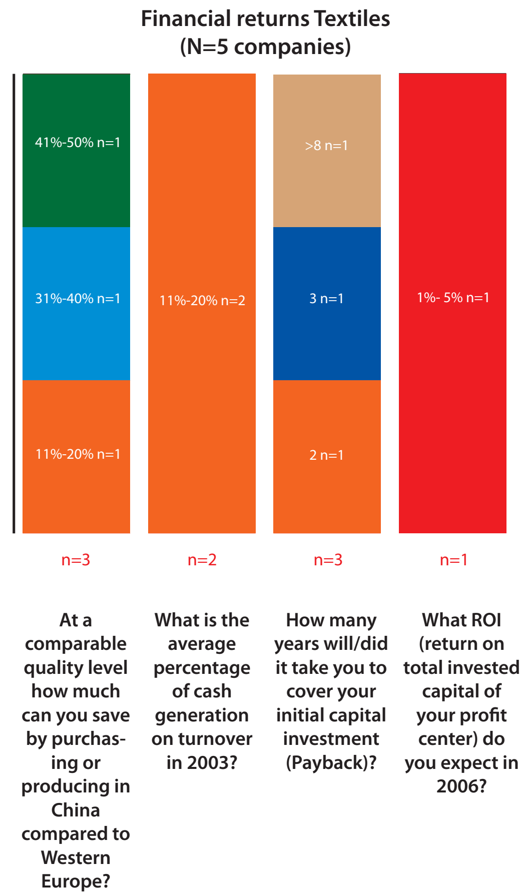




Source: Swiss China Survey, 2005

5.1.2 Financial returns

Survey Chart V -12



Swiss China Survey, 2005

5.1.3 Factors for Success

Factors for success are not available because of too few respondents in the textile category.

5.2 Textile industry: China's development and impact on the supply chain, from equipment production to finished garment

5.2.1 China garment making, fabrics & finishing industry

Textiles are the first industrial export products of China since her recent opening to world trade in 1980. **Until recently textiles accounted for the main export of China, with about 30% of the total**. (Yet, electronics are now a bigger proportion of China's total export.) With the up lift of quota system, the textile export from China has experienced rocket increase in the first half of 2005. However, the quota system is reinstated, but will be lifted again latest by end of 2007 if WTO agreements are respected by the EU and the USA]

In the first half of the 20th century (up to 1949 and the expulsion of foreign company out of China), the production of yarns, fabrics and garment making quality was up to world standards in the areas of China under foreign control (particularly Shanghai and Hong Kong, both stimulated by the British textiles technology and know-how).

Interestingly enough, while England was exporting more than USD1.3 billion of cotton to China in 1900, by 1935 the quantity had dropped 10 times – the Chinese (and Japanese) were producing locally more efficiently [1] .

5.2.1.1 The garment making industry

The Chinese garment industry of the 80's was born as a supplier to Hong Kong based garment makers and traders, themselves serving first the low-cost segments of the US market, then the European and Japanese mass markets.

Western garment collection producers and chain stores (Marks & Spencer, Liz Claiborne, Valentino, for example) followed and started purchasing in China directly. All of them, however, provide complete details of designs and technical specifications to their Chinese suppliers, who act as "OEM" producers

Due to the enormous production capacity potentially available in China (garment making is labor intensive) and the lack of exposure to Western fashion (Chinese did not learn English for decades like Indians, nor was it easy for them to travel in the 80's), **the garment producers of China have concentrated on large quantities low and mid-market items, produced according to clients' designs and specifications.** Though garment-making started as a state-owned activity, the low capital needed to start a garment producing operation allowed quickly the development of private Chinese (and mixed private-state-owned) garment factories.

Foreign investment in garment making was permitted from the initial opening of China, drawing mostly Hong Kong/ Macau and Asian capital (including Japanese).

As a result and due to the low cost, traditional "Fingerspitzgefühl" and high discipline of the Chinese workforce, garment manufacturing has reached excellent levels. However, design capacities remain comparatively very low: there are no Chinese fashion designers known internationally or in Asia (and practically none in China itself), even though there are international fashion names from Japan and Hong Kong designers known in Asia, at least.

"Design" department of Chinese textiles companies are prototyping departments, developing products based on clients' designs and detailed specifications.

5.2.1.2 The fabrics and finishing industry

On the other hand, spinning and weaving as well as finishing are capital-intensive activities. Additionally, and since they are closer to raw materials in the supply chain, foreign investment was initially restricted in these fields by the Chinese government to protect the investment in the sector made by state-owned companies and to promote the labor intensive garment making activities in the country. As a result, the production and finishing of fabrics has stayed in Chinese government hands until either they were privatized or Chinese private entrepreneurs were able to gather sufficient capital to start spinning, weaving and finishing factories. **The time has actually come, however, for small and medium private Chinese weaving operations to be set-up in large numbers, while management buyouts of larger spinning and finishing mills also bring these production steps in private hands.**

In addition, foreign investment in spinning, weaving and finishing has been completely opened and made simpler by China entry into the WTO (even though such investments were allowed earlier), so that **the international textile industry has started setting-up yarn and fabrics production as well as finishing ventures in China as well**. (These investments are however limited from European high know-how producers since most try to defend their position by keeping these capital-intensive activities at home as much as possible.)

Since spinning and weaving know-how in natural fibers has not evolved considerably in the last 50 years, China has been able to reach international quality levels in loom-state fabrics simply by purchasing up to date equipment (though top quality is not yet a priority for Chinese producers).

5.2.1.3 Finishing in China

Finishing in China has evolved differently. This production step did not keep up with the international progresses and just reaches and average quality, this for mostly two reasons:

- minimum investments are large (larger than for weaving) and not very attractive in terms of returns, to this day, to private Chinese investors
- new processes and know-how have been consistently developed abroad while state-owned enterprises did not have the creativity and openness to develop their own or acquire such know-how from abroad.

As a result, **quite some fabrics made into garments in China is still produced and finished abroad (mostly Italy for fashionable items, Japan, Taiwan and Korea for synthetic and technical textiles)**.

Yet, privatization and management buyout of state-owned factories is happening. It will certainly change the situation and provide China with the opportunity to catch up on the finishing of fabrics as well.

5.2.1.4 China, the world producer of garments

Nevertheless, China has become the world's main producer of garments, China's garment export reached USD 78.85 billion in 2003, account for 24.5% of the world total garment exported [2]. Current estimates bring this share to 50% in the next few years if no new protectionist barriers are set-up in replacement of textiles quotas that should be completely abolished at the end of 2007.

There is not much doubt left that China will be the main center of textiles production worldwide in the 21st century, replacing Britain in the 19th century and Europe, the USA and Japan in the 20th.
This trend is confirmed by these additional facts:

- **Textiles machinery suppliers sell 50 to 70% of their output to China.**
  More and more Western textile equipment producers are setting-up sourcing and assembly operations in China. They are re-engineering and re-designing their products to suit China, the main customer. Most of textiles machinery producers will eventually produce part of their range in China to stay competitive with locally equipment manufacturers.
  (For example: Benninger, Saurer, Rieter, Steiger to cite only some of the Swiss established in the Shanghai area.)
- The Italian and French fashion textiles producers (the garment-makers at least but also the rest of the production chain, by repercussion) are closing one after the other, replaying the disappearance of the Swiss non-technical textile industry in the 90's.

5.2.1.5 Achieving quality in China

There is an apparent contradiction between the level of quality of fabrics (particularly their finishing) and the ability of Chinese garment makers to conquer the world. To understand and resolve it one must put in light two aspects:

- In terms of yarn and weaving defects, due to a cheap and disciplined workforce, Chinese producers are able to spend time repairing defects or cutting around them. As a result, they can produce as good quality garments as Europeans with less good equipment and know-how, therefore less good materials.
- China allows the tax free import of materials for processing and re-exporting, so that all specialties fabrics that need a particular yarn or weaving know-how (for example microfibers or goretex) or a particular finishing can be easily imported, made into garments in China and re-exported.

This is also valid for accessories or fabrics used as part of garments, therefore enabling Chinese garment producers to combine their cheap materials with imported ones when needed for best economic efficiency.

5.2.2 Western advantages and China trends in the garment supply chain

Overall, the "West" (Europe, the USA and Japan) still has an important set of advantages in the garment supply chain. They are listed below from less strong to stronger western advantage. (Interestingly enough these advantages also follow an order from harder ware to softer ware; and this order also reflects how physically close the supply-chain element must be in order to serve effectively the sophisticated high-income end-users of developed markets):

1. R&D and production of textile equipment
2. R&D for finishing treatments and general high-class finishing of yarns, fabrics and garments
3. R&D and production of new fibers or fibers combinations
4. design and creation, both for fabrics and garments
5. branding, marketing and sales, distribution and retailing networks

These advantages will most probably be eroded from the hardware end in direction of the software one:

- textile equipment will be more and more produced in China, if only because China is the main consumer of such equipment and suppliers need to be close to their clients. With production moving, R&D follows naturally, again to serve customers better.
- Designers, marketers and retailers will need to remain close to those who wear their products, as a result such activities as fashion design, will naturally remain geographically located in the markets with high buying power.

5.2.2.1 R&D and production of textile equipment

Examples are already available of foreign companies re-engineering their equipment to produce it in China in a simpler way and at a cheaper cost, to meet the Chinese market demand and to use more of China's low cost workforce. As a result, textile production equipment will be more and more re-engineered and made in China for the Chinese textiles producers, be it by foreign textile machine manufacturers or by (fast) developing Chinese ones.

In similar cases (such as mobile phones for which China is the biggest world market), foreign multinationals came to dominate the Chinese market through local production because local technology was not available at China's opening and foreign companies served the market fully while also producing for export.

This trend will certainly push western textile equipment producers to reduce the development of sophisticated textile equipment geared for developed economies until the level of Chinese salaries start to rise and make production of textiles in developed economies more attractive, by comparison.

Such a rise in Chinese income is expected and hoped for by the whole world. However, such salaries increase in China (more than productivity will) in the next 10 to 15 years is doubtful. (See also Chapter VIII Sourcing & Purchasing, 'Are China low costs here to stay?') An important revaluation of the Chinese Yuan is also very much unlikely (see also Chapter II Legal, Tax and Finance, 'China's banking and currency system for foreign invested enterprises' including RMB exchange rate reform and RMB revaluation). In the coming decades, an important part of textiles machinery R&D and production will happen in China, at local costs level.

It will depend on western textile machinery producers to keep developing equipment for their own markets to maintain a textile industry in Europe and other developed economies: the temptation will be high to concentrate on the Chinese market when a considerable part (probably 80% or more) of the demand will come from China.

Yet and should the strategic choice be made to supply decreasing home markets, such choice will mostly be possible only if western textile equipment producers make sure to derive enough revenues from the Chinese market by producing and selling in China (the main market), and maintaining margins by dominating the sales of textiles equipment in China (This is the situation achieved by the multinationals producing most of mobile phones in China for China and an important part of them for the rest of the world).

5.2.2.2 R&D for finishing treatments and high-class finishing of yarns, fabrics and garments

We would expect treatments R&D and textiles finishing to follow the equipment manufacturers in China: such activities require relatively few additional investments considering the existing finishing mills; besides Chinese engineers are getting up to date in most fields. (R&D is actually becoming the next big investment in China for multinationals and China as a country may spend more than the EU in R&D by 2010 [3])

The current state-ownership of finishing mills and the low attractiveness of the textile industry for bright chemists may be a temporary delaying factor; however , the privatization (often through management buyouts) of state-owned factories will be a stronger factor. On the other hand, finishing is the bottleneck of the Chinese manufacturing supply chain: yarn production, weaving and garment-making all reached good or very good levels of manufacturing quality. It is unlikely that this situation becomes structural.

5.2.2.3 R&D and production of new fibers or fibers combinations

Technical fibers and textiles produced in Europe are in many cases niche businesses, whereas American and Japanese (Taiwanese and Koreans, often as copiers) produce the larger volumes.

As long as worldwide volumes generated by niche technical textiles remain low and other opportunities are available for Chinese in the bigger volume businesses, the technical textile industry of developed countries will most probably remain competitive. Besides with new developments following fast enough, intellectual property protection (e.g. Schoeller of Switzerland) and branding (e.g. Lycra of Dupont, Goretex) should keep this sector alive in the long term.

5.2.2.4 Design, branding, marketing, sales, distribution and retailing networks

By keeping access to the consumer, fashion companies that own design branding and sales channels may keep a very strong advantage as long as there are large numbers of high-income end-users in the developed world.

Owners of the customer end of the garment supply chain have little loyalty to manufacturers: their main target is to remain competitive and to maximize profit. As a result, **they are flexible with the rest of the supply chain and manufacture where it is most convenient and efficient for them [this cannot be used as a marginal: we do not know who is they]**. (Top class fashion names are also producing in China for their developed markets.)

Many such names are also looking forward to sell into the Chinese market and are manufacturing in China for that purpose (Givenchy Men, for example). It may not take very long until the same manufacturing capacity is used for export to the world markets.

The delaying factor to this trend will be the negative "Made in China" perception for luxury items. As soon as production origin is not legally required, however, brands omit the manufacturing origin and use their name to achieve the selling advantage. ("Givenchy of France" instead of Givenchy, Made in France, for example.)

Besides, the time when "Made in China" is a sign of quality in textiles manufacturing will come (Japan is a good example of quality perception changing from poor to excellent over time).

Sources

[1] Studwell, J. (2005). The China Dream. Profile Books Ltd.
[2] China US Business Council, Oct 20 2005
[3] Chinese Garment Producers are Prudent about the Pro-quota Era. (2004). Guangzhou: www.xinhua.net. Retrieved October 8, 2005, from http://news.xinhuanet.com/fortune/2004-11/01/content_2163791.htm

5.3 Saurer Textile Machinery Co., Ltd.

Textile Machinery Industry

SUMMARY

The Saurer group is composed of two divisions providing solutions for the textile machinery and automotive transmission systems: Saurer Textiles and Graziano Trasmissioni. Saurer Textile is the world's leading manufacturer of technologically sophisticated systems for spinning, texturing, twisting and embroidery. Graziano Trasmissioni is a leading manufacturer for sophisticated gear, gear groups and complete transmission systems for agricultural, earth moving and special vehicles as well as for four wheel drive passenger cars and luxury sport cars.

This case study focuses on Saurer Textile's activity in China with particular attention to the man-made fibre business unit and to:

- Total solution systems and customer orientation
- Supplier's management
- Operational and legal aspects
- Human resources and internal structures

Figure 1:
Saurer Textile's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing			Saurer				
Purchasing	For own China operations	Saurer		Saurer			
	For mother company						
	For third party						
Selling	SOE		Saurer		Saurer		
	POE		Saurer		Saurer		
	FIE Global		Saurer		Saurer		
	FIE Local		Saurer		Saurer		

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of SAURER Group in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of SAURER Group in the global scale

GLOBAL TEXTILE TRENDS and OUTLOOK

EU[1]

EU15 textile and clothing import growth slowed markedly in value after the late 1990s, while in the recent years, imports have declined consistently. After rising in value in 2000-2001, imports fell marginally in 2002-2003. But in 2004 growth resumed with an increase of 3.4% to Euro66.7 billion (USD89.3 billion). In volume terms, imports have continued to increase over the years. In 2004 they rose by 7.5%, reaching 7.44 million tons.

Price competition among suppliers has intensified as trade liberalization progresses. In 2004, the average import clothing price fell by 3.8%, following declines in 2001-2003. This brought the total decline between 2000 and 2004 to almost 19%.

The fall in import prices is causing concern among EU producers who are finding it increasingly difficult to match the lower price levels. Furthermore, EU exporters suffered in 2002-2004 from the appreciation of the Euro against the US dollar. This eroded the gains made in 2001 when the Euro weakened. With export growth weak and import volumes up, EU15 textile output fell by 4.9% in volume in 2004 after having fallen by 3.5% in 2003. EU15 clothing production, meanwhile, declined by 6.1% in volume following a 6.7% fall in 2003.

World cotton production [2]

Since 1950 the world consumption of cotton has more than doubled from 7.6 million tons in 1950/51 to 18.5 million in 1999. Three main factors have promoted increases in cotton production since the mid 1990s:

- new technologies
- the creation of new areas dedicated to cotton growing
- government support to cotton producers

These same factors are expected to continue to support cotton production until 2010.

The trade of raw cotton between China and the rest of the world is one aspect influencing global prices since China is the largest producer and consumer of cotton. Consumption rose to a point where in 2003 and 2004, with internal stocks depleted, China needed to import raw cotton. China is expected to end 2005 having imported a near record amount of cotton, but its stocks have continued to tighten. With output down in 2006 and consumption continuing to rise, China will have to import three tons of cotton just to keep ending stocks from shrinking further in absolute terms

Another influence on global prices is given by new technologies, the most visible being the genetic engineering of cotton. The growing areas of genetic engineered cotton rose from 2% in 1996 to 21% worldwide in 2004. Genetic engineered cotton is commercially approved and grown in nine countries: Argentina, Australia, China, Colombia, India, Indonesia, Mexico, South Africa and the US but its use is concentrated in Australia, China and the US.

The area dedicated to genetic engineered cotton varieties is expected to rise to 40% of the world area under cultivation by 2008, accounting for 50% of the cotton production. Genetically engineered cotton does not result in higher cotton yields but reduce the use of insecticides, lowering the cost of production and the chemical pollution due to pesticides.

The most significant impact of the use of genetically engineered cotton has occurred in China, where the adoption of genetically engineered cotton in the eastern part of the country has significantly reduced damage from insects, lowered production costs and increased the income of growers. The increased use of other existing technologies and crop management techniques has also contributed to contain the cost of producing cotton and to increase world cotton production.

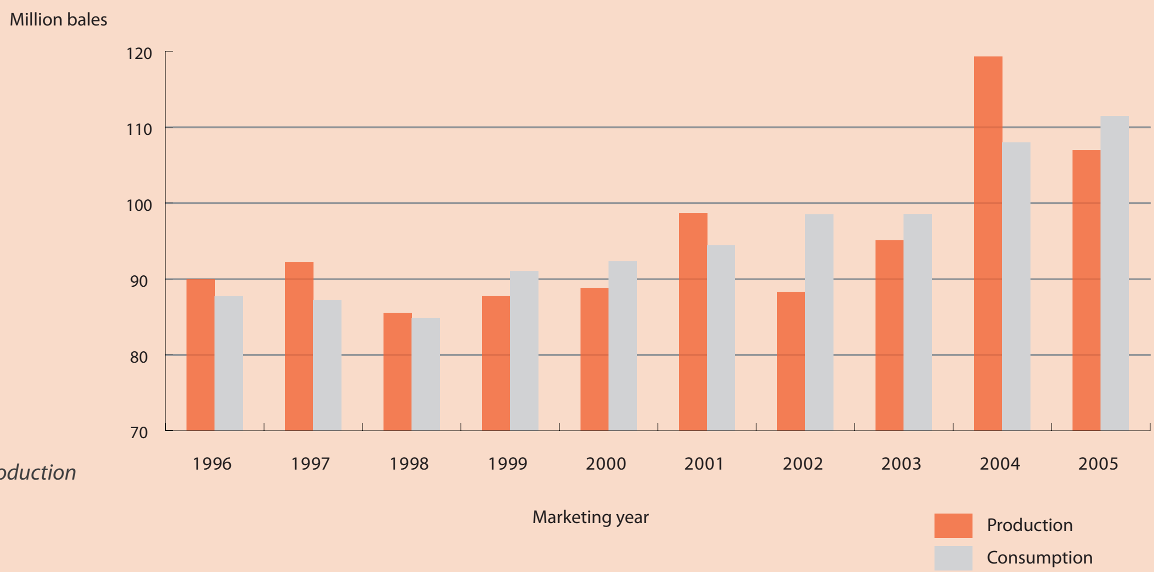


Figure 2:
World cotton production and consumption
Source: USDA.

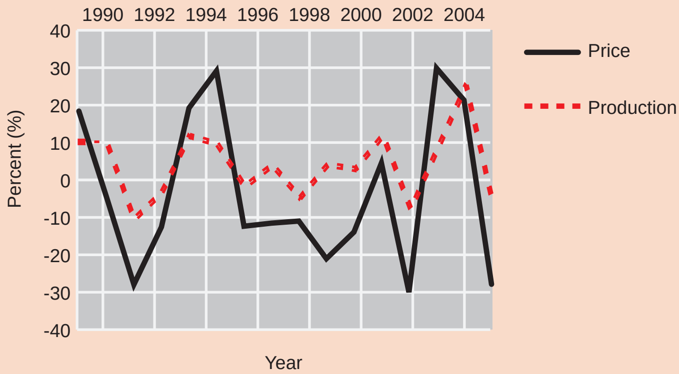


Figure 3:
World cotton prices and production, percent change
Source: USDA and Cotlook Ltd.

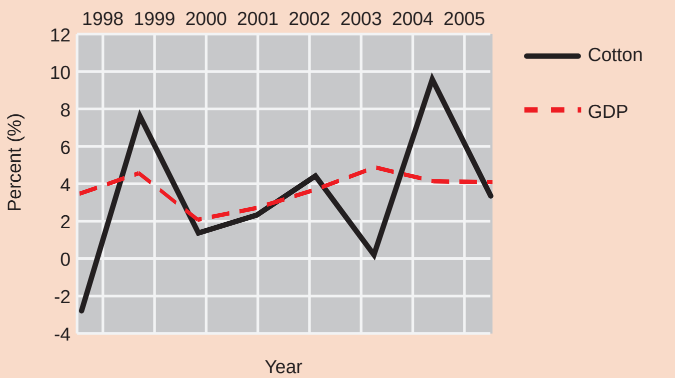


Figure 4:
Growth in world cotton consumption and GDP
Source: USDA and International Monetary Fund (IMF)

Under pressure from lower prices, and with more normal yields, world cotton production in 2006 is expected to fall 10%, to 23 million tons. With three-quarters of the 2005 marketing year completed, world cotton prices in US dollars have fallen 26% from the same time one year earlier).

Imports of raw cotton by China are expected by the USDA to average one million tons a year until 2010, equivalent to 15% of world trade in raw cotton, which will probably make raw cotton prices grow in average until 2010.

MOTHER COMPANY – SAURER Ltd.

Company background and current situation

Saurer Group's two business divisions (Textile Solutions and Transmission Systems), employ almost 9,000 employees generating a turnover of about USD1.5 billion. Saurer Textile Solutions is based in Germany, with business units in different countries of the world. Several companies and brands have been acquired by the group to round the product and services portfolio:

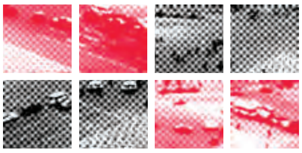
- Barmag and Neumag: engineering, construction and integration of equipments for the production of synthetic staple fibres [3] and BCF [4] yarns [5]
- Allma and Volkmann are experts on the yarn twisting and steel cable twisting sector
- Schlafhorst: rotor spinning and winding with the Autocoro and Autoconer products
- Zinser: construction of ring spinning systems.
- Saurer Hamel and Melco: worldwide market leaders in the embroidery machines sectors , from the technical embroidery design to the finished product

Customers and market segments

Saurer Textile Solutions' customers are more than 3,000 textile producing companies worldwide. The textile solutions divisions serve the following segments:

- Spinning systems (winding systems, ring spinning systems, rotor spinning systems)
- Filament (filament spinning, synthetic stable fibre, texturing systems)
- Twisting (twisting systems)
- Embroidery (embroidery systems)
- Nonwoven solutions
- Automation for textile industry

In 2005 Saurer Textile Solutions Group is making more than 30% of its turnover in China. The reason for the big growth in Asia and especially in China lies in a shrinking demand for textile machines in the rest of the world due to relevant market shifts.



CASE STUDY

Competitors and competitive advantage

Saurer Textile Solution's competitive advantage, lies in its leading technology position, combined portfolio of equipment and its competence in plant design, construction and engineering, enabling Saurer to deliver total solutions for its customers, starting from engineering until installation and marketing support. Figure 6 shows the main competitors of Saurer Textile Solutions in the different market segments and the market leadership of the company in almost every segment.

As can be seen from Figure 7, the Japanese companies form the biggest number of competitors, followed by Italian companies. However, no competitor is present in the full range of all technology segments. Also, growing local competitors in China and India have to be considered.

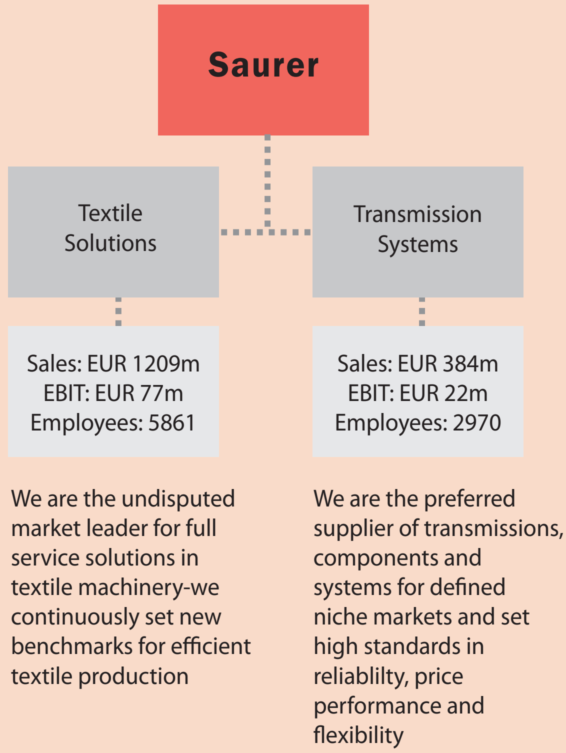


Figure 5:
Saurer Group structure and figures for each core business division
Source: Saurer Textile Solutions

CHINA INDUSTRY TRENDS and OUTLOOK [6]

Since 1998, China (Mainland) has been the driving force of the world textile industry. The Chinese industry processed 6.5 million tons of raw cotton in 2002-2003, an increase of 2.2 million tons since 1998/99.

The textile industry in China is highly dependent on the export market, which in turn depends on political trade agreements and foreign countries protectionist measures. Low labor costs and Chinese policies have improved the country's competitiveness vis-à-vis other textile exporting developing countries, and China has been able to increase its share

Figure 6:
Saurer Textile Solutions' global market share and competitors
Source: Saurer Textile Solutions

	Brands	Mkt. Vol. in CHF mill.	Market Share	Pos.	Main Competitors
SPINNING					
Ring Spinning Systems	Zinser	500-1000	25%	1,2	Rieter, Toyota, Marzoli, Süssen, Howa
Winding Systems	Schlafhorst	500-800	38%	1	Murata, Savio
Rotor Spinning Systems	Schlafhorst	400-800	60%	1	Rieter, Savio
FILAMENT					
Filament Spinning	Barmag	900-1700	40%	1	Teijin Seiki, Toray, Murata, Rieter
Synth. Stable fibre	Neumag	250-500	40%	1	Lurgi Zimmer, HILLS, Fare
Texturing	Barmag	550-1100	35%	1	Murata, Rieter (ICBT)
TWISTING					
Twisting Systems	Allma, Volkmann	500-750	30%	1	Murata, Rieter, Daewon, Savio, local Manufacturers
EMBROIDERY					
Embroidery Systems	Saurer, Melco	300-500 (excl. multihead)	50%	1	Lässer, Tajima, Barudan

of world textile and apparel exports since 2000. The rapid expansion of the Chinese textile industry has changed the Chinese trading position from net exporter to net importer of cotton. Net imports are projected to average one million tons a year until 2010, providing upward pressure on cotton prices during the period. China is widely expected to catch 50% of the world textiles market by the full removal of protectionist barriers, between 2008 and 2010.

SAURER in CHINA

Subsidiary background and current situation

Saurer and its daughter companies represented by worldwide well-known brands have strong business relations for decades, which includes own production sites, joint ventures (JVs) and sales offices in Beijing, Shanghai, Hong Kong, Wuxi and Suzhou.

Barmag, now part of Saurer Textile Solutions, was exporting to China since 1978. Barmag obtained the exclusive delivery of the textile machines for synthetic yarn production until end of 1984, when the government opened the market for the selling of textile equipment. The first licensing cooperation contract happened in 1984, through a group of Chinese organizations, which transferred the technical know-how to Hong Yuan Machinery in Wuxi and to Jing Wei Machinery in Beijing.

In 1996 the cooperation contract was transformed into two JV. Later the local JV partner (Hong Yuan Machinery (Wuxi), was transformed in 2002 into a WOFE and transferred to Suzhou. In September 2005 Saurer Textile Solutions moved into a new facility four times the current size prepared for the whole group in Suzhou. In total, ten business units will operate from there, ranging from service and sales activities to full-line production including design, assembly and mechanical manufacturing. The new company has a total size of 70,000 square meter roof area and will be the central hub of Saurer in Asia. It employs about 600 people to be expanded to over 1,000 within the next year. The new hub will contain 4,000 square meters of high-tech CNC machines, enabling Saurer to specifically design and produce components for the Chinese market. Designers and engineers are capable of 3D-CAD works so that there is constant innovation in the products, bringing new releases within short time to market and complete focus on the demand of the Chinese customers.

All design and engineering is coordinated and structured in the international network. Saurer's business units control and guide this process in their worldwide responsibility for R&D, production, logistics and sales of their products. There are joint projects run with European and Chinese engineers as well as exclusively Chinese-run projects.

Country of origin	Companies
Japan	HOWA, Toyota, Tajima, Barudan, Teijin, Toray
Italy	Savio, Marzoli, Faré S.p.A.
Switzerland	Rieter, Lässer
Germany	Süssen, Lurgi Zimmer,
Korea	Daewon
USA	HILLS Inc.

Figure 7:
Competitor's countries of origin
Source: Saurer Textile Solutions

CASE STUDY

Motivation

The focus on China is driven by the group's strategy to be close to customers and be substantially present with company set ups in the biggest world markets. As China is of major relevance today further investment is planned.

The main motivation has always been the sales potential of the Chinese market. Formerly, machines have been ordered and supplied directly from Germany to China. Later in 1996, through the establishment of a JV, Saurer started production and purchasing activities in China. Today, they are going completely local in value adding .

Customers and sales

The market especially in China divides into three segments high-end, middle-end and low-end. The company's main activity is in the high and middle-end market.

The machines sold from China are mostly manual machines targeting the middle segment, allowing producers to keep production costs low with cheap labor, while being able to keep high quality through more extensive (manual) quality checks. Machines are sold 80% locally, while 20% are exported to Vietnam, Thailand, Pakistan India, Indonesia, Brazil and Egypt.

Since 2000 the local customer's profile is changing from state-owned companies to private-owned ones, which now form the majority of customers. Sales of man-made fibres equipment is not expected to grow, while for the cotton segment a growth of 6% to 7% is anticipated.

Suppliers

Saurer Suzhou Ltd. has around 150 suppliers, ranging from small to big, mainly local private-owned companies. Eighty percent of the purchasing is done with eight key suppliers. Although a high degree of localization has been achieved, key technologies are supplied from the European mother companies.

Value chain

Saurer is a machinery supplier for the textile industry and is active in the whole value chain, from the local purchasing, to engineering and producing until installation and customer services.

Competitors in China

Local as well as international competitors are present in the man-made fiber segment. Apart from the international competition, local competitors are also well established. Most of the local competitors are originally state-owned companies or new private-owned companies that were introduced to the market since 1999. The textile machinery market will face a consolidation in the coming year. This shakeout will let only the financially strong companies with international scope of business survive. Strong competitors are the Japanese textile machinery companies .

Competitive advantage in China

An advantage towards local competitors is achieved through better quality standards which the customers rewards with better price.

Local manufacturing and sourcing allows lower cost operations, while the international Saurer standards of quality, applied in China as in Europe guarantee for the quality of processes, assembling and final product. This is an advantage towards international competitors that are not present in China with own operations importing completely into China. Assured by the brand names, the customer recognizes that he is served with superior quality and service. For instance, the name Barmag adds more edge to the advantage, being known in the industry for its long lasting reliability and for the total services offered (from engineering to integration).

FACTS and ANALYSIS

Set up (location selection)

The reasons for choosing Suzhou as a location are due to the quality of human resources available for textile machinery production and related services that can be hired and the quality of the infrastructure. Starting up with a small rented building in the mid 90's, Saurer's investment in the Suzhou Industrial Park amounted to USD30 million.

Structures

In China, the structure and the use of synergies mirror the policy of the company in Europe. In both regions Saurer is organized in business units which run their main processes, sales, fulfilment, R&D in own responsibility and are supported by centralized service processes (Finance, IT, HR, etc.). This concept drives synergies and leads to most efficient and cost saving results.

Sourcing and suppliers management

Maximized localization is the policy of Saurer Textile Solutions in China. One hundred percent of the material can be bought locally and should be done at least within a period of four or five years. This applies also to electronic or mechanical components under IP protection. With some technical creativity it is possible to find alternatives to standard components sold by third parties under IP rights that produce the same result with a different functionality (hence not breaking any patent law). These components can then also be bought locally at a cheaper price than the patented ones. Rethinking the process can lead to substantial savings.

Compared to the year 2000, the local suppliers reached a quality standard that makes intensive audits and regular checks of their workshops less necessary.

Corporate culture and human resources management

Saurer believes that especially for the start-up phase of a company the selection of employees is extremely important. However, for established businesses like Textile Solutions the selection is less critical (but still important), because processes are well prepared and described, from the inquiry to the end of the approbation period. This enables employees to clearly understand their responsibilities, duties, and scope of operation. Internal development and career opportunities as well as attractive compensation packages are important tools for HR to manage the difficult conditions of today's China labor market.

To retain the best employees Saurer has an internal assessment centre that helps employees to develop their career by looking at their strength. Intercultural events and management seminars further round the package of services offered. Most important for retention is a management style, that delegates responsibilities. Employees must identify their work with the success of the company, then they will bring the extra power needed in a successful organization.

To start-up a subsidiary Saurer Textile Solutions considers the use of expatriates the best choice for the first two or three years, before transferring the company to local managers. This is so because it is important for the subsidiary to have a structure similar to the mother company. A corporate culture has to be first established by people that have worked in and know the mother company, only then step by step, can the leadership successfully be transferred.

Business model

About 90% of the machine production costs are material costs, the remaining 10% is labor cost. The machines are delivered within four to six months; installation time is ten days. Later on technical people are sent to optimize the product outcome and to help them with process optimization. Spare parts and maintenance are part of the overall business model. After sales service is also an important part of the revenue; maintenance throughout life time is particularly profitable, especially considering that some machines have been running for 30 years.

CASE STUDY

Intellectual property and technology transfer

The protection of IP is difficult under the existing condition and market behaviours in China today. Saurer as technology leader has to incorporate measures of protection in all processes and operational levels. Starting from IP strategy to employees and supplier contracts know-how drain has to be eliminated. Codes of conduct for IP and purchasing and technical data security policies assure a maximum protection level.

Legal environment

There are no special legal restrictions for the textile machinery production. Common regulation on imports duties and licenses apply. The legal framework is perceived by Saurer Textile Solutions to be volatile. For instance changes in the amount of taxation can be announced and enforced by the authorities within two month, sometimes authorities even make a change valid retroactively. Some changes however, have been announced but never implemented.

An example is the misuse by some foreign companies of the import duty free right, for parts and components destined to the production of equipment for export. After cases of companies selling locally the equipment made with the duty-free imported materials were discovered by authorities, a strict regulation was announced: all companies had to pay import duties on imported parts or components and then had to prove the export of the final product in order to get a refund on the import duty within about five years. This regulation has never been implemented, but had a psychological impact on the management of all companies.

Another unique example is an announced import duty on Intellectual property rights. New, nowadays executed regulations, consider, that also imported patented know how through licensing, royalty or on technical transfer agreements shall become subject to import duty.

Saurer Textile Solutions has a general business license for manufacturing all kinds of textile machines including upgrades, customer services, and other related services as well as a trading licence.

Courts and disputes

Saurer does not hesitate to bring patent infringers, if necessary. The legal system, although still open to many interpretations, is considered to be improving. Some cases can also be settled by direct negotiations with competitors violating Saurer IP rights.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

- The new manufacturing hub placed in Suzhou is a big opportunity, since the group can make use of synergies.
- The hub is a potential place for enhanced R&D activities, hiring highly qualified scientists, for the local market products

Risks

The following risks have been identified:

- more difficult finance situation in China
- protective measures by central government to regulate economics with impact on Saurer China business (soft landing, micro economics)
- in the location choice, which might lead to power shortages
- in the legal environment, where new regulations that have an impact on the company's profitability are issued within short term notice
- in the copying of parts and potential loss of know-how

Difficulties

Following difficulties have been identified:

- Coping with the fast changing legal environment with new or changing regulations obliges the company to quickly adapt to the new situation. This means that efforts are needed every time a change is announced and (possibly) implemented.
- Ways of splitting the know-how have to been carefully prepared, for example by selecting suppliers in different geographic regions and giving to them only the necessary parts for manufacturing of the design.
- Difficult protection of IP in praxis

Success factors

Human resources management

Keeping the key human resources is one of the key factors for success for Saurer Textile Solutions in China. Saurer was able to achieve a fluctuation rate of less than 1% for key positions, while keeping salary structures stable. The low fluctuation rate is sustained owing to a consistent policy:

- clear definition of all the procedures
- mutual respect and delegation of responsibilities, enabling the identification of the employees achievements with the company's success, hence motivating them
- salaries according to market
- an assessment centre to help the career development of the employees
- management seminars and activities
- flat hierarchies

Customer orientation, selling solutions

Customer orientation is the main issue to achieve success. Offering a one point solution for all the customer's needs connected with textile machines is a major success factor. The awareness to keep an ongoing relationship and to understand the customer's needs and future plans is the duty of all Saurer employees and implemented in the companies vision.

The total solution package allows:

- To reduce the total cost for the customer, since he benefits from Saurer's synergies
- To generate income out of the whole product life cycle (from engineering to spare parts and maintenance)
- To get better margins through services
- To get customer feedback for future developments

Localization and suppliers management

To be competitive in all segments of textile machinery market, Saurer is fully localizing its products. Quality must be maintained and success with suppliers is one key to it:

Following factors have been mentioned by Saurer:

- long time business relations
- growing together business wise (win-win relationships)
- defined processes between the partners

In China to gain trust of new suppliers, keeping the word given is a must. Saurer has been working with certain suppliers for six to seven years.

Conclusion

The integrated mastering of operational aspects (product localization, human resources, client management) and strategic elements (systems solutions) in the specific Chinese environment (legal system and changes, difference of approach towards local and international customers) allows Saurer to be profitable in its key and highly competitive market.

Notes

i Source: www.textilesintelligence.com

Sources

1 Source: USDA

2 Source: USDA

3 Textile raw material, generally characterised by flexibility, fineness and high ratio of length to thickness (Source: TexWorld.com)

4 A textured continuous-filament yarn, generally used either as a pile yarn in carpets or for upholstery fabrics. BCF yarn is usually made by hot-fluid jet texturing (Source: TexWorld.com)

5 A product of substantial length and relatively small cross-section consisting of fibres and/or filaments) with or without twist (Source: TexWorld.com)

6 Telecom, electronics & precision

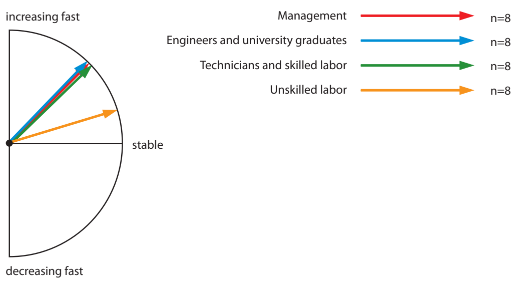
6.1 Industry trends

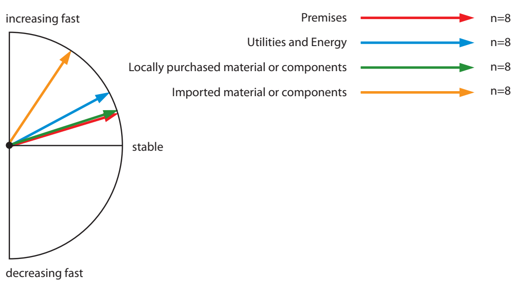
Below are the trends for the telecom, electronics & presiscion industry as perceived by Managers of Swiss subsidiaries in China.

6.1.1 Cost trends

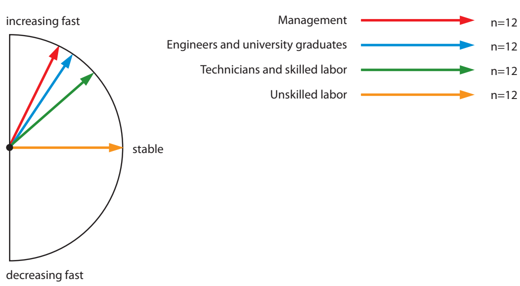
Survey chart V - 13

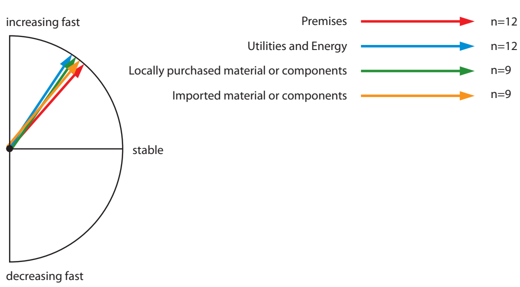
In your industry and field of activity how do you expect following costs to evolve?
Electronics / Electrical Engineering / IT / Telecom N=9



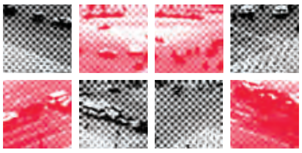


In your industry and field of activity how do you expect following costs to evolve?
Manufacturing N=12





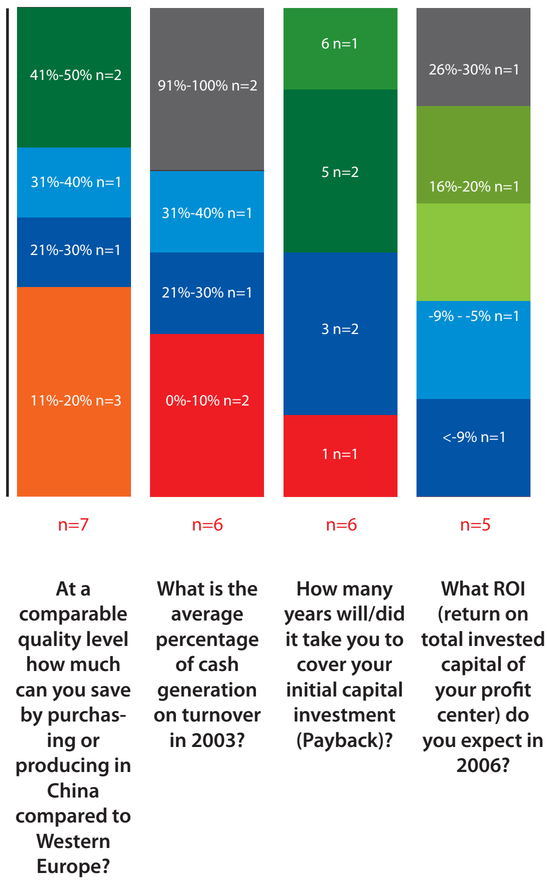
Source: Swiss China Survey, 2005



6.1.2 Financial returns

Survey chart V - 14

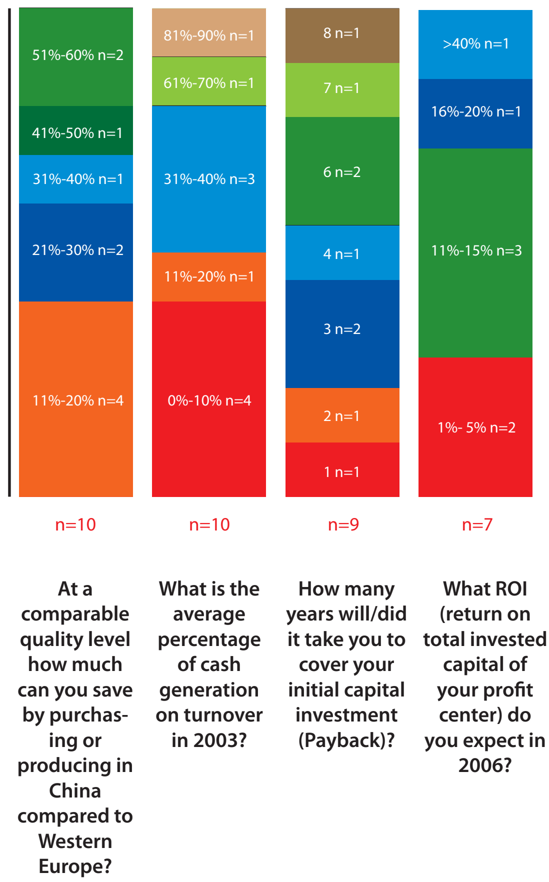
Financial returns Electronics - IT - Telecom (N=9 companies)



Source: Swiss China Survey, 2005

Survey chart V - 15

Financial returns Manufacturing (N=12 companies)



Source: Swiss China Survey, 2005

6.1.3 Factors for success

Survey chart V- 16

Success Factors Electronics / Electrical Engineering / IT / Telecom
(Companies in China, which achieved at least 50% of their objectives N=9)

Source: Swiss China Survey, 2005

6.2 Precision parts for the telecommunication industry

by Tim Wieringa, project manager and head of the HR department, CH-ina

6.2.1 Introduction

This section provides an introduction to the precision parts industry in China and their applications in the mobile telecommunication sector. This industry is not regarded as a classical industry and is rather a characterization of suppliers for high-precision parts for a range of varied industries.

Precision parts companies are mainly derived from the watch industry, where very small and precision-made parts are needed. The starting point for this high precision manufacturing was the mechanically-controlled CAM-machines, later replaced by CNC, electronically-controlled machines. Today, laser-equipped lathes and machinery dominate the production techniques used in this industry.

One of the traditional homes of the industry can be seen in Switzerland in the Jura Arc region (a range of hills which starts in Geneva, passes Neuchatel and Bienne and goes on up to Basel). Today, the industry extends to Southern Germany and the Eastern sub-alpine part of France. Depending on their skills, precision parts companies today are suppliers to industries such as watch, consumer electronics, telecoms, automotive, medical devices, weaponry, and aerospace. The last two examples represent large high-precision parts; whereas the other industries are mostly concerned with rather small parts and applications.

The precision parts industry is only represented by eight country associations worldwide -USA, UK, France, Germany, Ireland, Spain, Sweden, and Switzerland - and one global association: "Syndicat International du Décolletage". This small number of associations goes to show how few countries actually view the manufacture of precision parts as an industry in itself. Yet, in the US, the industry achieves an annual trade volume of USD 5.0 billion [1].

6.2.2 History of precision parts in China

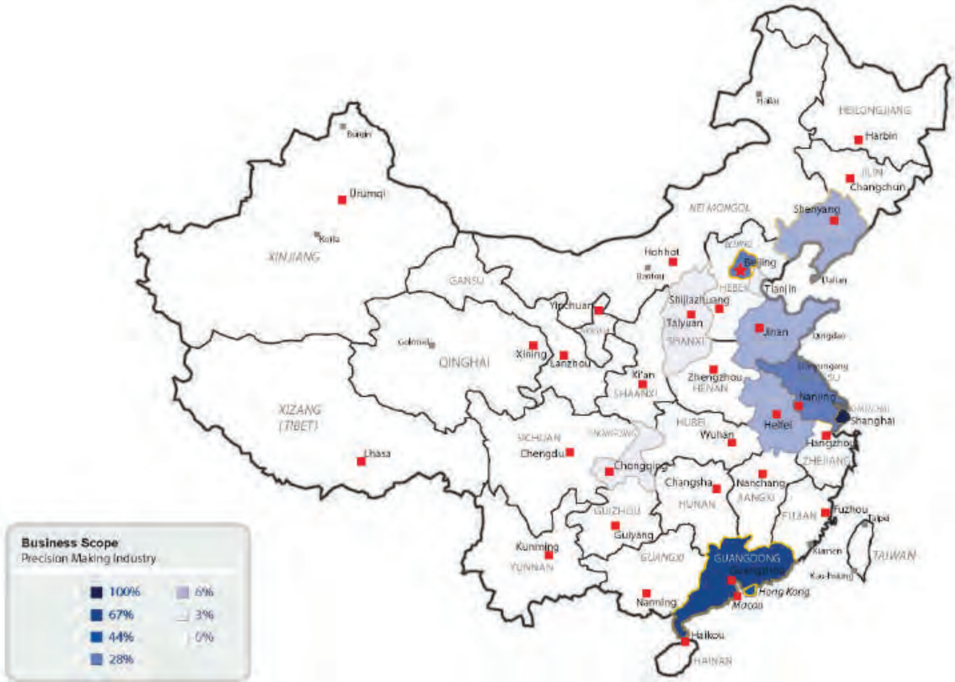
In China, precision parts are not regarded as an industry (in fact a foreign company is at the origin of the creation of the category 'Precision Parts Manufacturers' in China's Yellow Pages). Still, many precision parts manufacturers operate in China in the various above-mentioned fields. Actually, high precision parts originally started in China with the manufacture of weaponry.
Later on, particularly **during the 1980s and early 1990s, the watch industry was actively encouraged by the government**, which led to the establishment of 30 vertically-integrated state-owned watch making factories. Yet, besides being fully equipped with imported precision lathes, most of these companies failed to meet international standards for the manufacture of watches and other precision parts; in fact, only a few privatized workshops are currently able to produce reliably to internationally required levels of precision.

Precision parts for the watch making industry

Mostly they are found in the Yangtze Delta, Shandong Peninsula, and in the Guangdong area. In some industries, such as automotive, the lack of local qualified suppliers has forced the vehicle manufacturers to produce these parts in-house.

Density and distribution of Swiss companies in the Precision Parts Industry
(indexed on Shanghai which has the highest density,100%).
Calculated on basis of data supplied by Swiss Business Hub Bei-

jing



Though the precision parts industry in China is not yet mature, some foreign companies have experienced very rapid learning rates in their Chinese subsidiaries. **A few months only after start of production, the Chinese subsidiary of one Swiss manufacturer surpassed the productivity and scrap rate of its parent company**. Such steep learning curves indicate that Chinese have the potential ability to efficiently produce quality that will rival traditional Swiss companies.

The precision parts industry in China today is highly fragmented and still in its infancy. However, given the market needs, Chinese traditional skills for detailed and minute work, and private entrepreneurs' acquisition of valuable, state-owned equipment, a growing number of local and foreign-invested specialized precision parts manufacturers will develop in China.

6.2.3 The mobile telecommunications industry

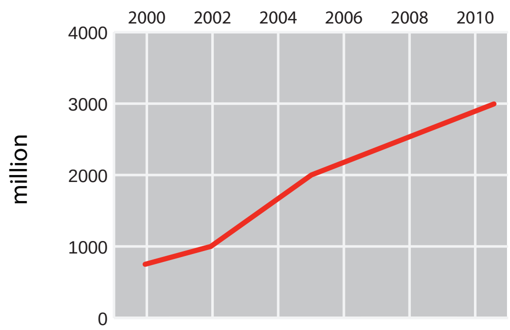
Most interesting might be the case of the mobile telecommunications industry which has become one of the largest and fastest growing worldwide. Many high precision parts are needed in the manufacturing of telecommunication equipment, particularly in the mobile part of the industry, in applications for handsets, but also for land-based transmitting and switching equipment.

In September 2005 news spread that the global number of subscribers to mobile phone network services passed two billion: **China, the largest mobile phone market in the world, has 398 million subscribers, or 19% of the world total.** The forecast for subscribers and handsets still is for high growth – though slowing down – mainly in less developed regions, such as China, India, Eastern Europe. The number of subscribers worldwide is expected to reach three billion by 2010. At the same time, in 2005, global handset sales are expected to reach 750 million units. China, where sales have been growing at around 15% per annum over the past two years, currently accounts for 12% of total global sales [2].

In the manufacturing arena, 60% of global production of mobile handsets is handled by Taiwanese companies [3], some of which are produced at sites on the Chinese mainland. In total, a third of the world's mobile phone handsets are produced in China by foreign and Chinese manufacturers.

The main manufacturing sites for handsets are in Malaysia, Taiwan, and China, with China developing very quickly and Malaysia stagnating. China's role as the global workshop for mobile phones is even expected to further raise: By 2009, 74% of the world's mobile handsets will be made in China [4]. In addition, China will also be the major market for selling these devices.

Development of Global Subscribers to Mobile Networks



6.2.4 Mobile handsets market in China

Compared to most European markets, China is significantly different due to its wide range of brands and the frantic pace of new product launches. In addition to the internationally-known brands, local brands are also very successful in China,TCL, Bird, and Amoisonic, for example. In addition to the number of brands and manufacturers, the number of products on the Chinese market is particular: around 500 different mobile phone handsets are available at any one time, and each year sees the introduction of some 250 additional new models. Both figures are currently dominated by the local brands.

6.3 The supply chain for precision parts

The supply chain for the precision parts industry is quite straightforward, as the main suppliers are the raw material providers and the machinery industry. The biggest portion of the value creation is done in-house, with a lot of research and development, special procedures and strong knowledge management.

In the last two years raw material prices have strongly impacted the industry: price increases of 30% (Comex Aluminium) to 130% (bundle steel scrap) for the main raw materials has led to more careful cost management and more complicated logistics. The main reason for this price development is attributed to the increased demand of the Chinese market for key raw materials [5.]

The machinery suppliers act in a relatively consolidated market, with the main players coming from Switzerland (Tornos, Schaublin), Germany (Index, DMG), and the USA (Hardinge). These suppliers are regarded as having the highest quality standards, while Japanese suppliers (Citizen, Nomura, Tsugami and Star) are gaining in importance. Chinese machinery manufacturers produce imitations of these products, but the quality has not yet reached international levels.

The distribution of precision parts usually does not rely on agencies; parts manufacturers normally negotiate sales directly with the OEM, without the use of an agent. Many part manufacturers are faced with the situation that most of their customers are moving their manufacturing sites to China and therefore will require their supplier to move as well. In the telecommunication industry this trend is even more significant, because not only is the manufacturing moving to China, but the market is representing a growing share worldwide.

6.4 Precision part customers in mobile telecommunication

The customers for telecommunication precision parts are the original equipment manufacturers (OEMs), the companies that make the mobile phones and telecommunications equipment for the global brands and their suppliers. The Greater China region is home to the world's telecommunication OEMs: the majority of Nokia, Motorola, Sony Ericsson, Samsung handsets - and others - are produced in this region. Interestingly, OEMs often supply several brands, sometimes with products that partly share the same designs. This is important in the Chinese market, with its diversity of brands and models. The picture below demonstrates this situation.

6.5 Trends

Several relevant trends are apparent for telecommunication related precision parts:

6.5.1 Low-end products

As mentioned above, the main growing areas for mobile handsets are the developing markets where growth is driven by consumers that are not yet connected. These local consumers are normally non-affluent people that can only be attracted with low-price models. As a result, in China and India, Motorola and Sony Ericsson follow the local brands and start to focus on these markets [6].

6.5.2 The advent of 3G handsets

Third-generation mobile phone technology is slowly taking off in mature markets such as Europe and the US. It will start in China a few years later. This means a lot of replacements or upgrades so that analysts expect additional sales of USD 25 billion per year in China when 3G takes off, or double today's sales. This is, however, still one or two years away. [7]

6.5.3 Chinese Brands go Global

As in many other industries, Chinese companies also enter the global market in the telecommunication industries. Two prominent examples are Huawei and ZTE – both telecommunications and network service providers. They are targeting immature markets outside China such as Eastern Europe. Neither of them is currently very successful in terms of sales volumes in their local markets so they have begun to develop in international markets.

Huawei's overseas sales were more than USD5.5 billion in 2004 (46% of total sales) and are expected to reach 56% in 2005. In the same year, ZTE is expected to sell USD2.5 billion worth of products and services outside of China; more than 35% of the company's sales. They are both growing rapidly in international markets [8] in the above-mentioned fields.

High precision parts originally started in China with the manufacture of weaponry. Later on, particularly during the 1980s and early 1990s, the watch industry was actively encouraged by the government, which led to the establishment of 30 vertically-integrated state-owned watch making factories. Yet, besides being fully equipped with imported precision lathes, most of these companies failed to meet international standards for the manufacture of watches and other precision parts; in fact, only a few privatized workshops are currently able to produce reliably to internationally required levels

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Comparison of Samsung C330 and TCL C808

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6.6 KUK (Shanghai) Co., Ltd.

Electronics and Precision Industry

- Setting up a production in China to follow a customer
- Achieving better quality, productivity and costs with fully automated and imported production equipment

SUMMARY

KUK AG ('KUK'), a most innovative supplier of micro-coils, electromechanical parts and printed circuit board (PCB) [i] designs and boards is uniquely able to manufacture a particular high-precision micro-coil allowing the production of mobile phones incorporating larger screens. Following the development of handsets production to China, KUK has set up and improved quality production in a China subsidiary in record time.

Factors for success are analyzed:

- Speed in the fast changing electronics industry
- Location for keeping stable human resources after their training
- Local project management and operations management support to achieve speed and reduce risks

KUK's single client and product line are the obvious risks of its China operations.

Figure 1:
KUK's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Electronic Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing		kuk electronic					
Purchasing	For own China operations						
	For mother company						
	For third party						
Selling	SOE						
	POE						
	FIE Global	kuk electronic					
	FIE Local						

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of KUK in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of KUK in the global scale

INDUSTRY TRENDS

Mobile telecommunication is an industry that is growing at a tremendous rate. From 2002 to 2010 the number of mobile subscribers is expected to jump from 1 to 3 billion worldwide. Today, 400 million out of 2 billion subscribers are Chinese. By the end of 2005, about 750 million mobile handsets are expected to be sold globally, with China accounting for 90 million phones. China is currently the biggest producer of mobile phones worldwide. Experts forecast that close to three-quarters of the world's mobile phones will be produced in China by 2009.

MOTHER COMPANY – KUK Electronic AG

Becoming the most important Swiss coil producer in 15 years of existence

KUK Electronic AG is a highly innovative, family-owned and fast growing small-medium enterprise (SME), founded in 1990 in Appenzell and employing over 70 full time employees (and a number of temporary personnel working from home) with a turnover of about USD20 million in 2004. KUK has become one of the biggest employers of Appenzell Innerrohden. KUK mostly serves the automotive, medical electronics, information technology (IT), industrial electronics and machine industries with three product ranges.

Design and in-house production of:

- PCB assemblies
- specialty electro-mechanical components such as custom-miniaturized electromagnets
- micro-coils (small copper wire coils of specifically high requirements and/or particular shapes)

KUK provides PCB assemblies especially for the field of micro and precision electro-mechanical components. KUK is ISO9001.2000 certified.

In its 15 years of operations, KUK has grown to become the most important coil winder in Switzerland.

Competitive advantages

KUK owes its success mainly to the following strengths:

- Strong capacity to a speedy innovation in electro-mechanical products. In the rapidly moving, short product life market of electronics, KUK does not register patents and develops new products fast instead.
- The capability to develop production equipment in-house. KUK produces its own coil-winding machines for applications where large production capacities are needed.

KUK in CHINA

A unique micro-coil to allow bigger mobile phone screens

Competing with electronics and telecommunication giants like Siemens, KUK developed an innovative rectangular micro-coil which makes the use of rectangular loudspeakers for mobile phones possible, thus allowing more space and bigger display screens on mobile phone handsets.

KUK was able to offer the most competitive product/price advantages by developing its own coil-winding machines. As a result, KUK was selected as the sole supplier of micro-coils by its client which delivers unique (and patented) rectangular loudspeakers to the major mobile phone makers (Nokia and Sony Ericsson, for example).

KUK's subsidiary in China (the only other production site of KUK other than the one in Switzerland) was founded at the end of 2003 and was set up to begin operations in May 2004. A year later, the subsidiary was employing 100 full time employees and producing one million micro-coils per week.

Supply chain

Producing one product, KUK China has the added advantage of needing only one particular raw material — a thin insulated copper wire. This wire is purchased by the subsidiary from the initial Swiss supplier and exported to China. Finished coils are sold to KUK's lone customer.

Start up general management

The initial management of KUK's China operations has been carried out, on part time terms, by one of the managers of the mother company who was also in charge of the company's overall sales since the production project was brought about by the client's requirement.

The sales manager traveled every two months to China to support two local managers:

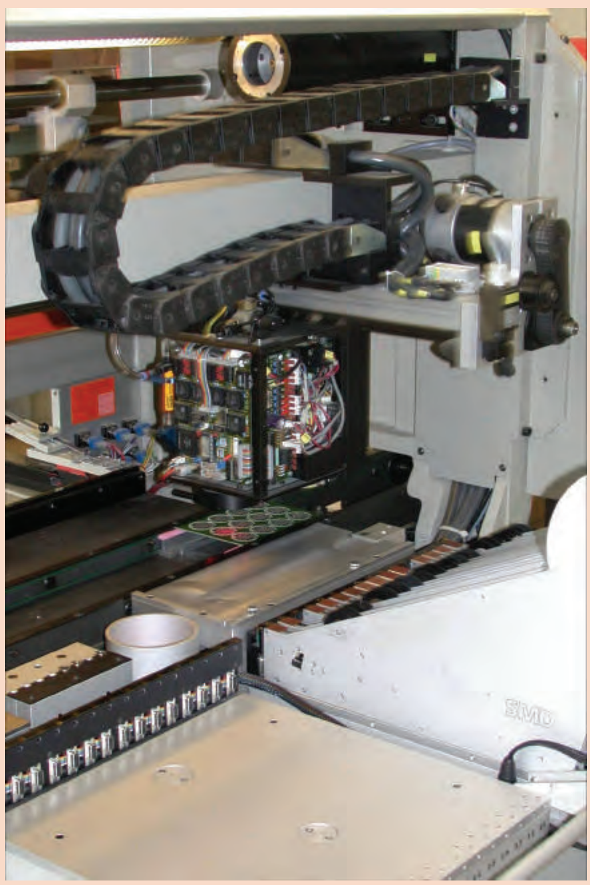
- a local production manager overseeing production planning, productivity and quality
- a local administration manager in charge of ensuring material imports, delivering products, dealing with government bureaus to fulfilling the complex formal requirements of the Chinese administration and contacting the mother company in case of difficulties

Financial administration, accounting and related legal aspects were supported by a local services company (one which also managed the set up of KUK's project).

FACTS and ANALYSIS

Reasons to enter China: proximity to the client and prospects for other opportunities

KUK's client for the mobile phone coil — a Danish company — decided to move its operations to China in order to be closer to its own mobile phone-producing clients in China as well as to benefit from lower assembly costs. Moreover, as the quantity of orders for the new loudspeaker grew, mobile telephone clients required the set up of a second production site for KUK's micro-coil. Indeed, the production of mobile phones was dependent on the ability of a single supplier to deliver millions of dozens of coils. Should there be any production interruption in KUK's facility in Switzerland, the production of an equivalent number of mobile phones would be interrupted. The forecast for 2005 was for KUK to deliver a total of 50 million micro-coils in 2005 from two different production sites.



KUK had the option to set up a second production site either in Switzerland or in China. Any other location did not make sense to the management given the supply chain configuration.

In addition to being close to the client, a KUK subsidiary in China provided the opportunity to access China's market through one client and a minimal turnover to start with. KUK saw the possibility to serve other global clients in China and to source and procure components more economically from the country.

KUK's decision was made after the management was convinced of the feasibility of a China operation. Though not usually available in China, a start up workshop of small enough dimensions was obtained through the Swiss Center in Shanghai (SCS). Moreover, the SCS' network of support professionals was able to provide KUK with the necessary additional management resources to set up its operation professionally in China.

The decision to go ahead with the CHF3 million (USD2.34 million) investment mostly comprising custom-made coil winding machines was made in September 2003.

Better productivity and quality through abundant, well-trained workforce

With the support of a China-based project management company implementing the set up, key staff hiring and company registration started in November 2003. Technicians and skilled workers were trained in Switzerland in February 2004. The first three custom-made production lines were imported under special tax and VAT-free (value added tax) status in April and production began in May 2004. Break even was achieved during the subsidiary's first year of operation. By the end of August 2004, the China production unit already achieved better productivity and a better scrap rate compared to the one in Switzerland, although the Swiss production facility is fully automated with machines designed and produced by KUK, thereby substantially reducing the costs of manufacturing.

The reasons for such performance are:

- KUK China's workforce is willing to work any possible shifts, allowing seven days and 24 hours operations for a maximum of 21 eight-hour shifts. By comparison, Swiss workers would be difficult to find for week-end and night shifts, so that KUK's Swiss headquarters would only be able to run about 17 shifts per week on average.
- KUK China could afford to hire more employee for effecting quality control than KUK would in Switzerland. As a result, more checks are performed ensuring a better monitoring of quality, faster reactions in case of quality problems and a lower overall scrap rate. Yet, well-trained and disciplined operators and middle-management were necessary to ensure that negative effects would not drag results down.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Expanding in the China market

KUK's workshop (around 800sqm including offices) has been planned and installed with extra space to accommodate productions for new clients in China. Quite some of KUK's other customers have operations in China and KUK is preparing to serve them adequately.

Freeing space for the Swiss operations

KUK's production in Switzerland is growing constantly; some of the labor-intensive operations maybe effected more efficiently in KUK China, thus allowing best use of the Swiss infrastructure and better production costs.

Risks and difficulties

Single client and product

KUK China's main and obvious risk is its reliance on a single client and a single type of product. Though there are variations in the size of coils produced by KUK, they all fulfill the needs of the same mobile phone loudspeakers application.

Changes in client's requirements (or in technology) or the possibility of a company developing a competing loudspeaker for which KUK would not be a supplier present considerable risks. Diversification to acquire new clients is therefore a key priority.

Stretched management resources

Sales management in Switzerland and in China as well as the overall management of the China operations are delegated to only one person. To reduce the risk of insufficient management capacity, KUK has hired a local Chinese administrator, who studied in Switzerland, to support China operations from Switzerland. Yet, the challenge to ensure long-term suitable local management still needs to be conquered by KUK.

Factors for success

Speed

In an industry of short product life cycles and unforgiving customers when deliveries are late, KUK had to make a quick decision to set up in China or in Switzerland and then to ensure a quick and seamless set up allowing for no loss of machine time. Equipment was actually shipped by air.

Human resources and location

To achieve speed and quality, finding suitable and qualified initial technicians and skilled operators who have been able to learn quickly in Switzerland is essential. Additionally, skilled personnels as such need to stay with the company long enough and to be capable to train colleagues and subordinates to meet the growing demand.

In order to retain staff after training in Switzerland, it was important for KUK to select a location where there is available and enough labor force that is already skilled. Indeed, should the skills of the staff in the area be far from standard level, they would be an interesting target for other foreign companies needing to hire skilled people after they obtain training from KUK. Some competitor companies would rather increase remuneration than invest on training newly hired staff on their own.

The industrial zone of Xinzhuang, south west of Shanghai, provides a good access both by car and metro, therefore it is convenient for well-trained Shanghai staff to travel to work.

Local project management and operations management support

To achieve speed without major oversights during the set up, KUK selected a professional project management company for the project preparation in all aspects as well as its execution. This enabled all set up elements to run in parallel, optimally and reduced considerably KUK's need for project management.

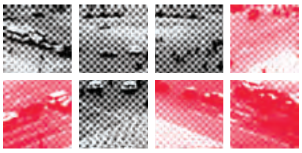
Professional handling was also instrumental in obtaining VAT and duty-free import of KUK's equipment, saving over half a million USD in taxes.

To sustain a smooth running operation during the first years, KUK retained the services of the same professionals, particularly to support reporting to the mother company for internal controlling and to optimize tax and legal issues.

Information on KUK Shanghai courtesy of:
Walter Akeret - General Manager, KUK Shanghai, China
Case Study written by: *Nicolas Musy*
Approved for publication on: *April 2005*

Notes

i Printed circuit board (PCB) - is a thin plate on which chips and other electronic components are placed. They are also called *"cards"*.



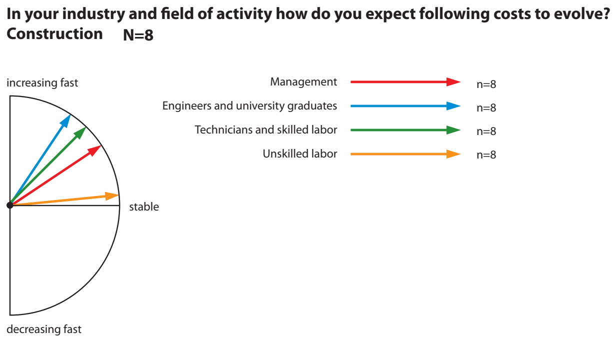
7 Construction

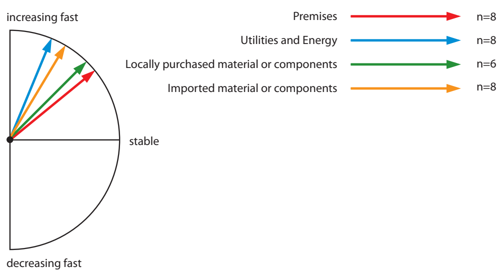
7.1 Industry trends

Below are the trends for the construction industry as perceived by managers of Swiss subsidiaries in China.

7.1.1 Cost trends

Survey chart V - 17

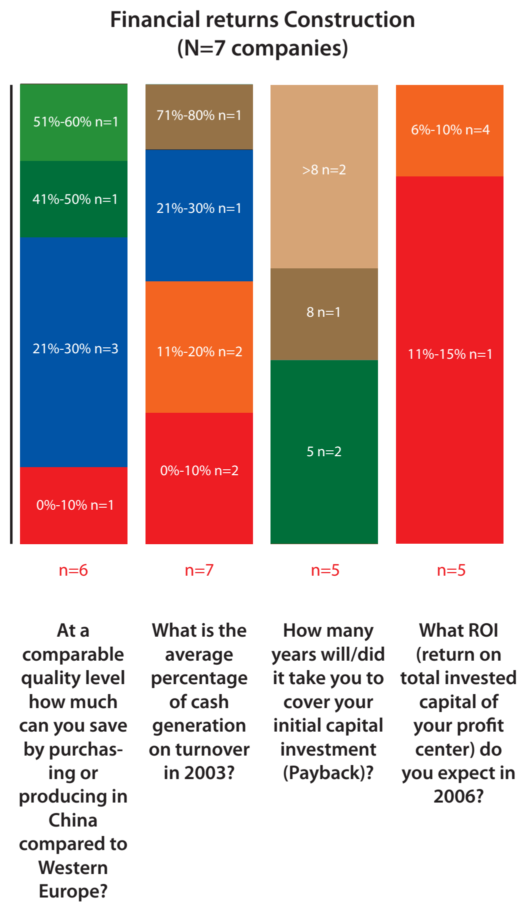




Source: Swiss China Survey, 2005

7.1.2 Financial returns

Survey chart V - 18



Source: Swiss China Survey, 2005

4.1.3 Factors for success

Survey chart V - 17

Factors of Success Construction
(Companies in China, which achieved at least 50% of their objectives N=8)

How important are the following factors to be successful in China

Source: Swiss China Survey, 2005

7.2 Construction Industry

by Marco Cabalzar, member of the editorial team, CH-ina

7.2.1 General Information on the Chinese construction industry

In 2003, around 49'000 construction enterprises were active in the Chinese market. The number of people working in their industry various between 24 million [1] and 40 million – most of them are migrant workers [2] and do often not appear in statistical data. The Chinese construction enterprises generated USD 285 billion in gross output value [i] and USD 55 billion in added value in 2003. Areas of 2'500 million square meters were under construction; completed areas covered 1'200 million square meters. Profits totaled USD 6 billion, with taxes at USD 9 billion.

The industry's output value increased 12% in 2000, 23% in 2001, 20% in 2002 and 24% in 2003 [3]. With the steady development of the national economy, the construction industry is expected to continue its momentum of growth in the coming years [4].

Of the total amount of USD 285 billion in 2003, USD 177 billion were generated by building construction, which accounted for 62% of the total, USD 72 billion by civil engineering, USD 22 billion by construction installation and USD 10 billion construction decoration, accounting for 25%, 8%, and 3% of the total respectively. The construction industry has maintained a strong level of development in China in recent years demonstrating a higher growth than that of its gross domestic product. The number of enterprises for real estate development reached 37'123, which completed RMB 1'015 billion (USD 125 billion) investment in real estate development and a total revenue of RMB 914 billion (USD 113 billion)[5].

Since the construction industry has the third highest rate of fatalities at work behind the transport and mining industry in China, the government took steps to reduce accidents in recent years, such as implementing laws and regulations on work safety and the prevention and control of occupational hazards. The two main reasons for accidents are:

- 80% of the 40 million construction workers are migrant workers from the provinces with no prior safety training
- many employers cut down costs on safety equipment for their workers

However, the implemented measures seem to reduce the accidents and the resulting deaths. In 2004, 1'144 construction-related accidents were recorded nationwide, resulting in 1'324 deaths. The number of construction accidents and deaths resulting from them went down 11.5% and 13.1% respectively compared to 2003[6].

7.2.2 Restrictions to foreign investment

Foreign companies can set up a construction or construction design enterprises as wholly foreign-owned enterprises (WOFEs) and Joint Ventures (JVs). The Chinese investor of a JV must hold at least 25% of the registered capital in construction and construction design enterprises.

Construction companies are classified according to the field of business activity and the registered capital:

- General Contractors: 12 possible fields of construction such as railway, electric power, communication engineering and building construction
- Special Contractors: 60 fields like elevator installation, telecom, bridge and tunnel construction
- Labor sub-contractors: 13 fields such as bricklaying, painting, concrete production and heating, ventilation and sanitary systems

The business scope of a construction enterprise set up as a WOFE is limited to the following kinds of projects depending on their classes:

- Projects built exclusively with foreign investment and foreign grant.
- Construction projects financed by international financial institutions or awarded by international bidding

according to loan terms.

- Joint projects with 50% or more than 50% of foreign investment; or joint projects that, though with less than 50% of foreign investment, cannot be independently implemented by Chinese construction enterprises due to technical difficulties, approved by the construction department of governments of provinces, autonomous regions and municipalities.
- Joint contracting is allowable for a pure domestic-invested project that is not able to be independently undertaken by Chinese enterprises due to technical difficulties. It has to be approved by the responsible Government construction department. JVs must contract projects within the authorized scope corresponding to its class.

For **construction design enterprises**, there are three main classes:

- General Design: Has not been published by now
- The Industry Design: This class has three sub-categories according to the registered capital of RMB 600 million (USD 74 million), RMB 200 million (USD 25 million) or RMB 80 million (USD 10 million) respectively
- Every sub-category is divided into 21 fields of construction design such as coal, oil and gas, electrical power, building houses and railway
- Specialized design: Two sub-categories of RMB 100 million (USD 12 million) or RMB 50 million (USD 6 million) of hregistered capital

In construction design WOFEs one-quarter of the staff has to be foreigners with the relevant technical background, and in JVs one-eight respectively. [7]

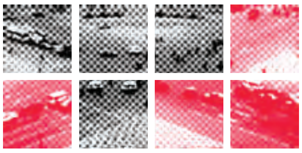
Due to the ongoing development of the Chinese construction market, the corresponding laws and regulations are subject to changes and some may not even be published. Candidates should therefore carefully check what class and category applies for them.

7.2.3 Opportunities for Swiss companies

By July 1, 2005, 1’388 Sino-foreign joint or collaborative ventures were engaged in construction industry which mainly dispersed over Shanghai, Beijing and Guangdong province. Chinese investigation and design units have set up joint venture with units from 16 other countries or districts. Those foreign contractors in China are mainly from the U.S., Japan, Korea and 14 other countries or districts, of which 24 enterprises are ranked in the 225 largest international project contractors worldwide.

In 2004, the number of foreign investment projects in constructions reached 411, down by 6.59% over the last year. The contractual foreign investment value was USD 1’769 million, up by 3.26%. The actual utilized foreign investment value was USD 772 million, up by 22.91%.[8]

Some Swiss construction and construction material companies are already active in the Chinese market, besides a few Swiss architects. The well-known Mario Botta and the duo Herzog & de Meuron won international design competition for prestigious construction projects in China such as the Olympic Stadium for the 2008 Olympic Games and the Qinghua University’s Museum of Art in Beijing. [9] These projects and their architects attract a lot of publicity not only in Switzerland, but also in China. Swiss construction and construction design companies might benefit from that fact they are from the same country which may have a positive impact on their business.
Since Chinese buildings mostly lack isolation and construction standards used in western Europe, and especially Switzerland, the Chinese government considers improving these standards in order to save energy and to protect the environment. However, it has not yet implemented regulations on sustainable construction. As soon as the Chinese government does so and also enforces these regulations plenty of possibilities for Swiss companies involved in building planning and producing isolation materials should arise.



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Notes

i Gross Output Value of Construction refers to total of construction products and services, expressed in money terms, produced or rendered by construction and installations enterprises during a given period of time

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7.3 Schindler (China) Elevator Co., Ltd.

Elevator and Escalator Industry

SUMMARY

Schindler (China) Elevator Co., Ltd. manufactures and supplies high-speed elevators for high-rise buildings, escalators, commodity elevators and their key components for the commercial and residential structures in China. The company also provides after-sales services for elevator and escalator maintenance and repairs.

This case is about Schindler's market strategies, focusing on the high-rise elevator segment and highlighting the following factors for its success in China:

- early market entry
- streamlined R&D processes for more competitive selling prices
- customer management and performing risk analysis of local projects
- managing employees to ensure high motivation and minimize staff turnover

Figure 1:
Schindler's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing		Schindler	Schindler				
Purchasing	For own China operations	Schindler					
	For mother company						
	For third party						
Selling	SOE		Schindler		Schindler		
	POE		Schindler		Schindler		
	FIE Global		Schindler		Schindler		
	FIE Local		Schindler		Schindler		

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of Schindler in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of Schindler in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

The elevator and moving stairways industry growth is supported by several inter-related factors such as demographic and socio-economic development, the desire for efficient use of space, increasing movement of people and goods through major gateways (i.e. airports, metros, etc.) and stricter safety requirements.

The industry worldwide grew at an annual average rate of 3.8% [1] from 1999 to 2003. The average annual growth is estimated to reach 5.1% from 2002 to 2008 [2]. In 2004, the global elevator market size was estimated at USD 37 billion; 40% of which consists of new sales and 60% of maintenance and modernization of existing systems [3].

Figure 2:
Elevators and moving stairways - industry revenue growth and forecasts
Source: Integra Information. (2005). Industrial Elevators, Hoists and Lifts - SIC 3534. JT Research LLC - www.industryresearch.com.

YEAR	Historical Growth(%)	YEAR	Forecasted Growth(%)
1999	7.90%	2004	8.00%
2000	11.50%	2005	5.20%
2001	11.70%	2006	4.10%
2002	-10.10%	2007	4.30%
2003	-2.10%	2008	4.00%

Approximately 7.4 million elevator units were in operation by the end of 2004 worldwide — out of which 335,000 were installed in the same year [4]. Meanwhile, the escalator market is estimated to have reached a global market size of USD 1.85 billion [5] in the same year, excluding after-sales services.

CASE STUDY

China is purchasing 25% of all new elevators and 50% of new escalators worldwide. It is very close to Europe in installation of new elevators and by far the most important of regions in escalators.

The maintenance and modernization business (after-sales service) is more stable than the new equipment sales segment (new sales). The five leading elevator companies — Otis (USA), Schindler (Switzerland), Thyssen-Krupps (Germany), Kone (Finland) and Mitsubishi (Japan) — generally make a significant portion of their profits from after-sales activities. These companies, along with other strong Asian players — Hitachi (Japan), Toshiba (Japan), LG (South Korea) and Fujitec (South Korea) — account for nearly 80% of the global elevator market [6].

The demand for elevators and escalators follows the general economic growth and developments in the construction industry. The global construction and engineering industry — excluding homebuilding — is estimated to reach a market value of approximately USD1.3tr by 2008, a 25.2% increase from 2003 [7]. Growth is expected to be driven by the recovery of Western economies, the continued expansion of the developing markets in the Asia Pacific and eastern Europe, and the world's growing population.

Figure 3:
Elevators in operation vs. new elevator market in 2004 by region
Source: Kone Corporation. (2005). Business Environment - Elevator Market. www.kone.com.

Elevators in Operation in 2004 (%) Total: 7.4 million units		**New Elevator Market in 2004 (%) Total: 335,000 units**	
REGION	**PERCENTAGE**	**REGION**	**PERCENTAGE**
Europe	51%	Europe	29%
Americas	17%	Americas	12%
Japan	8%	Japan	10%
China	8%	China	26%
Korea	3%	Korea	7%
RoW	13%	RoW	16%

Figure 4:
Escalators in operation vs. new escalator market in 2004 by region
Source:Kone Corporation. (2005). Business Environment - Escalator Market. www.kone.com.

Escalators in Operation in 2004 (%) Total: 328,000 units		**New Escalator Market in 2004 (%) Total: 28,000 units**	
REGION	**PERCENTAGE**	**REGION**	**PERCENTAGE**
Europe	23%	Europe	13%
Americas	18%	Americas	7%
Japan	17%	Japan	9%
China	24%	China	51%
RoW	18%	RoW	20%

MOTHER COMPANY – SCHINDLER Holdings

Company background and current situation

Robert Schindler founded the company in 1874 in Lucerne, Switzerland. From its modest beginnings as a small family-owned mechanical engineering workshop, Schindler has matured into a global enterprise that is now one of the industry's biggest elevator and moving stairways companies. For the past 125 years, the company has concentrated on the elevator and escalator business making it today's leading supplier of escalators and the second largest elevator manufacturer in the world after Otis.

Business divisions

Schindler Group has two major business divisions and is legally structured under the umbrella of Schindler Holdings

- The Elevator & Escalator Division (E&E) is a worldwide operation that supplies elevators, escalators and moving walkways worldwide through subsidiaries in all major markets of the five continents.
- ALSO Group is the leading Swiss company active in the wholesale, distribution and logistics services of information technology and consumer electronics.

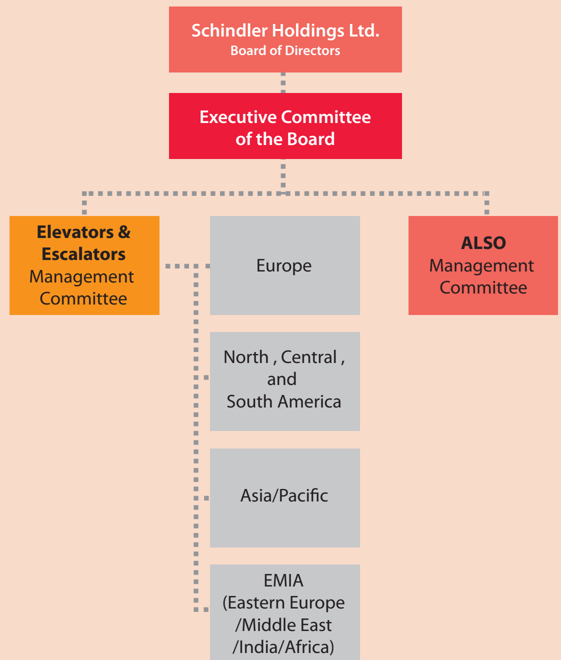
Company size and structure

Schindler Group's consolidated operating revenue rose by 6.9% to CHF 8.26 billion (USD 6.56 billion) in 2004 from the previous year. The Elevator & Escalator division contributed CHF 6.40 billion (USD 5.09 billion), or 77.5% of the Group's overall revenues and ALSO generated CHF 1.85 billion (USD 1.47 billion) or 22.5% [8].

Schindler has 97 subsidiaries around the world and a total of 39,443 employees (end of 2004), grouped as [9]:

- **Elevator & Escalator Division** – 38,841 total personnel
  - Switzerland – 3,720 (9.6%)
  - EU countries – 14,680 (37.8%)
  - Rest of Europe – 1,298 (3.3%)
  - Asia, Australia, Africa – 7,127 (18.4%) (China – 2,000 employees from all segments with 35 staffs working in the high-rise division)
  - North, Central and South America – 12,016 (30.9%)
- **ALSO Group** – 602 total personnel
  - Switzerland – 392 (65.1%)
  - EU countries – 210 (34.9%)

Figure 5:
Schindler Group structure
Source: Schindler Group. (2005). Schindler Group Annual Activity Report 2004. Schindler Holdings Ltd.



Competitors and competitive advantage

Otis, the largest elevator company in the global scale, has the most market share with 22%, followed closely by Schindler and Kone with 15% and 10% shares respectively [10]. Schindler (Elevators & Escalators) remains competitive with the following advantages:

- an extensive range of custom-made vertical transportation solutions for the whole market — from basic transport needs to residential and commercial structures to high-speed systems for high-rise buildings
- reliable and very affordable products benefiting from the latest technology that enhances elevator efficiency and performance
- research and development focused on:
  - advanced software that drives a logic program for intelligent traffic management
  - unique and innovative control systems that guarantee reduced travelling time and discomfort
  - built-in, dependable fault detection security system that allows for instant problem detection and timely preventive maintenance
  - ride quality solutions for high-speed elevators that assures quiet, gentle, comfortable and smooth ride
  - environment-friendly products and economical in the use of energy which contributes to minimizing operating expenses
- skilled technical employees who are highly trained for installation, maintenance and service to ensure maximum availability and minimum down time of Schindler elevators and escalators

CHINA INDUSTRY TRENDS and OUTLOOK

With new building (residential, commercial, business, hotels and retail spaces) taking place across the country, China presents a significant market for elevators and escalators. The major markets for elevator business in China are the booming cities of Beijing, Shanghai, Chongqing, Guangzhou and Shenzhen.

CASE STUDY

China became the largest elevator market in the world in 1996, set off by the soaring construction industry that followed the country's open-door policy in the 1980's. Even so, there is still one elevator for every 2,000 people in China today compared to one elevator or escalator for every 700 to 750 people in the rest of the world [11].

Owing largely to its growing domestic demand for vertical transportation solutions for high-rise buildings, the country is believed to be one of the largest elevator-manufacturing nations globally. The Chinese elevator market is characterized by new installations and after-sales activity with demand for services growing faster than new sales as the country develops. Currently, half of the business volume in the Chinese elevator market is generated by after-sales services.

SCHINDLER in CHINA

Subsidiary background and current situation

Established in 1980, China Schindler Elevator Co., Ltd. (CSE) was China's first industrial joint venture with a Western company, set up after the founding of the People's Republic of China in 1949. The subsidiary has evolved into the present wholly foreign-owned enterprise Schindler (China) Elevator Co., Ltd. (based in Shanghai), after the Schindler Group acquired its Chinese partner's shares in 2002.

Figure 6:
Schindler's historical milestones in China
Source: Swiss China Survey, 2005

1980	1988	1997	1999	2000	2002
Set up JV that formed China Schindler Elevator Co.(CSE), Schindler's 1st operation company in China	Suzhou Schindler Elevator Co. (SSE), the 2nd operation company, was established in Suzhou	Schindler China's own training center, Shanghai Schindler Elevator Technology Services Co., was opened in Shanghai	Established Schindler China's own Research & Development Center in Shanghai	Schindler China's own production facility, Schindler Electronics Suzhou Co., operated in Suzhou	Schindler (China) Elevator Co., Ltd, formerly CSE, became a 100% foreign-owned enterprise

Schindler China's operation companies manage sales, installation and after-sales services through a distribution network, covering China geographically in the north, east, central and south. The subsidiary has approximately 2,000 employees country-wide — 35 of which work in the Top Range (high-rise) Division.

Subsidiary size and branches

Schindler has more than 80 authorized distributors and branches that manage sales, installation, maintenance and repair services in the following major cities and provinces: Beijing, Shenyang, Xián, Shijiazhuang, Harbin, Qingdao, Jinan, Wuhan, Chengdu, Chongqing, Urumuqi, Suzhou, Hangzhou, Nanjing, Fuzhou, Kunming, Guangzhou, Hainan, Shenzhen, and Zhejiang. To date, the company has established in China the following:

- one wholly foreign-owned company (Schindler [China] Elevator Co.,) that manages sales and services headquartered in Shanghai and produces escalators for the Asia Pacific region
- one joint venture based in Suzhou (Suzhou Schindler Elevator Co., Ltd) that has become a major production base of elevator components in Asia, as well as managing domestic sales and services
- two wholly owned component plants; one for escalator steps (Suzhou Esca Step Co., Ltd) and moving walk pallets and another for elevator components and control system software (Schindler Electronics [Suzhou] Co., Ltd) both based in Suzhou
- an R&D center (R&D-AP) located in Shanghai that develops that latest elevator technologies
- a training center also in Shanghai (Shanghai Schindler Elevator Technology Services Co., Ltd) that delivers managerial and technical training to sales, installation, maintenance and management personnel of Schindler China.

Supply chain

Part of the key components of Schindler's high-rise elevators produced in China are imported from the mother company in Switzerland or are bought from its own component facility in Suzhou. For basic high-rise elevator components, the subsidiary purchases from five main suppliers in China.

Schindler Electronics (SEL), the company's own component production facility in Suzhou, was set up in 2000. SEL is a wholly-owned subsidiary of Schindler Group that manufactures electronic components and develops software for the control systems of Schindler elevators and escalators. In 2005, the facility began producing controllers and safety components for high-rise elevators and it has been supplying Schindler China directly. Finished elevators and escalators are sold to foreign, government and local private investment construction projects all over the country. Installation and maintenance of the equipment is administered by Schindler China's own technical staff.

FACTS and ANALYSIS

Timing and motivation to enter China

Schindler entered China early through a joint venture with a local company before the country opened its doors to wholly foreign-owned companies. As a result, the subsidiary managed to gain a considerable share of the market and expand its activities (from selling commodity elevators to specialized high-rise/high-speed elevators) prior to the influx of international elevator companies that are now competing for market share. Presently, Schindler China is building up a strong market base for its high-speed elevators in the high-rise segment and managing the shift of production of key high-rise elevator components from Europe to China.

Targeted market segments

Schindler elevators, both commodity and for high-rise buildings, are often perceived to have the highest quality with the corresponding steep prices. But, Schindler China believes that this marketing strategy may not be effective in the long run, since it is difficult to sell high-priced products in China. Therefore, contrary to the common perception that Swiss-branded products are expensive; Schindler's Top Range high-rise elevators are reasonably priced for the mid-level market segments.

To sustain, and in the long term, advance its position in the market, Schindler China is continuously improving the quality of its products and services. Also, now that well-known international brands are present in China, the company is working on making the overall cost of its products even more competitive. Schindler notes that Chinese customers perceive major elevator brands like Otis and Mitsubishi almost equally and, unlike in Europe, local customers are not as loyal to a specific brand. In the end, therefore, the deciding factor in selecting elevators is cost.

Schindler China offers premium quality products and services at very competitive prices to business-to-business customers comprising:

- government entities or government-funded projects
- local privately-funded building projects
- overseas Chinese investments (from Hong Kong, Macau and Taiwan)
- foreign-funded constructions

Local competitor and competitive advantage

Competition in the elevator and escalator industry in China is growing increasingly strong since most of the biggest global players have now entered the market and begun setting up here. China's high-rise elevator market segment is dominated by international producers mainly from Europe, the USA, South Korea and Japan. In 2003, there were only five international elevator companies in the market; in 2005, there are at least eight of these companies vying for market share.

Schindler China captured a majority of the market upon its entry with a joint venture in 1980, earning a profit of USD4 million in its first year. However, in the late 1980s, the Chinese economy retrenched due to substantial state budget deficit and high inflation rate. In 1989, the construction and elevator industry in China posted a 25% drop in sales compared to 1988. All these, on top of the fierce competition among major global elevator companies that entered China in succession by means of joint ventures (Otis in 1984, Mitsubishi in 1987 and Hitachi in 1988) made Schindler China lose some of its market share. In the early 1990s, Schindler China slowly regains its foothold by employing several business strategies:

- reshaping its major joint ventures in China from production-oriented companies to service-oriented companies
- constantly improving the quality of its products and services
- making its manufacturing facilities more focused and specialized
- reinforcing its R&D in China
- strengthening its employment training

At present, Schindler China does not face strong competition from local companies in the high-rise field. The high-speed segment starts from 2.5 meters per second and goes up to as high as 8 to 10m/sec. Some smaller local companies may manufacture elevator units capable of 2.5m/sec., but higher speed specifications are produced mainly by international companies. Schindler China believes that local companies are unlikely to be able to make big investments in the development of high-speed technology in the short term; therefore, the company does not perceive competition from the local manufacturers in the high-rise segment as an immediate risk.

Schindler China's competitive advantages against its competitors are:

- engineering capacity to develop cost-effective elevator solutions specific to the high-speed requirements of high-rise buildings
- proximity to its customers
- proximity of its facilities (i.e. R&D, training center and key components manufacturing sites) to the market
- the technology to develop innovative products with simplified processes

Supplier relationship management

Three out of Schindler China's five main suppliers are privately-owned Chinese companies and two are foreign suppliers. As a prestigious Swiss brand, Schindler lends its suppliers its premium image to aid their advertising and marketing activities. In turn, this helps the subsidiary secure its suppliers' loyalty and high levels of service.

Schindler China evaluates and selects its suppliers not only according to the price and the quality of their products, but also on their service levels and timely delivery of supplies. Schindler makes certain to obtain the best possible price and quality in purchasing components by encouraging internal competition among its suppliers.

Customer assessment and management

Schindler China appoints business agents who interface between the customers and the company and ensure that good relationships are maintained through direct contact, after-sales service and steadfast follow-up even after the sales have been concluded. Customer management is very important especially since Schindler's projects in China have long lead times. It normally takes 18 to 36 months from the discussion of agreements to the awarding of contracts and finally to the completion of the project. Some projects even take as much as eight years to complete (some are either discontinued or delayed).

It is a common occurrence in China, especially in some areas outside the main developing cities, for building constructions to be halted midway when investors run into financial problems. To prevent losses or unfinished construction projects in the future, Schindler China invests time in performing a project risk analysis prior to signing up an agreement with a local customer. Schindler also investigates the potential customers or investors of a project to:

- review their business history
- assess the current condition of their entire business
- check the availability of their resources

By carefully examining these factors, Schindler can analyze and measure the likelihood that the investor will not be able to complete a construction halfway through the project.

Product and R&D

Schindler has set up its own R&D center in Shanghai to cater to China's domestic market and the entire Asia Pacific region. As China becomes an increasingly important market, it was essential for Schindler to obtain direct input from this market for future development of products intended for the Chinese and Asia Pacific customers. Likewise, having an R&D site in the country (as opposed to relying on the R&D center in Europe) minimizes the distance and the risks of making mistakes in designing products intended for this region.

Schindler China is able to offer very competitive prices for their high-rise elevators without diminishing the quality of its products by making the development and production processes more straightforward, efficient and cost-effective. For example, in developing a component of a high-speed elevator, Schindler China's R&D center uses the observations and feedback of the technicians that handle the equipment installation and servicing in the field in terms of how specific high-speed elevator components may be simplified. If development and production of a mechanism is streamlined it can also simplify the production process, thereby reducing costs and enabling the subsidiary to offer more attractive end user prices.

In addition to streamlining existing products, Schindler's R&D engineers are continuously developing innovative elevator designs and functionalities. Schindler believes that the company's access to an outstanding R&D center and highly-skilled engineers help it facilitate the development of reliable, functional, user-friendly and aesthetically attractive elevators.

Recruitment and people management

China offers plenty of employment opportunity to skilled individuals. Schindler China observes that with the country's growing job market, especially in the metropolitan cities, the local employees don't find it difficult to find companies that offer good employment benefits. The company has implemented the following employee management measures to help secure staff loyalty and lower the turnover of its skilled employees:

- providing progressive staff training (through the company's own training center in Shanghai)
- offering attractive career development plans
- unbiased performance evaluation
- providing very competitive compensation and benefits package
- entertaining staff and organizing leisure time and other social activities for team building purposes
- ensuring that employees learn continuously and are properly recognized for their efforts by promoting them to higher positions based on their highly satisfactory performance

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

New sales

With a booming construction industry, huge population and increasing number of gateways (i.e. metro stations, airports, railway stations) in its developing cities, China has become the biggest and most important market for Schindler. In 2004, the commercial and office building market accounted for over 40% [12] of all construction expenditures in China. Residential building construction expenditure, meanwhile, is expected to climb at over 11% annually through 2009 [13], driven by government efforts to further increase average per capita living space and privatize home ownership. The replacement of many poorly constructed housing units built during the 1980s and 1990s will also spur growth in residential construction spending.

Schindler Top Range elevators for high-rise buildings

In the high-speed elevator segment, the worldwide market is around 6,000 units and 60% of these are sold in the Asia Pacific region with China holding a two-thirds share of Asia's total. The market in China for high-speed elevators is now growing at approximately 10% faster per year than two or three years ago. All these factors point towards an opportunity for Schindler China to improve its sales figures in the high-rise new equipment segment in this market.

After-sales services to meet increasing safety standards

Although the requirements for maintenance and services in China are yet to become comparable to Hong Kong's and Europe's levels, changes are expected to happen within the next five years as standard levels for service, quality and safety increase. China has begun implementing stricter standards and requirements for safety measures of vertical transportation equipment. Similar to the trends observed on the global level (where maintenance and modernization business is looking more lucrative than new sales), an opportunity is therefore, presented to Schindler China to strengthen and build up its after-sales services to meet maintenance and modernization needs of elevators.

Risks

Local investors and business entities alike are striving to take advantage of China's economic upsurge while they can. Owing to this, it has become a common occurrence in China that local investors run into problems and are rendered incapable of sustaining construction projects financially before they are completed. Without properly investigating and doing the necessary assessment of potential local customers to guarantee the stability of an investment, Schindler China will run the risk of ending up with many unfinished projects.

Competition in China's elevator and escalator industry among the international players is fierce and the technology for manufacturing these products is not difficult to replicate as long as they have access to the know-how and development skills. Despite Schindler's head start in developing innovative elevator control systems, it is not unlikely that its competitors — both international and local — will manage to catch up and develop the same technology. Without incessant innovation and an immediate, dedicated R&D team situated in China, Schindler risks losing its foothold in this market.

The attraction of better compensation packages from elevator companies that have just arrived in the market present Schindler China with the risk of losing its skilled staff and the knowledge of these individuals (from years of training with Schindler) to the newcomers who have the advantage of counter-offering higher remunerations to win over experienced elevator company employees. To address this threat, Schindler China needs to implement stronger HR retention programs to win the skilled staff's loyalties and retain them.

The current construction boom is credit driven and may end with a sudden decrease (or even a crash) as the government tries to cool down the economy and stop real estate speculation. In such a case, elevator and escalator sales may suddenly drop considerably which will lead to price wars.

Difficulties

In keeping with the Schindler Group's global culture of minimal investment on advertising and marketing, the Schindler brand is not as strongly established or promoted in China as that of its competitors'. In China, the local customers respond better to brands with bigger presence in the market. It is a challenge for Schindler China to persuade and influence its mother company in Switzerland that the subsidiary may have to implement a somewhat different marketing strategy in this particular market.

Success factors

The following factors have been identified as the elements that have supported Schindler's success in China.

- **Early market entry**
  Schindler's early entry to China through a joint venture enabled the company to understand the Chinese market ahead of all the other international competitors. Schindler obtained a fair share of the market and managed to strategize accordingly by re-structuring its operations from production-focused to service-focused.

  To further strengthen its position in the market, Schindler China has worked out a series of aggressive business strategies by setting up its own R&D center and key elevator and escalator components manufacturing facilities in the country. At the moment, Schindler China establishes a strong market base for its Top Range division and is one of China's top suppliers of high-rise elevators.

- **Streamlined local R&D for more competitive product costs**
  Schindler China counteracts fierce competition in the market through its technology and innovation to achieve better quality price ratio. Presented with equally renowned elevator brands, customers will look into costs as the overall deciding factor. Schindler China's capacity to develop well-designed, reliable and innovative products at very competitive prices gives it the winning edge against strong competition. The subsidiary has achieved this by establishing a local R&D, simplifying its processes and minimizing costs through immediate input and feedback directly from the market.

- **Customer management and project risk analysis**
  Schindler China's complete knowledge of the market enables it to deal with Chinese customers, aided by constant and direct communication with clients through its appointed agents before, during and after the implementation of a project. This strategy is implemented in all of Schindler China's several branches located throughout the country which ensures that all of Schindler's customers anywhere in China obtain the best pre- to post-sales services.

  Despite the frequency of halted building projects in China due to the investors' inability to sustain the investment, Schindler, thus far, has been successful at signing up profitable and successful projects. This is due mainly to the thorough potential customer examination and project risk analysis procedure that the company performs prior to signing agreements with the clients.

- **Employee management**
  Notwithstanding new elevator companies entering China that offer higher compensation and better benefits packages to employees, Schindler has so far maintained a low employee turnover rate. Schindler continuously motivates its employees by providing them with adequate training and support in terms of career advancement. In the end, the company benefits from the expertise and skills of its dedicated employees and lowers the risk of losing these talents to the competition.

Information on Schindler (China) Elevator courtesy of:
Bernard Schwegler - General Manager, Schindler Top Range Team, China
Interview conducted by: *Marco Schueep, Luca Bortolani and Patrick Schaufelberger*
Case Study written by: *Maria Luisa Dacera*
Approved for publication on: *October 2005*

Notes

[i] CGT – Compensated gross tons

[ii] Service station – a center for repair and maintenance of engine turbochargers for power plants and marine vessels

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8 Software Development

by Monika Siegenthaler, Director Communications & Partnerships I.T. United

The rapid rise of China reminds of the German Wirtschaftswunder after World War II. There is one fundamental difference though: China will not only transform itself, but the world economy in its wake. One of the key areas of development is information technology. **China set to become a global technology hub**

8.1 Information technology as the 'Motor of Modernization'

China is recognized first and foremost as a global manufacturing hub, supplying goods at highly competitive prices thanks to its cheap, unskilled labor force. It is still little known that the country has started competing for its share of the global IT market nearly two decades ago. In 1988, the State Council approved the **TORCH program, which is designed to develop, commercialize and internationalize high technology industries in China**. The program is viewed as an important component of China's national strategy of "Revitalizing the country through Science and Education". Today there are 53 high-tech zones including 29 national software technology parks, which offer IT and software companies tax breaks and support their export efforts. Most of these industry incubators are located on the East coast, where the regional administrations have succeeded in fostering close ties between universities and the corporate world.

8.2 Why China?

A 2002 Foreign Direct Investment (FDI) survey by the Asian Development Bank indicates that **foreign companies establish a presence in China mainly because of the market potential (33%)** and because the country is part of the company's global growth strategy (27%). In comparison, only 8% of respondents referred to the low operational cost, thus rating this factor as least important for their decision-making. There are three main reasons which contribute to China's attractiveness:

8.2.1 Potential of the domestic market

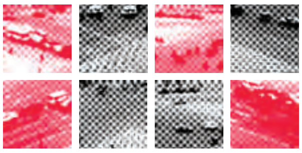
The primary reason for Swiss companies to go to China is the huge potential of the domestic market with a population of 1.3 billion. According to Gartner, a leading technology market research firm, "**country before company**" should be the paradigm for any decision regarding outsourcing. In essence, this means that corporate entities should determine first, in which markets they want to build a strong presence, before choosing the right partner for that specific market.

8.2.2 Telecommunications infrastructure

China has continuously and strategically invested into renewing i.e. building up a brand new telecommunications infrastructure. Furthermore, China has become one of the key decision-makers in global industry standard forums like the Institute of Electrical and Electronics Engineers (IEEE).

8.2.3 Talent pool

Chinese IT companies can tap into an abundant and growing pool of talent as the work force of highly skilled engineers with excellent English language skills is growing rapidly. The number of IT graduates per year has exploded over the past years; in 2004 alone, 250'000 new Computer Science & Software graduates entered the job market[1].



8.3 Outsourcing – is China the next India?

Traditionally, India has been the leader of the pack when it came to IT and business process outsourcing (ITO/BPO). **In the past years, India itself has discreetly started to outsource to China, and is actively seeking cooperation**. In mid-September the largest ever NASSCOM delegation (Indian National Association of Software and Service Companies) met with Chinese government representatives at the Sino-Indian Software Developer Summit in Beijing. While India is trying to defend its leading position (Tata Consulting, Infosys and other Indian big players have all set up development centers in China to save cost), China obviously seeks to catch up as fast as possible. „Cooperate first, compete later" has become the motto under which these tentative approaches take place, which aim at bringing together India's experience as a provider of high-quality IT services with the Chinese ability to produce hardware at rock-bottom prices. A comparison shows the following picture:

	China	**India**
FDI (2003)	135 billion USD	5.3 billion USD
Domestic software sales	17.3 billion	4.3 billion USD
Users online	103 million	39.2 million
	(57 million broadband users)	
International bandwidth	82.6 Gbps	4.2 Gbps
Hourly rates for software developers	12-25 USD	24 USD
Literacy	90+%	64%

Sources: MII August 2004, US-China Business Council Feb. 2004, indiainfoline Aug. 2004, CISA 2004, TIMES NEWS NETWORK 2003, ITU World Telecommunication Indicators Database, 2004; internetworldstats.org, November 2005, NASSCOM, 2005; Chinese Ministry of Commerce, 2005; OECD International Investment Perspectives, 2005.

It is estimated that Chinese will be the number 1 Internet language by 2007. While the 103 million Internet users may sound impressive, in relation to the absolute population, the usage of the Internet is still at "peanuts stage": currently, only 7.9% of China is online. There is also the potential of the mobile Internet to consider. In September 2005 the number of mobile phone users reached 387 million as opposed to 345.8 million fixed lines [2].

The sheer size of China commands attention. Beijing alone generated over USD 6 billion revenue from its software exports (33.8% of the country) and USD 227 million from outsourcing (about 40% of the country total)[3].

8.4 Customized applications in demand

There is no way around it: intellectual property rights (IPR) are an issue in China. However, there are ways of mitigating the risks. Non-disclosure agreements (NDAs) and in-depth vendor evaluation will protect you to some degree. Also, the extent of the problem needs to be carefully assessed as some industries are less exposed than others. Chinese copycats are rife first and foremost in manufacturing and fashion, and focus mainly on off-the-shelf products, which can be easily reproduced. Since becoming a member of WTO, China has passed new laws and made efforts put into practice the TRIPS agreement (TRIPS = trade-related aspects of intellectual property rights). Even so, there remains ground to be covered with regard to the enforcement of these regulations.

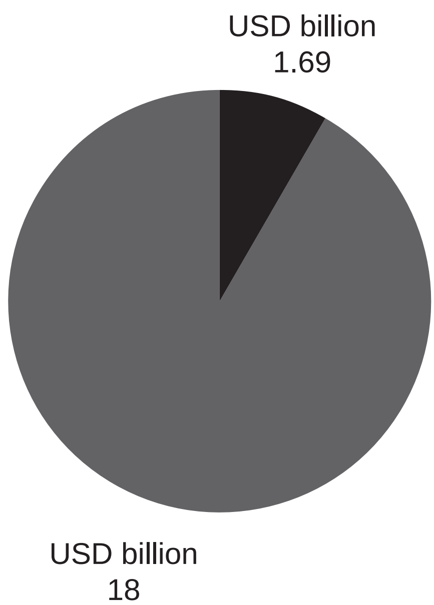
Customized applications that have been refined over time have plenty of opportunities in China. The demand for this kind of software products is as impressive as the annual growth rate of China's economy, which is still well over 9%. **What customized products need to succeed in China is the extra local touch to make them fit local user behavior, graphic interface conventions, government regulations, etc**. Often the whole product needs to be re-thought also from a marketing perspective (distribution channels may be different) – and this is exactly where an experienced, local partner adds value.

When localizing a product or service the following aspects should be taken into consideration:

- User expectations with regard to language, writing style and phrasing
- Graphical user interface conventions: the way information is structured may differ from Western standards.
- Payment methods for online purchases: credit cards rarely accepted, the preferred method is still cash on delivery.
- Different look & feel: issues such as color harmony and meaning, standardized type fonts etc.

8.5 Outsourcing market trends

As for outsourcing, the trend in China is pointing upwards. Forecasts by the IDG group projects a continued high compound growth rate of up to 35% for China, stretching towards a 10% share of the global IT outsourcing market by 2008.



Source: IDG Group 2005

Custom code writing is already well-established, and BPO as well as system writing project research and development are catching up. According to the Global Outsourcing Report 2005 China will continue to expand in the R&D area, and focus on high-end offshoring. For more than half of multinationals with a China presence outsourcing is an integral part of their overall operations strategy [4].

Japan is China's biggest customer for business process outsourcing (BPO) and numerous call centers operate from East coast cities such as Dalian and Shanghai. **The expansion of BPO for the Japanese market provides the base on which China intends to grow its outsourcing industry globally**. In 2003, China's BPO market was USD 0.2 billion. Industry experts expect China to increase its BPO market by 20 to 30% annually over the next five years. In a reverse sense, the ongoing relocation of corporate headquarters from Singapore or Hong Kong to Mainland China shows that multinational companies are well aware of the strategic importance of the Chinese domestic market.

As yet, no major China-based outsourcing players have emerged. More than 90% of the players are SMEs with less than 500 employees. With the continued growth of the Chinese technology industry, consolidation is bound to kick in fast. It is therefore imperative that the selected vendor demonstrates a clear understanding of and strategy to deal with the challenges to service continuity during mergers and acquisitions.

8.6 Getting outsourcing right

In any complex and relation-based market teaming up with a trustworthy local partner will make the ride easier for you. A local vendor will bring in his network of contacts and resources into the partnership and can save you time and costly mistakes thanks to its market expertise. It is therefore only natural that finding the right China vendor is one of the primary concerns of multinationals seeking to outsource, together with regulatory issues, and IPR and data security issues.

10 tips for successful offshore outsourcing

1. Allow enough time for assessing vendors and pay attention to include public holidays
2. Sign a NDA with the vendors included in the request for proposal and, once you have chosen your partner, with every project team member. Make sure that the contract is under your home jurisdiction.
3. Use common sense. With all due respect to cultural differences: apply the same due diligence procedures as you would at home. Look for a commitment to global quality standards, conduct an IPR audit, ask for references and resumes of team members, and generally try to gather as much information as possible.
4. Take a close look at past vendor achievements and ensure that the company showcases were actual productions, not just drafts for a pitch. Also, try to get unofficial references through other channels you have at your disposition to validate the references you were given by the vendor.
5. Start with a pilot project that is a safe distance from your core competencies to protect your business even if the project should unexpectedly meet with difficulties.
6. Confirm your key contact before the contract is signed. Make sure to meet the project manager who will be your interface and find out if you can comfortably work with him or her.
7. Ensure that the communication schedule is adapted to your time zone.
8. Ask questions and gather as much information as possible. Also, listen to suggestions. Experienced local partners will be able to give you valuable input.
9. Check if the vendor is capable of format standardization and can adapt to your standard rather than the other way around.
10. Negotiate staggered payments as per milestones achieved and signed-off. In addition, you should have 24/7 online access to the project or development status.

China's potential may be dazzling, so keep a cool head and visit your local partner to ensure that you share a strong commitment to international quality standards. It will provide a sound base for building mutual trust and for your successful growth in China.

Suggested further reading

- The Changing Face Of China – China as an Offshore Destination For IT and Business Process Outsourcing, AT Kearney, 2004
- The Global Outsourcing Report 2005, produced by Mark Minevich, Going Global Ventures Inc., and Dr. Frank-Juergen Richter, Horasis, March 2005
- TORCH program: www.chinatorch.gov.cn/eng/index.htm
- WTO – TRIPS agreement www.wto.org/english/tratop_e/trips_e/trips_e.htm

Contributed by ITUC

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Communications. I.T. UNITED consistently delivers high-performance business results as a supplier to global technology companies, as a partner to mid-market regional IT companies, and as a solutions provider directly to corporate clients.

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9 The Education Industry in China

by David Zhang, Glion Institute for Higher Education and Zhong Jianping, Project Manager and Head of sourcing and market research CH-ina

9.1 Historical background and literacy

Prior to 1949, Chinese people did not have an equal chance to attend universities, since only wealthy people could afford a higher education. The scale of the education infrastructure was also very small in comparison to its vast population. As a result, illiteracy was widespread, affecting 80% of the adult population (18 years and above).

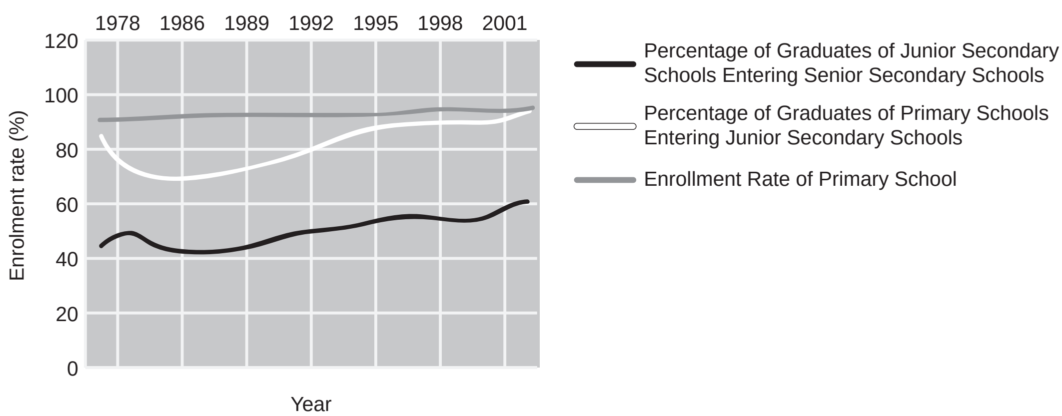
Since its establishment, the Chinese government strove to offer equal education to all and to raise the general level of education. **Great efforts have been made to eradicate illiteracy and to improve basic education levels**; nowadays a nine-year education is mandatory in China. As a result, the illiteracy rate among 25 to 45 year old was below 7% in 1995. The annual average of school-age children actually attending school was 97% between 1978 and 2003. The rates of primary school children entering junior secondary school, and junior secondary school children entering senior secondary school were 83.9% and 43.4%, respectively, for the same 1978 to 2003 period.

From 1949, the country's education was planned and free-of-charge; students were able to choose subject and university, dependant only on their academic achievements and the availability of university places. Upon graduation the government would assign and guarantee an employment role for every individual.

Then China's higher education experienced a ten-year period of interruption during the Cultural Revolution (1966 to 1976) and was only able to return to normal by 1978. Since the early 1990s, however, university graduates are now free to find their own employment, without interference by the government.

For more information on the attitude of Chinese towards education, also see Chapter I, General Environment, Chinese history, business culture and psychology.

Enrolment rates in China's basic education since 1978:



Source: National Bureau of Statisics of China (2004) China Statistical Yearbook 2004. Beijing: China Statistics Press.

9.2 Levels of education

China has several levels of education, as below:

- Primary school
- Secondary school:
- Vocational secondary school
- Conventional secondary school: junior/senior secondary school
- Specialized secondary school: Technical/teacher secondary school
- Higher education:
- Specialized Subjects (three years)
- Normal university/college (four years)
- Postgraduate institute

9.3 China's higher education situation

9.3.1 China's higher education reform since 1989

China's higher education is provided by the central and local governments and is directly under their administration. Private education appeared in the early 1980s, mainly in the form of part-time, non-degree courses. From the early 1990s, private education branched out into the field of middle- to high-level vocational education and training. The greatest growth has been since 1997, when relevant regulations and policies were issued to promote private investment in education. By 2003, there were more than 70,000 private schools and colleges/institutes at all levels (from kindergarten to higher education), with around 1.4 million students. This includes a number of schools that have been especially set up to cater for foreign children in China.

The Chinese state is highly centralized and so is the state education system, as a result, schools have lacked the flexibility and autonomy to provide education to meet the needs of society. The structure of the educational system has been seen as strangely segmented and ill-conceived, especially in the face of recent rapid economic development, the pace of which has far outstripped that of education reform.

China began the process of reform of its higher education system in 1989. This reform has mostly involved the management of education as an industry, its commercialization and the launch of so-called higher education institutes (HEIs) onto the market. Different forms of HEIs are encouraged, with government support for both private and foreign-invested models.

State-owned HEIs are allowed to pool resources and funds from many channels, including enterprises, societies, organizations and the people themselves. HEIs have more autonomy in internal affairs, such as course setting, personnel, allotment, recruiting and the charging of fees.

Students are requested to pay reasonable contributions for their own education. On graduation, they are not guaranteed a job through state assignment, but have to find one on the market by themselves.

9.3.2 Impacts of China's higher education reforms

The changes implemented by the education reform that have had the greatest impact on the education system as it stands today are: financing, recruitment of students, the charging of tuition fees and the graduate job placement system. Of these, the one with the biggest impact on students and their families is that of financing, since they now have to contribute a share of their education fees.

9.3.2.1 Great increase in student enrollment

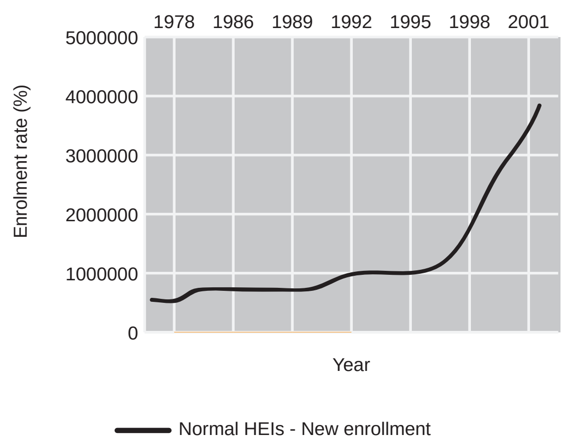
In May 1995, the Ministry of Education of the People's Republic of China (MOE) announced that it had decided to enlarge its university student intake, heralding a new era of expansion in the country's education. Over the 1999 to 2002 period the annual increase in university enrollments averaged 42.4%, which contrasts heavily against the rate for 1978 to 1998: a mere 5.1% average per annum. A corresponding increase in numbers was also seen in the recruitment of postgraduates: in 1995 only 51'053 new students enrolled for a Master's degree; by 2005 the annual enrollment had rocketed to 316'000.

This increase has been mainly due to a slight relaxing of the academic requirements needed for entry, enabling more students to make the grade, thereby increasing their numbers. At the same time, the universities are able to increase their own funding by charging a portion of the study fees to the students.

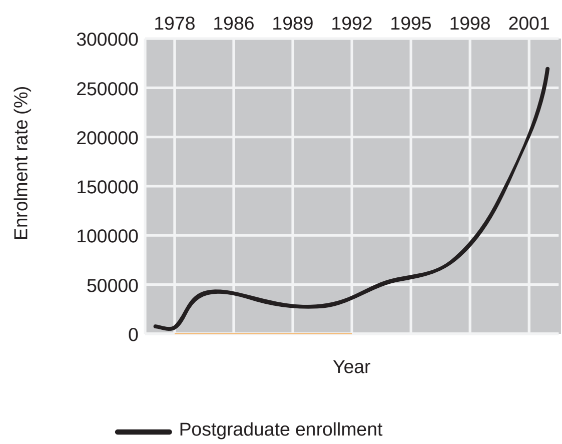
Education is traditionally valued by Chinese to get a good position in society, and the heavy competition on the job market makes a bachelor degree an absolute necessity to have a hope of finding a reasonable job and income. Thus universities, by relaxing their standards, are able to attract more fee-paying students and increase their own financing.

National Bureau of Statisics of China (2004) China Statistical Yearbook 2004. Beijing: China Statistics Press.

Normal HEIs - new enrollment



Postgraduate enrollment



The great scale and speed of this increase in student numbers has helped to raise the general education level of the population throughout the country. The number of universities and colleges with more than 10'000 students increased from just nine in 1978 to 86 by 2003. However, this increase is to some extent at the expense of lowering the entry requirements, meaning that there is a greater quality difference between students than previously.

9.3.2.2 The great increase in the cost of tuition

According to the World Bank, on average, public education expenditure costs some 4.8% of GDP worldwide; 5.7% in developed countries (7% for the US) and 4% in developing countries, while China's spending only amounts to 3.2%. Other data shows that, on average, families worldwide pay only 1/8th or 1/9th of the total cost of higher education, whereas in China, the family share is a much more onerous, ranging from a half to a third.

In fact, the cost of higher education in China has increased ten-fold for the student, from RMB 500 in 1995 to RMB 5'000 per year in 2005, making education one of the ten most profitable industries in the country. At the same time, the high cost of education has become one of the three big burdens for the Chinese family (the other two being housing and health care). All in all, the rapid expansion and commercialization of China's education system has generated new problems:

9.3.2.3 Imbalance in education opportunities for city residents and people from the countryside

During this more than ten-fold increase in education fees from 1995 to 2005, personal incomes have only quadrupled. In addition, the difference in income between city dwellers and countryside people has also increased, with a per capita income of RMB 9’400 and RMB 2’900, respectively, in 2004.

This big difference has meant that the relative cost of tuition has become an increasing burden for students from the countryside. Students from poor areas cannot afford the high expense and are therefore unwilling to go to university or college even when they have passed the entrance exams. Before the arrival of higher tuition fees, students from the countryside accounted for 60- 70% of the total share of university students, while now that rate dropped to just 30%.

9.3.2.4 Increasingly varying levels of quality among universities

The State and local government have worked together to create 52 model universities, such as Qinghua University and Beijing University, providing them with strong financial support. These universities, in turn, have invested heavily in infrastructure (new buildings, libraries, laboratories and dormitories) and personnel (recruiting ever more well-known professors and lecturers to teach and research). The level of quality has continued to improve in these model institutions.

However, some of the other HEIs are unable to keep up with the increase in student numbers and the pressure that this puts on existing college infrastructure. There is a noticeable lack of, or delay in the increase of, classrooms, laboratories, libraries, sports fields and computer hardware and software as student numbers grow. Moreover, the number of qualified lecturers/professors is not increasing as rapidly as needed, and thus the ensuing shortage is resulting in a drop in the numbers of teaching staff able to act as personal tutors to students. Under this continuous pressure to expand, the teaching or overall education quality levels in many HEIs have experienced a drop. Consequently, the difference in quality levels between the HEIs has increased, and the competition between colleges is becoming stronger.

9.3.2.5 Imbalanced market need and supply of graduates

A bachelor degree used to be a guarantee of a well-paid job and work was still relatively easy to find for university graduates in the 1990s, before the great expansion in student numbers. In those days, the demand for graduates was greater than supply, but now the situation has reversed, with the emergence of a buyers’ market since the first batch of students graduated after the great drive to increase student numbers in 1999. In that year the first year employment rate (the percentage of fresh graduates attaining employment within three months of graduation) for newly-graduated students stood at 82%, and that rate has been on a downward slope ever since, down to 74% by 2001.

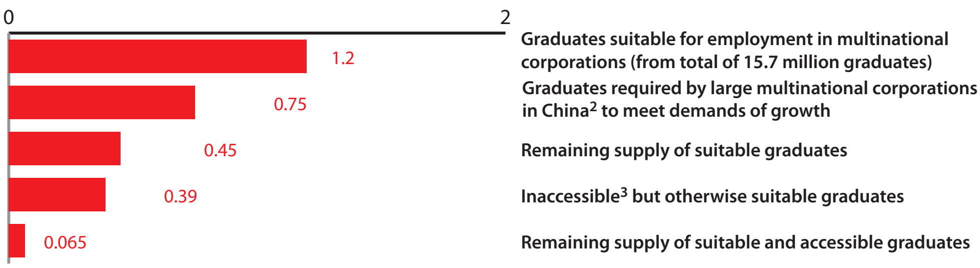
The result of this over-supply has been that employers can be more choosy over whom they recruit, increasingly showing a tendency to overlook those without some degree of work experience. University graduates now need to look further afield for employment, competing for jobs which used to be done by someone with a qualification from a technical school or junior college. Starting salaries have naturally fallen: in 2005, the starting salary of a new graduate in Shanghai was below RMB 1’500, while in 2000 the figure stood at around RMB 2’000.

Some students are now even offering to work for free during their probationary period (although those students are sometimes considered to be near or at the lower end of the academic scale). Good, or top, students, however are still able to find rewarding jobs, particularly with foreign companies in first-tier cities, and are achieving starting salaries of up to RMB 2’500.

9.3.2.6 shortage of suitable graduates for service occupation in multinational companies

Despite this apparently vast supply, multinational companies are finding that few graduates have the necessary skills for service functions. Poor English, low skill levels and overall communication style and cultural fit are the main reasons that Chinese applicants are rejected. A looming shortage of suitable candidates can be foreseen, as shown in the following chart. [1]

Projected Supply of Chinese University Graduates[1],2003-08,millions



[1] Includes all university degrees except MOs, figures do not sum to total, because of rounding

[2] Enterprises with revenue over USD604'000 in 2002 and a workforce of > 1'000 full-time equivalents (FTEs); excludes employment in those companies whose parents are based in Hong Kong, Macao, and Taiwan.

[3] 3 Because of geographic dispersion and lack of mobility; assumes strong growth in accessibiltiy, from 51% in 2005 to 83% in 2008 (India's 2005 level)

9.4 Foreign education ventures in China

Education as an industry has become very profitable and has attracted increasing overseas investment since the early 90s. By end of 2002, there were 712 joint foreign education projects covering 28 provinces, municipal areas and cities; nine times the number of such ventures in 1995.

9.4.1 Geographic distribution

These joint education institutes have mainly clustered in the big cities along the eastern seaboard, where the economy and culture are more developed. The top five areas are: Shanghai (111), Beijing (108), Shangdong (78), Jiangsu (61) and Liaoning (34), all of which are in great need of a well-educated workforce.

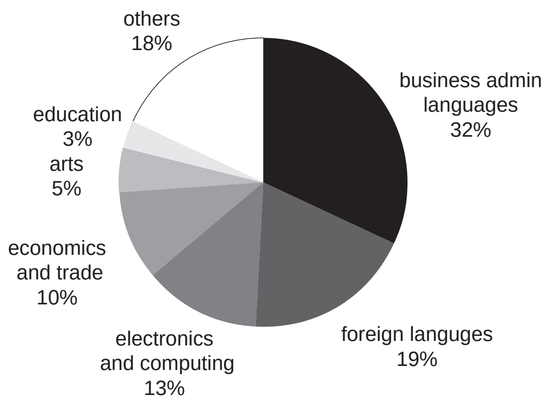
9.4.2 Country source of the foreign cooperators

Most of the **foreign education partners are from developed counties and areas: in particular those areas with advanced** science, technology and education. The top five countries/areas include: the US, Australia, Canada , Japan and Hong Kong, with numbers shown in following chart.

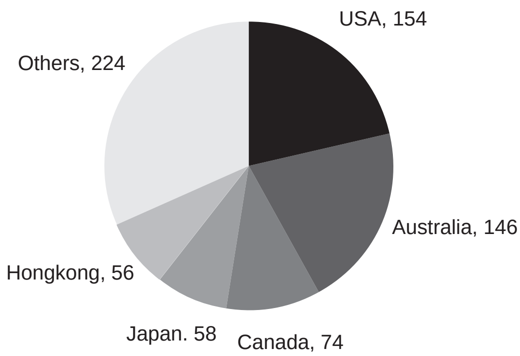
9.4.3 Differing academic levels of the joint education institutes

The academic level of each of these joint education institutes varies and can be broken down as follows: 372 diploma/certificate schools (including 74 postgraduate institutes); 69 are conventional universities; 82 specialized colleges; 36 specialized secondary schools; 69 vocational secondary schools; 40 senior secondary schools and two junior secondary schools. The remaining 313 schools do not issue certificates or diplomas, mainly providing training courses such as foreign language and IT courses, along with (in China) the essential academic qualification tests: IELTS, TOEFL, GRE, CFA, and ECDL/ICDL. There are also 27 joint education-initiated kindergartens around the country.

Major joint education courses in China (end 2002)



Number of foreign-invested educational establishments in China (by investor)



9.4.4 Major courses

The major courses are concentrated in the areas summarized in this chart.

9.4.5 Advantages and disadvantages of joint education in China

Joint education has developed rapidly in China over the past ten years, and nowadays almost all of the well-known HEIs have established some form of joint arrangement with foreign partners.

9.4.5.1 Advantages

Joint education brings high quality education resources and techniques in terms of curricula, methodology and philosophy, which helps to optimize the courses and improve teaching methods. Increasing numbers of bilingual courses are offered, thus helping the Chinese students with their English language written and spoken skills. New media and methods are also used to make the lectures more interesting and interactive.

Moreover, joint education enables students to access a wider point of view than was previously available through state-run educational establishments; students have more chances to meet and listen to famous professors and high-level executives. In 2003, for example, 27 Nobel prize laureates and 47 CEOs of multinational corporations gave lectures in Qinghua University. Another good reason for students to attend such joint education colleges is to expand their skill sets: superior English skills, professional skills and certification accredited by foreign countries are increasingly becoming a required competence when looking for a job, at least in foreign companies.

A good example of higher quality generated by a joint-education project is the China European International Business School (CEIBS), which is a non-profit joint education venture, established and invested in as a result of an agreement between the Shanghai government and the European Union in 1994. The two participants are Shanghai's Jiaotong University, and the European Foundation for Management Development. According to the Financial Times' MBA ranking for 2005, the CEIBS MBA course ranks at No. 1 in the Asian region and No. 22 worldwide. This is the third consecutive year in which CEIBS has received this ranking, and it offers the only Chinese MBA course that has been accredited worldwide. CEIBS can issue both diploma and degree certificates due to its government background.

9.4.5.2 Disadvantages

a) **Diploma and degree**

In China, students are granted both a diploma and a degree after graduation. The diploma is to certify that the holder has completed certain courses, whilst the degree confirms that the holder now has Bachelor or Master's status. In China, **the diploma still prevails when job hunting or in promotions, particularly in state-owned enterprises**.

However, only a very few joint education institutes - traditionally only able to give a degree - are able to award a Chinese diploma in addition to the foreign degree.

On the other hand, **foreign degrees are not recognized by state-owned enterprises unless accredited by the Ministry of Education**.

b) **Student source**

Because of the above-mentioned issue over degree certificates and diplomas, the joint education institute will not be seen as a first choice when it comes to Chinese looking for a high quality school. The current joint education institutes thus normally target those students that cannot pass the entrance exam to a normal HEI, but whose families are willing to pay higher tuition fees in order to get a degree.

However, for most Chinese families, the main aim in seeking higher education is to find a better job. The low acceptance of a foreign degree prevents the students from entering well-known local enterprises. As a consequence, this makes it even more difficult for the joint education ventures to attract better-qualified students onto their undergraduate courses.

9.4.5.3 Some policy issues

Education as an industry is not yet fully open to the outside world. No wholly foreign-invested diploma/certificate issuing education institute is yet allowed to operate in China. All the joint education projects have to be approved by the relative authorities. The foreign partner need to be a public HEI or an HEI accredited by the MOE, otherwise it will not be qualified as a joint education project. With this necessary approval it is thus still difficult for a private education institute to apply for a foreign joint education status in China.

At this point there are two main types of foreign education venture in China.

- Cooperation between local government and foreign country or international organizations, such as the CEIBS project, which was funded by the Shanghai government and the EU
- Cooperation between local school/university and foreign school/university; most foreign education ventures operate along the lines of this model.

A foreign education venture offering different levels of education is required to apply for approval from different authorities. The details can be found in the table below:

Of the various categories listed above, the Chinese-foreign cooperatively-run school, offering specialized higher education or higher education for non-academic qualifications, is probably the easiest type of foreign-invested education project to be approved.

9.4.5.4 The market for foreign-invested education ventures

The potential market for foreign-invested education ventures is huge in China, especially in the two fields of pre-school education and vocational education.

a) **pre-school education**

Chinese families have traditionally placed a very high value on good education from infancy. Pre-school education is currently quite weak in China. Some private or foreign-invested kindergartens appeared in early 90s mainly to cater for foreign children, and more and more parents now want to send their offspring to these kindergartens as they see it an advantage to study in an international environment and learn English at an early stage. More and more bi-lingual kindergartens have been set up to meet this need. Though their charges are much higher than for other types of schooling, parents are willing to pay this premium.

b) **vocational education**

Vocational education has long been a weakness in China. Some multinational enterprises, such as Volkswagen, have set up vocational training courses especially for their current or potential employees. One benefit of this

Level of education	**Approval authority**
Higher education: for academic qualifications at, or above, conventional university education	The education administration department of the State Council (central government level)
Specialized higher education, or higher education for non-academic qualifications	The local government of the province, autonomous region, or municipality where the proposed school is to be located.
Secondary education: for academic qualifications; tutoring programs for self-taught students to pass examinations; teaching programs to supplement school courses, and pre-school education	The education administration department of the local government of the province, autonomous region or municipality where the proposed school is to be located.
Vocational technical training	The labour administration department of the local government of the province, autonomous region or municipality where the proposed school is to be located

Source: Regulations of the People's Republic of China on Chinese-Foreign Cooperation in Running Schools (Adopted at the 68th Executive Meeting of the State Council on February 19, 2003, promulgated by Decree No. 372 of the State Council of the People's Republic of China on March 1, 2003, and effective as of September 1, 2003)

type of vocational training is that the students are guaranteed a job on graduation.

The profit for foreign-invested education in China is quite high, due to the need for good education. CEIBS, for example charges USD 18'270 for domestic students and USD 24'000 for international students to attend its 2005 MBA course. The profits are usually transferred to the foreign investor by means of consulting or service charges and foreign employee salaries.

From the beginning of 2005, new policies have been issued, making it clear that non-diploma/certificate education institutes are profitable entities and that the interests of investors are protected by law. Since the issue of these new policies, such profits can be legally transferred abroad

9.5 Chinese studying abroad

Since the reform and opening up in 1978, more and more Chinese students and scholars now go abroad for further study. In terms of financing, they can be divided into state-funded, employer-funded and self-funded. However, the golden dream of an overseas education for wealthy Chinese students has recently been soured by accusations of profiteering on the part of unscrupulous overseas colleges and their Chinese agency counterparts. In fact, the number of Chinese studying overseas has actually fallen since 2003. Families are increasingly looking to send their children to study abroad for two main reasons:

- Looking for a chance to emigrate
- Coming back as an overseas student with enhanced possibilities for a good job.

In 2003 the total number of students and scholars studying abroad was 117,300, among which 3,200 people were state-funded, 5,144 employer-funded and 109,200 self-funded. **Of those Chinese studying abroad, with a 93.1% share, self-funded students make up by far the largest group**

In terms of geographic distribution of students studying abroad in 2003, 10.5% went to Asia; 1.8% to Africa; 49.8% to Europe; 15.4% to North America and Latin America, and 22.5% went to Oceania.
More and more foreign countries are now realizing that Chinese overseas students can bring bihg economic benefits. Australia issues 20'000 student visas to Chinese students each year, accounting for 16% of that country's total student visas. In return, these Chinese overseas students contribute AUD 200 million [USD153 million] to the

Australian economy. Education export ranks as No.4 in Australia's export business to China.

As a result, **Chinese overseas students are becoming a lucrative business for foreign countries.** One growing trend nowadays is the increasingly important role played by foreign governments in attracting overseas students, rather than the individual recruitment efforts of universities and colleges alone. Foreign governments manage participation at education exhibitions in order to guarantee the quality of the participating HEIs and promote the country as a whole. On the other side, favorable policies are offered to the students, such as free medical insurance, loans and allowing them to work more hours per week while working [why is this a benefit?!].

9.5.1 The role of recruitment agents for students wishing to study overseas

At this point in time the market for students wishing to study overseas is still not fully opened. The MOE does not permit foreign education institutes to have an office to carry out direct recruitment activities in China. All recruitment must be carried out via agents employed by MOE-licensed agencies, for which fees will be charged depending on the volume of business. **At the time of writing there are only 270 qualified agencies to recruit Chinese to study abroad across the entire country**.

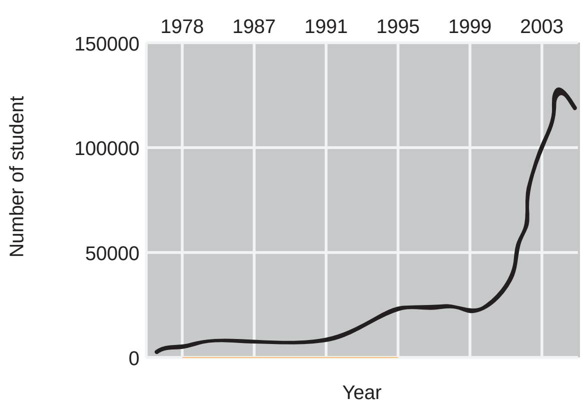
The agents:

- Provide consulting services for students wanting to study abroad
- Help the students in school/university choice and application process
- Help the students with visa applications
- Provide relevant training courses
- Hold introduction meetings and lectures on behalf of the foreign education institute
- Participate in education exhibitions on behalf of the foreign education institute
- Carry out recruiting activities on behalf of the foreign education institute.

Such an agency necessarily becomes an important business partner for the foreign institute wishing to recruit students in China, since it acts as the interface between the students and the foreign institute. However, many agents are purely profit-driven: they don't really carrying out consulting services but 'lease' the agency license and charge lease fees to anyone wishing to join the business.

First-tier foreign universities and institutes are conscious of the dangers of having too large a proportion of students of Chinese or other Asian country origin, which could adversely influence the nature and academic level of the courses themselves. Thus many Chinese students are ending up in second-or even lower-tier colleges, who are interested in the additional tuition fees that Chinese students can bring. Together with the agents, they exaggerate the quality of their education and college benefits and have a tendency to accept all applications. This type of short-sighted, exploitative activity has harmed the overseas education market.

Number of student studying abroad (1978 - 2003)



Source: National Bureau of Statisics of China (2004) China Statistical Yearbook 2004. Beijing: China Statistics Press.

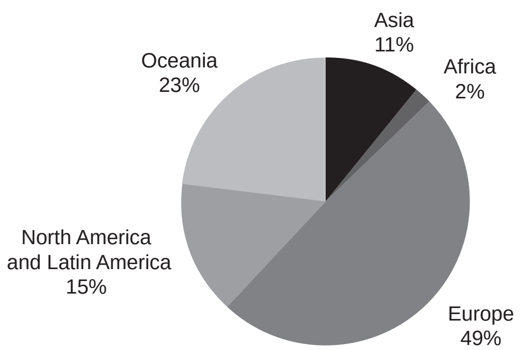
9.5.2 Demographics of students going abroad

Shanghai is one of the main sources of students that go abroad to study. Blow are the results of a survey by an overseas education recruitment agency on Shanghai students preparing to study abroad in early 2003:

a) **Age**

The survey divided the sample into seven age

Geographic Distribution of Chinese Students Studying Abroad



groups: 60.8% of the students were 20 to 24 years old; 27%, 15 to 19 years old and 10.1% were 25 to 29 years old. This shows that parents of 15 to 19 year-olds are less willing to send their offspring overseas at an early age, though the quality of university education is generally better abroad.

b) **Graph**

Channels for students to learn about overseas study recruitment agencies. The survey showed: 74.6% of interviewees found agencies through newspapers and magazines; 18.8% through word-of-mouth; 16% through the internet, and 4.3% through television.

For Chinese families, it is a big decision to send students abroad, especially considering the great amount of money involved. Most of the time, the parents (40 to 50 years old) are the decision makers, and are more trusting of tradition and the conservative media than the younger generation.

c) **family income of the students studying abroad**

The effort to support a son or daughter studying overseas is still a very big expense for Chinese families. The survey discovered that those whose monthly family income exceeded RMB 5'000 made up the largest proportion of self-funded students abroad. These families have great expectations of their child and are willing to pay for a better education abroad.

9.5.3 Chinese students studying in Switzerland

Between 1999 and 2004, Switzerland issued around 2'500 visas a year to Chinese students, of whom only around 30 were state-funded. Swiss public universities don't usually accept Chinese middle or high education degrees and have strict requirements on language and professional qualifications, therefore most Chinese students are unable to enter, so instead they apply to private universities, whose enrollment requirements are comparatively low. Most of the Chinese students are spread amongst hotel management and language schools.

Unfortunately, some private schools offering hospitality/hotel management courses have done considerable damage to the reputation of Swiss education establishments in China. For example, The University of Finance in Geneva is a private school; it is not qualified as a higher education institution by the Swiss government nor is its diploma accredited by the relevant Swiss authority.

However, it faked the relevant qualifications and cheated in its recruitment literature by claiming that its courses and diplomas were well-accepted by the government and all types of financial institution. Its faked certificate was uncovered by the Chinese embassy in September 2001 and quickly exposed to the media. However, by this time quite a number of Chinese students had already applied to, and begun making preparations to travel to, that school; this event, among others, has had a very negative impact on the image of Swiss education in China.

9.6 Market opportunities for education in China - an expert opinion

9.6.1 Target high income families

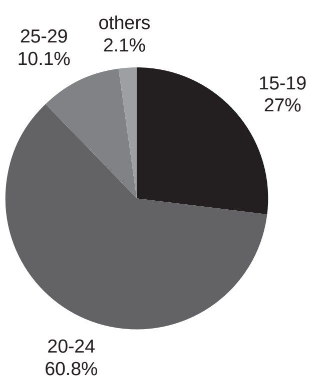
Education has become one of the most important issues in the family, especially in developed areas. **Young parents are, more than ever, willing to invest in the child's future, even from the kindergarten stage**. However, China is not very strong in pre-school education (kindergarten age) and this is a good area - with little competition at present - where relatively low investment can generate high profits.

9.6.2 Invest in inland areas

Compared to China's coastal areas, inland China is less developed, and more in need of investment in its education system than its richer cousins. The market need for education in inland China is huge. However, one should take into account this region's relatively low personal income level when conceiving pricing policy, investment scale and product design.

9.6.3 Invest in vocational education

Vocational study is another area that needs further investment; Chinese people have traditionally attached more importance to degree-style, academic education, whilst neglecting vocational studies. As a matter of fact, multinationals complain that compared with engineering graduates in Europe and North America, who work in teams to achieve practical solutions, Chinese students get little practical experience in projects or teamwork. This is mainly due to the educational system's bias toward theory. The market demand for skilled technicians is now higher than ever, and some experienced technicians are better paid than degree holders these days.



Age Spread of Chinese Students Going Abroad

The Chinese government has put development of vocational education at the topt of the list in its 9th plan for educational development. This is good news for the foreign education institutes that have extensive experience in this field. However, more attention should also be paid to promoting the prospects of well-educated and skilled technicians.

9.6.4 Provide free tuition in order to attract best students in foreign institutes

Good Chinese students are well-known for their sound knowledge, hard work and willingness to work for comparatively low income: they are welcomed by research institutes. However, some high quality students are unable to go abroad for financial reasons; free tuition would be very attractive to these students and as a result, both parties would benefit.

Contributed by David

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10 China's Healthcare Services

by Marco Cabalzar, member of the editorial team, CH-ina

10.1 China's average public health system far behind Western standards

After its establishment in 1949, the People's Republic of China began to make big efforts in the health sector: so-called 'barefoot doctors' (chijiao daifu) were sent out to the countryside under Mao's slogan 'wei renmin fu' (serve the people). With these doctors, educated in setting bones; delivering babies; treating wounds and other basic medical skills, health care was made available to the lowest levels of society. [1]

While in the days of Mao nine out of ten country people had access to basic medical treatment, according to a government survey conducted **in 2001, as much as 60% of the country's rural population nowadays avoids hospitals because of the high cost of treatment**. Diseases once declared vanquished, such as tuberculosis, measles and snail fever, are making a comeback, and HIV is rapidly taking hold. Furthermore, China is the only country in the western Pacific region which relies on patients to finance the immunization of childhood diseases – an effective barrier for parents wishing to have their children immunized in hospital.

The World Health Organization (WHO) ranked its 191 members' public health systems in 2000, placing China 144th – behind India (112th) and some of Africa's poorest countries. [i] In this WHO assessment the main focus was on accessibility to health services and the quality of patient care. The WHO also stated that in China, many physicians derived part of their income from the sale of prescription medical drugs. [2] As doctors depend on selling medicines to increase their income, over-prescription and corruption are serious issues. Patients frequently complain that in order to get good treatment they need to bribe doctors and nurses. [3]

10.2 Health care financed through private savings

Since 60% of the urban, and 90% of the rural population lack medical insurance cover, treatment in most hospitals has to be paid in advance. **Many Chinese people therefore save money in preparation for illness**. Those without savings, or whose medical treatment costs exceed their savings, will need to borrow money from their families and friends to pay for medical care as they get older. This may cause considerable problems, since by 2040, each 60-years and older person will be supported by only two working-age people .[4]

10.3 Privatization of the medical sector

In 1979, the Ministry of Health took the first steps to managing health services with a market-oriented approach. Six years later, a medical system reform was initiated and more decision-making power was given to hospitals. Government subsidies to the medical sector's running costs dropped from a third in 1980 to a quarter of total expenditure by 1990.

In 2000, Suqian, a city in Jiangsu Province, became one of the first to take a fully market-orientated approach by offering private health care to compensate for the shortage in government funding. Within five years, it had sold the two state-owned hospitals and another 133 local hospitals. [5] In 2005, Xinxiang, a city in Henan, followed the same example and sold majority control of all of its five state-owned hospitals to a Shanghai-based, state-owned pharmaceutical group. This was one of the most controversial sell-offs, because it seemed that one over-priced monopoly was being replaced by another – only this time it was by a private-, rather than a state-owned monopoly. Therefore further such deals between drug companies and hospitals were forbidden by the Shanghai government. [6]

10.4 Outlook

In August 2005, the China Daily newspaper conducted interviews with managers of health and beauty care companies on the role of the private sector in the nation's health care reforms. The interviewees said that emergency care in hospitals should be paid by the government through a compulsory medical insurance [ii] and that hospitals should have higher charges for the patients who wanted better, or private, service. [7]

The government is considering privatizing most of the hospitals in urban areas and only retaining control of the main hospitals. Privatization candidates could involve up to 60% of the country's urban hospitals .[8] Forecasts indicate that nearly RMB 10 billion (USD 1.23 billion) in private and foreign capital will be invested in China's medical system in the future. [9]

10.5 Foreign investment restrictions

Foreign companies are not allowed to establish wholly foreign-owned medical institutions but can set up either joint venture or cooperative medical institutions in which both parties have to be legal entities that can independently bear their liabilities. They must also have direct or indirect experience of medical and health investment and management; furthermore they have to be able to provide international cutting-edge medical technologies and equipment.

The resulting Chinese-foreign joint venture or cooperative medical institution is an independent legal entity, with a minimal investment of RMB 20m. The Chinese party must hold at least 30% of the interest, and the lifespan of the joint venture or cooperative medical institution can only exceed 20 years under certain poorly/not clearly defined circumstances. No foreign-invested or cooperative medical institution is allowed to set up subsidiaries or branches.[10]

10.6 Potential opportunities for the Swiss health care industry

There are two ways for foreign institutions to provide health services to the Chinese: either by treating them in clinics and hospitals in their home countries or by setting up hospitals in China. While some foreign-based private clinics have already started to contact wealthy Chinese for medical treatment abroad, at present the establishment of hospitals in China is rare.

So far only a few foreign-invested hospitals have been set up. In 2003, most of the 60 foreign-invested medical institutions were dental or plastic surgery clinics, which do not provide the wide range of services needed for them to be classified as hospitals. [11] The first fully- operational medical institution in mainland China was the Beijing United Family Hospital and Clinics, which opened in 1997 as a joint venture between the US-based Chindex International Inc. and the Chinese Academy of Medical Sciences in Beijing. In 2004, Chindex established the Shanghai United Family Hospital and Clinics as a joint venture with the Shanghai Changning Central District Hospital. Chindex has already signed a Letter of Intent with Xiamen Zhongshan Hospital for a third hospital in Xiamen, and the company has announced that others may follow.[12]

Given the troubled state of Chinese healthcare, the few foreign players in the country, and the excellent reputation of Swiss healthcare, there should be plenty of opportunities for Swiss private clinics to establish subsidiaries in China. The different dynamics, due to the immature health system and strategic limitations (the need for a JV or cooperative, 20-year time limit with uncertain possibilities for extension) are restrictions which require careful analysis and preparation beforehand.

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Notes

i The World Health Report, first published in 1995, is WHO's leading publication. Each year the report combines an expert assessment of global health, including statistics relating to all countries, with a focus on a specific subject. The 2000 report was on health systems. Unfortunately no more up-to-date information on China's health system's global rank is available at the moment.

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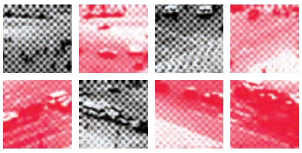
12 United Family Hospitals and Clinics web page - http://www.unitedfamilyhospitals.com/



11 Chinese Tourism

by Marco Cabalzar, member of the editorial team, CH-ina

11.1 General information on the Chinese tourism market

As a result of the growing wealth of China's urban population, more and more Chinese now have the financial ability to travel for holiday purposes and are willing to do so (also to show their social status). Tourism to foreign destinations (outbound tourism) from China has increased by an annual rate of 20-30% over past four to five years. Nowadays up to 90% of travelers are tourists, traveling on their own expenses, while in the past most outbound trips were business-related. In 2004 for example, outbound tourists numbered 28.85 million (only 2.2% of the total population, though), up 43% over 2003. **The World Tourism Organization estimates that by 2010, China will become the world's fourth largest source of outbound tourists.** [1]

Chinese tourists, from the beginning and to the present day, have mostly traveled on group package tours, often covering eight to a dozen countries over the period of ten days. Group traveling has a strong control function: The Chinese government aims at avoiding brain drain to Western countries during travel activities and the West fears and already experiences illegal immigration from China while depending on income for their tourist industries. Outbound traveling for Chinese is therefore restricted and subject to visa approvals.

The normal cost of such a group package tour is some RMB 10'000-20'000 (USD 1'200-2'500) per person, and includes return airfare, visa application fees, accommodation, tour guides, transportation and three meals a day. Due to the shortage of public holidays in China, longer stays, especially for young people, are not possible. Therefore itineraries are often promoted along various themes (e.g. a European football tour and an ancient castle tour). These special interest trips usually take seven to ten days and cover up to three countries. [2]

In 2004, however, a change in tourists' behavior began to emerge: increasing numbers of Chinese are starting to favor quality over quantity, wanting to spend more time at a single destination, rather than rushing from one country to the next on their holidays. For good food, a relaxed schedule and luxury accommodation they are willing to pay in excess of USD 2'000 per person. It appears that this kind of traveler has already visited Europe on a package tour and now likes to spend more time visiting historical sites and scenic spots of their personal interest than it was possible during the initial trip. [3]

To facilitate visa procedures for Chinese tourists, China has entered into so-called "Approved Destination Status" (ADS) agreements with other countries: Under ADS, Chinese nationals can obtain a single-entry visa to an authorized destination country, providing that the travel is organized by an approved tour operator. Authorized travel agents are designated by the Chinese National Tourism Administration (CNTA) and are required to handle all outbound travel arrangements for each and every traveler. [4] The letter of invitation, that in the past was an absolute necessity to obtain a tourist visa, has now became obsolete in these cases. China signed an ADS agreement with the European Union - covering 12 countries - on 30 October 2003 in Beijing, and then with Switzerland on 15 June 2004.

11.2 Chinese tourists visiting Switzerland

"Snow and the scenery are the main reasons for Chinese people to travel to Switzerland", says Juerg Schmid, director of Switzerland Tourism, and adds that sightseeing and shopping have become more and more important. [5] Switzerland Tourism expects a continuous increase in overnight stays by mainland Chinese visitors from 230'000 in 2004 to 300'000 in 2005, and a further annual growth of 25% for 2006 and 2007.

Chinese travelers spend around CHF 450 (USD 350) per day on accommodation, meals, transport and shopping during their stay in Switzerland. Therefore, the turnover from tourism in Switzerland can be estimated to be worth some CHF135 million (USD105 million) for 2005, CHF169 million (USD131 million) in 2006 and around CHF211 million (USD 164 million) by 2007. [6]

The Swiss Federal Statistics Office's half-year figures for tourism in 2005 (published on 15 September 2005) show that mainland Chinese tourists - without counting those from Hong Kong - have spent 74'022 nights in Switzerland since the beginning of the year. That is 96% more than for the corresponding period in 2003, although admittedly in the first half of 2003 the number of Chinese visitors to Switzerland was down by 33% as a result of travel bans brought on by the impact of SARS. Despite this, however, when comparing the figures for the first half of 2004 and 2005, a healthy 40.6% increase in Chinese visitors can be noted, and this is mainly seen as a direct result of the "Approved Destination Status" (ADS) agreement.

Over the past five years, the number of overnight stays by Chinese tourists in Switzerland has increased by an average annual rate of 19%; nonetheless, of all the overnight stays by foreign tourists in Switzerland for the first half of 2005 (9'005'535), the Chinese share amounted to just 0.8% of the total.

While mainland China becomes an increasingly important source of visitors for Switzerland, in the past five years the number of overnight stays by Japanese tourists has decreased by 133'857 – a drop of more than a third. [7]

11.3 Restrictions to foreign investment in China

In 2004 around 11'000 travel agencies were registered in China, but only 528 of them were approved to engage in outbound tourism. [8] All of them seem to be domestic Chinese, since setting up a foreign travel company in China is hampered by restrictions.

In China, a foreign company can set up a travel agency as a wholly foreign-owned enterprise (WOFE) or joint venture (JV) with a registered capital of at least RMB2.5 million (USD300'000). The main restriction is that such an agency is not allowed to offer trips from China to foreign countries for Chinese customers – only CNTA-designated Chinese companies can do so; however, foreign-owned agencies in China are allowed to sell travel services to be used at the foreign destination (for example, a Eurail Pass), domestic travel services within China to Chinese and foreign customers and international services for non-Chinese only. Furthermore, the foreign investor's main business scope has to be tourism and consequently it must be a travel agency. For a JV, the revenue of the foreign parent company must be at least USD40 million a year, or USD500 million for a WOFE. [9]

11.4 Opportunities for Swiss companies

1. Bring Swiss or other Western leisure or business travelers to China
2. Offer leisure or business trips in China to Chinese
3. Promote Swiss destinations, events and services to potential Chinese tourists to create demand and influence their decisions – due to legal restrictions, bringing Chinese tourists to Switzerland directly is not possible for Swiss companies.
4. Cater to Chinese leisure or business travelers in Switzerland
5. Swiss Class is a company which set-up a business model for option 4:

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11.5 Catering to the demanding Chinese high end individual in Switzerland

by Oliver Rossi, Managing partner Swiss Class

The difference between Chinese business associates and tourists

The present growth rate of Chinese guests in Swiss tourism only applies partly to the "Chinese High End Individual". The average Chinese tourist travels in groups and has essentially different expectations of Switzerland to those of a Chinese businessman.

Chinese high end Individuals almost exclusively consist of Chinese executives and management members demanding sophisticated services. Touristy motivation isn't central. The emphasis is being put on the specific added value to the business and satisfying the personal needs of the individual and his family. **High end Chinese travelers are business people with different interests from mass tourists**

The duties and tasks of Swiss entrepreneurs expecting Chinese guests

First of all you should think carefully about certain aspects: what are the values, abilities and skills you want to communicate about Swiss culture, quality and reliability – to mention just a few of them. The choice has to be focused on your project, because it's essential to create a lasting impression. The exclusive services your guest receives and his personal appreciation of your hospitality are crucial factors of this choice.

Chinese customers not only ask for special attention, but also for uncomplicated and professional support concerning their finances, private banking, health care and education. They expect a prompt and excellent response to their inquiries about these services; this way they have an overview of the benefits and possibilities they can achieve by doing business with you in Switzerland.

During a stay in Switzerland, private matters are often combined with business. Examples would be: which bank is the right partner both for business and private banking; what's the best school for my child; which medical specialist can provide the best medical care within a short period of time? If a professional, discreet and Chinese-speaking attendant can provide these services, the host will surely benefit as well.

The character of a Chinese guest

In general the **Chinese are very curious individuals**. That's how the great Chinese writer Lu Xun described his fellow people decades ago, and this still holds true today. They are not only curious about our workflow, manufacturing processes and corporate cultures, but are also interested in Swiss institutions, the historical background of the country and its political structures. Chinese are eager to learn and absorb as much as possible: Asking questions, watching and comparing are what's most important to a Chinese guest.

How to look after the guest appropriately

One might think that a Chinese attendant would be sufficient during the stay of an important Chinese customer. However, this would poorly satisfy the guest's expectations.

Superior care means that many more factors are crucial: who the guest is; which province he is from; what are possible activities he has never experienced before; what are his expectancies and demands concerning hotels and meals, and so on.

Of course, there are some stereotypes about Chinese guests and their culture. After all, we mustn't forget that when they meet with the Swiss, two completely different cultures collide. One common opinion is that the Chinese don't like to adjust themselves to our way of thinking, but one must not forget that there are reasons for their actions, embedded in their vastly different cultural background.

The guests expect appreciation, attention and appropriate treatment. That's the foundation of trust and success.
Appreciation, attention and appropriate treatment are the foundation of trust and success

The secret of the unforgettable care that leaves its mark on our guests is anticipation — to give and detect emotional attention, to anticipate wishes and to give your guest an unexpected special gift as if he would take it for granted.

This doesn't mean that you as a Swiss entrepreneur will need to change your traditional way of doing business. To cultivate successful business connections with China you don't have to act Chinese; you just need to accept and embrace the character of your business partners.

The future as opportunity

Globalization and its intensified business relations show a clear tendency for China. If the Swiss concentrate on their original qualities and integrate them into modern technological and commercial concepts, numerous opportunities will arise. The Swiss have always been excellent until the last detail. But to know these specific details it requests knowledge and experience. This knowledge makes the advantageous difference between you and your competitor.

That's the maxim for guest hosting or business with China, the key to success is: knowing the difference.

Contributed by Swiss Class
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12 Gate Gourmet Shanghai

Airline Catering Industry

SUMMARY

Gate Gourmet is an international airline catering company operating 109 catering units in major airports of 29 different countries around the world. Its core competence is providing catering services to airlines including various logistics and related specific services. The array of services provided in Shanghai through a joint venture with the Shanghai Airport Authority (which falls under the umbrella of the Shanghai government), includes food production, packaging, refrigerated transportation, laundry and airline equipment storage. Gate Gourmet Shanghai (GG PVG) is one of the only two caterers serving Shanghai's Pudong International Airport.

Figure 1:
Gate Gourmet's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Food Products	Services	Consumer Goods	Services
Producing				Gategourmet	Gategourmet		
Purchasing				Gategourmet			
Selling	SOE			Gategourmet	Gategourmet		
	POE			Gategourmet	Gategourmet		
	FIE Global			Gategourmet	Gategourmet		
	FIE Local			Gategourmet	Gategourmet		

SOE - State-owned enterprises in China
POE - Private-owned enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are customers of GG Group in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not customers of GG Group in the global sca

This study describes Gate Gourmet's experiences in China focusing on the company's success factors:

- training and employee retention
- adapting to the local environment for quality and efficient service
- sustaining good relationship with the joint venture partner

GLOBAL INDUSTRY TRENDS and OUTLOOK

In the past, airline food catering was done by the airlines themselves. Due to high air ticket prices, costs of meals were of little issue and concern was focused on the quality of food. With decreased margins, airline companies were later on forced to cut down costs and optimize quality. With the increasing number of flights, slight cost reductions for each meal imposed on caterers by airlines resulted in considerable global company savings, enabling airlines to improve their costs but adversely imposing high cost pressures on caterers. As a consequence, catering companies became independent, either as outsourcers or separate spin-off subsidiaries to improve management and reduce costs. With increasingly strict requirements, caterers evolved to either masters of malleability or simply disappeared.

However, the expense cutting practices of caterers are minimized with the imposition of strict airline regulations by the Hazard Analysis and Critical Control Point (HACCP). HACCP was developed in the 1960s in the United States to ensure food safety for the first NASA [i] manned space missions. Since then, HACCP principles have been defined and endorsed in international food standards and in European legislations.

HACCP is now the internationally recognized food safety methodology. 'Assured Safe Catering' is a system based upon HACCP principles developed for caterers to ensure food safety. Such regulations require transparent information that can only be

CASE STUDY

provided by competent organizations with firm comprehension and understanding of hygiene and safety practices. The strict quality standards imposed on the airline catering industry, its uncertain future and the high level of skills needed to maintain operations with the required standards tend to discourage further investment in this industry.

Yet, the surviving airline catering companies still face many challenges as they are most vulnerable to the ups and downs of the airline industry. The September 11 attacks or the SARS crisis, for example, have heavily affected the industry. Caterers were the first target of cost saving measures which resulted in tens of thousands of jobs lost across the industry. The surging oil prices will also affect the industry considerably. Airlines are considering more and more direct passenger sales, including the direct selling of food. The additional cost to passengers will result in less consumption and less sales for the caterers; these measures are now being implemented in short distance flights and are already strongly affecting the industry in the United States.

With the intensifying cost concern of airlines, high price segment caterers tend to disappear while few caterers are left to fight over low profit margins for high standard end product requirements. Airlines, with their cost cutting frenzy, tend to converge to a direct meal sale strategy to passengers, hence giving the passengers an option to choose whether and how much they want to pay for the meal.

Figure 2:
Gate Gourmet International facts and figures
Source: Gate Gourmet International, www.gategourmet.com

534,000 meals per day, 195 million meals per year
109 flight kitchens
29 countries
5 continents
22,000 employees
CHF2.4 bn revenue (2004)

Figure 3:
Gate Gourmet Shanghai facts and figures 2004
Source: Gate Gourmet Shanghai

Catered pax per day, average:	2,500
Catered pax per year, average:	890,000
Meals produced per day:	3,500
Maximum meals capacity per day:	25,000
Flights handled per day, average:	22
Flights handled per year, average:	7,651
Freezing capacity in sqm:	545
Cooling capacity in sqm:	1,210
Number of employees:	308
Number of high loaders in use:	10
Number of support vehicles in use:	4

MOTHER COMPANY – Gate Gourmet International

Company background and current situation

Gate Gourmet was founded in 1992 out of the Swissair Catering as a company of the part of the Sair Group. Gate Gourmet's essential market and core business is airline catering. However each of Gate Gourmet unit's management is independent and some units may outsource the logistic aspects while others diversify fields of sales.

Company size and structure

In 2004, Gate Gourmet consisted of 109 independent units worldwide, with over 22,000 employees and CHF 2.4 billion (USD 1.87 billion) in revenue. Gate Gourmet International is the second biggest catering company behind LSG/SKY Chef's (Lufthansa Group).

Competitive advantage

Gate Gourmet has managed to overcome the global decline of the catering industry by being highly adaptable and efficient. This has been achieved mainly by the administration system that Gate Gourmet has put in place. Conferring freedom to its different units in terms of management to address local issues but implementing a strong and professional training program to ensure standards and efficiency are maintained.

However, the Gate Gourmet brand name does not present any special advantage as airlines tend to choose regional partners. With the disappearance of Swissair and the takeover of Gate Gourmet by an investment company focusing on short term returns, fewer investments in new catering units resulted in the loss of significant contracts as Gate Gourmet failed to establish a strong worldwide geographical presence.

The strategy of conferring self-management powers and independence to its individual business unit affords Gate Gourmet the necessary flexibility to survive the war on costs in the airline industry in the recent years. For instance, with meals provided on airplanes costing at least five times less in China than in Switzerland, catering units have to constantly adapt to local expectations.

CHINA INDUSTRY TRENDS and OUTLOOK

Although China is rapidly developing its airline fleet and multiplying its flights, airline companies focus on very low fares and customers are less reactive to the in-flight meals' quality if ticket prices are taken into account. As such, the Chinese market, although in full development may not be as promising today as it may have been before.

GATE GOURMET in CHINA

Subsidiary background and current situation

GG PVG was established in 1999 through a joint venture with the government-owned Shanghai Airport Authority. By contract, no other international airline catering competitor may enter the market at Pudong International Airport for as long as the joint venture is not profitable. Gate Gourmet's investment is of 20 years up front rental fee for their facilities at the airport, making the initial investment too high to be immediately profitable, especially with the current low margins business environment.

Subsidiary size and turnover

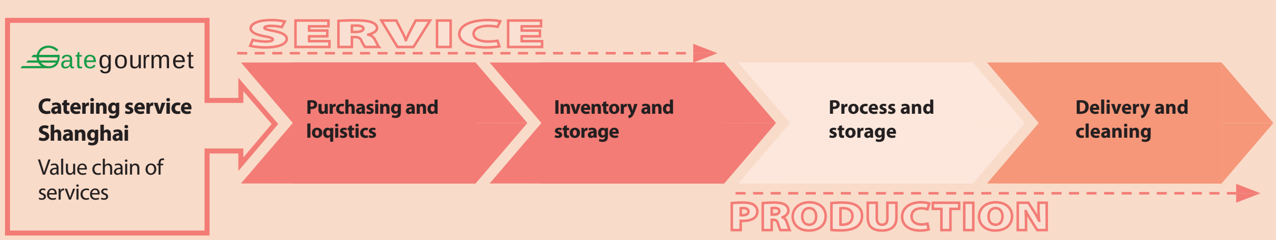
GG PVG enjoys a strong relationship founded on trust with foreign airlines and uses this relation at best. GG PVG currently has 308 employees with a year on year revenue growth of 20%.

However, due to the stagnant growth of the airline industry, GG PVG has diversified its market by extending its core competence as a caterer and offering services to local restaurants. As one of the preferred suppliers of Pizza Hut, GG PVG supplies to about 60% of all Pizza Hut outlets in the greater Shanghai area, accounting for 35% of the company's total revenue. Other industries such as hotels and food and beverage chains are also becoming clients of GG PVG, showing an aggressive expansion. Such diversification has enabled GG PVG to not solely depend on the risky operations of airline catering and to make additional profit.

Value chain

International regulations place the responsibility for ensuring food safety appropriately on the caterers and practically obliges the caterers to control the entire service value chain. This also allows more value to be derived from the chain. Not only are caterers responsible of what food they buy, but also of ensuring strict controls and that hygiene standards are met during the entire process. Responsibilities begin from the purchase of goods from the supplier to logistics and transportation, and from refrigeration and storage to cooking and packing.

Figure 4:
Value chain
Source: Swiss China Survey, 2005



CASE STUDY

GG PVG has complete control over its chain of services while its mother company allows outsourcing of some of the subsidiary's activities. Three years earlier, GG PVG evaluated outsourcing part of its activities in an attempt to further improve costs. But in the end it was abandoned because it was not cost-effective. Additionally, timely delivery of goods is GG PVG's key competency, therefore this aspect should not be subcontracted. More than just a strategic decision, it became an obligation particularly in China where local suppliers commonly fail to meet the hygiene and delivery time standards that GG PVG needs to sustain in order to fulfill commitments to customers as well as comply with international regulations.

The services that GG PVG provides include sourcing of food, beverages, dry goods, etc. from local suppliers, storage, food production and assembly processes as well as packaging, transportation and delivery on board the aircraft. Additional services include, but are not limited to, laundry services and VIP lounge catering.

Local competitors and competitive advantage

GG PVG's only competitor in Pudong International Airport is China Eastern Airlines Catering (SEAC), a domestic airline catering company owned by China Eastern Airlines and active in Shanghai for over 25 years. The strong relationship that SEAC enjoys with local and international companies leave GG PVG with 20% of the total market share (which includes China Eastern and Shanghai Airlines flight movements) but with 48% of free market share in all the international flights.

FACTS and ANALYSIS

Choice of location and legal form

According to its agreement with the Shanghai Airport Authority, GG PVG was provided a fully-equipped building within the airport vicinity with 20 years of rent paid up front. It was essential for GG PVG to set up its operations within close proximity of the airport to be able to provide fast and efficient service to its customers. The joint venture arrangement with the Shanghai Airport Authority has some advantages such as provisions for occasional administrative support on legal issues as well as acquiring domestic operating licenses. The drawback of the joint venture agreement however was the sizeable initial investment mostly allocated to the rental fees of GG PVG's facility — this investment was justified through calculations made at a time when perspectives were different.

Customers and sales

The sales in this particular business depend on customer acquisition. Caterers are invited to tender for the business from an international airline. A complete offer containing detailed pricing information, commercial proposal along with the executive summary have to be submitted. The airline conducts an in-depth cost analysis based on the offered price and then visits the caterer not only to evaluate the hygiene and safety standards of the unit, but also to get a first hand impression of the potential supplier. If pricing is advantageous over the competing bidders, the safety and hygiene aspects are up to the airline's quality and service expectations, the contract is then awarded to that caterer. Contracts are usually agreed upon for two to three years, thereafter the account is again put up for tender and the whole process starts all over again.

Suppliers

GG PVG chooses suppliers in nearby villages around the airport for logistic reasons. The company currently has around 82 suppliers, 30 of which supply food products only. For management and quality purposes, GG PVG's global standards require competitive sourcing processes. This is achieved through weekly and monthly bids to minimize costs and supplier training to ensure adherence to policies and regulations. Additionally, GG PVG changes some of the suppliers every year to avoid having suppliers forging private agreements among themselves.

The strict airline HACCP regulations previously mentioned require a transparent information flow right down to the suppliers. GG PVG has to ensure the traceability of all products throughout the entire production and packaging processes up to delivery on board the aircraft. Suppliers do not completely meet these requirements. To ensure adherence to HACCP regulations, GG PVG strictly selects, controls and corrects suppliers and deliveries.

Recruitment, training and people management

GG PVG's activities are labor intensive thus it puts emphasis on the importance of its labor force. The company implements a management training program available to all employees followed by a series of tests.

The subsidiary localized all its management positions except for the General Manager and Production Manager positions, for which expatriates are designated. These two key positions remain western due to the need of in-depth knowledge of the airline industry and to establish a small but important competitive edge over the competitor. Nonetheless, only a small number of employees understand English and communicating with them through a translator can never be as effective as having a Chinese manager who is proficient with the local language and culture. For this reason, GG PVG removed most expatriates and gave preference to Chinese managers to handle the local employees.

The difficulty of hiring qualified staff and the importance of employees for GG PVG has naturally led the company to develop strategies to retain its employees. Competent, skilled team members are hard to find and in a growing industry, it is also a challenge to allocate time to train each employee individually. However, GG PVG has managed to sustain a very low employee turnover rate of 2% (10% for non-Gate Gourmet labor contract employees) through the following measures:

- by motivating, giving responsibility and offering employees opportunities to evolve in their career. As an example of GG PVG's method: A promising young local employee hired two years before is sent out to visit the customer himself, to give him exposure, a chance to learn and to build up his self-confidence. He is given instructions about the basic issues only — the objective of the visit and what kind of conversation he should have with the customer. The rest is up to the employee.
- production employees get the chance to work in other subsidiaries abroad for several years (some have been sent to France, Germany and Bangkok) or for short trainings (sent to Dubai and London). This international experience is necessary for the employees to understand the specifics of airline catering operations. It develops the employees' competence and loyalty, and is likewise highly motivating because it's often a unique chance for locals to travel overseas.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Maturing of the airline industry

GG PVG extended its customer range by taking advantage of its main competence as a catering service and logistics company. Timely quality food service delivery developed into a completely new market, almost exceeding the core business with airlines, enabling GG PVG to generate its own operating cash. This strategy was chosen at first to support massive fixed costs as well as to become less dependent on airlines, in other words to create a diversification plan to minimize the growing concern on the airline catering industry's uncertain future. This shows how opportunities lie in tapping different market segments by using the company's competencies where it can bring value. More of these segments could be tapped, for example by delivering fresh food on demand to new fast food chains or even considering to adapt to non-food and beverage establishments where food hygiene is crucial, like deliveries to hospitals.

Risks and difficulties

Airline industry dependency

The big risk for GG PVG and the entire catering industry in general, is its dependence on airlines since they are the main customers. The airline industry suffers from unpredictable risks, such as accident scares, terrorist threats, sudden increase in

CASE STUDY

energy prices or degradation of international political relations. All of which contributes to justifying the slow but permanent process of reducing costs in an oversupplied market. The final aim of many airlines may actually be the complete elimination of meals on board for certain flights, or making in-flight meals an option to be excluded from the fare. As a result, caterers would have to start to sell directly to passengers which would adversely impact their volumes and margins.

Supplier training

One of the major difficulties that GG PVG encounters is dealing with suppliers. The main problem is the lack of professionalism among suppliers for which GG PVG has to provide training. Training the suppliers can take about six months up to a year and by that time, the policy of the company is to change suppliers to prevent private agreements among them. This situation obliges GG PVG to constantly control the quality of the delivery and provide constant training. The physical image of the supplier's staffs is also being taken into account as part of hygiene and quality service standards. GG PVG requires suppliers to use clean working suits and decent transport vehicles for food deliveries.

Success factors

Adaptation, quality service and cost and operational efficiency

GG PVG understood early that more than short term planning for the future was futile. Although owned by a demanding finance company, the environment in China changes so fast that there was no point in making business plans. The success of GG PVG was due to its ability to seize the opportunities at the moment. GG PVG's major strength in achieving this was by identifying the market efficiently, adapting quickly and implementing a very aggressive pricing policy through outstanding, efficient and professional approach. Market adaptation has been made possible by the independence given to the subsidiary from the mother company.

Relationship with the joint venture partner

GG PVG's success in managing the joint venture agreement is owed to maintaining contacts with key people and instilling a climate of trust. This has been achieved through many meetings, trips abroad and investments in time and money. The partnership was restricted in the beginning with the appointment of top officials of the joint venture company to GG PVG's management. However, by forging and sustaining trust, GG PVG managed to remove these restrictions by providing its partners with transparent information and an open price policy. This relationship allowed GG PVG to serve exclusively one of China's most progressive city's international gateway, as well as made bureaucratic procedures easier for the subsidiary.

Training, localization and employee management

The key success factors in GG PVG's operations is its human workforce. By rewarding training programs, employees do not only benefit from the best international standard training, the company also manages to keep its employees and maintain a very low employee turnover, a rare feat in China. This policy of training and keeping high level employees has enabled GG PVG to maintain high levels of service, professional organization and international standards that most foreign companies may have difficulties to implement in Chinese-run companies.

Information on Gate Gourmet Shanghai courtesy of:
Felix Muntwyler - General Manager, Gate Gourmet Shanghai, China
Interview conducted by: *Marco Schueep, Luca Bortolani and Patrick Schaufelberger*
Case Study written by: *Sebastien Drouin*
Approved for publication on: *November 2005*

13 Services

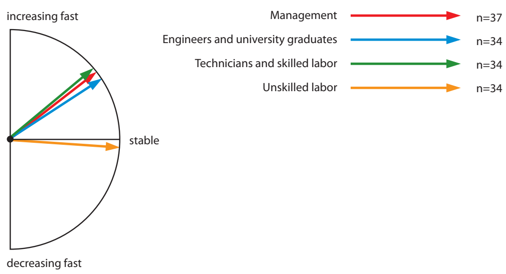
13.1 Industry trends

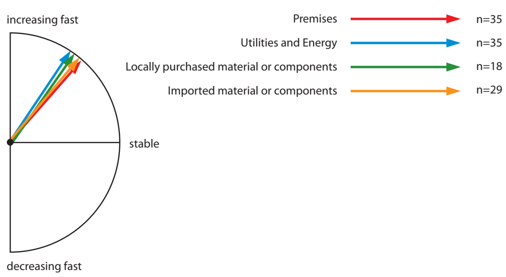
Below are the trends for the chemical / pharmaceutical industry as perceived by managers of Swiss subsidiaries in China.

13.1.1 Cost trends

Survey chart V --19

In your industry and field of activity how do you expect following costs to evolve?
Services N=38



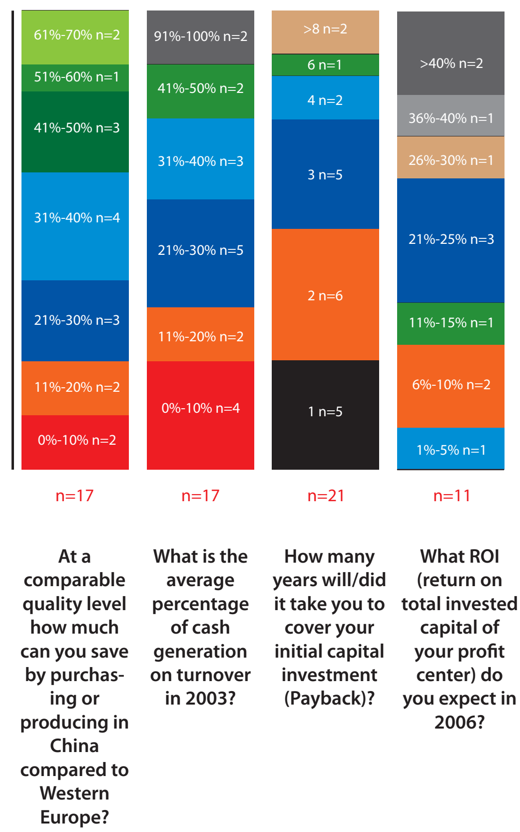


Source: Swiss China Survey, 2005

13.1.2 Financial returns

Survey chart V --20

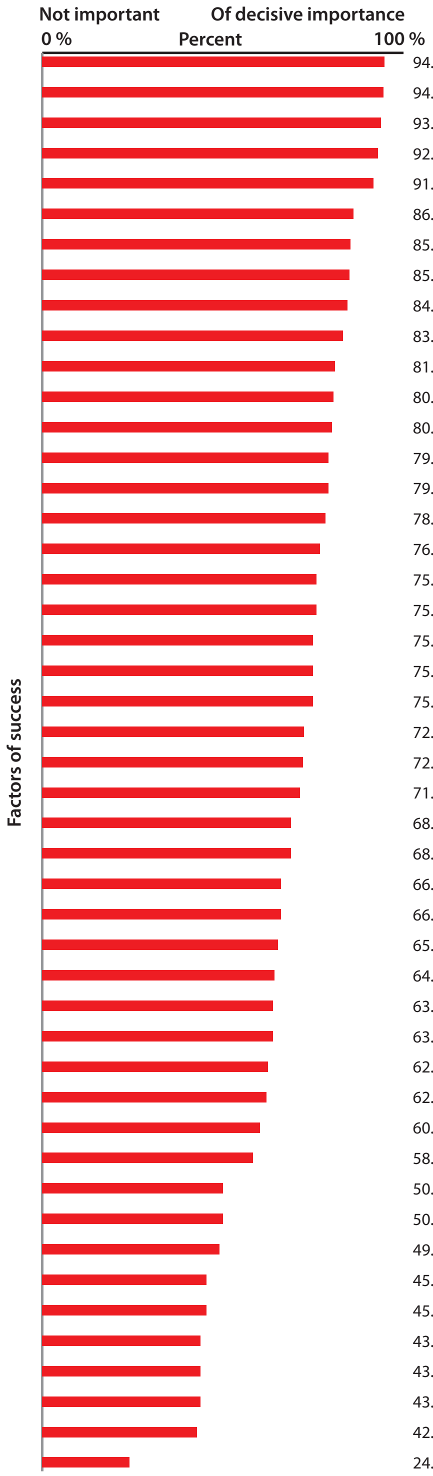
Financial returns Services (N=29 companies)



Source: Swiss China Survey, 2005

13.1.3 Survey chart V - 21

Success Factors Services
(Companies in China, which achieved at least 50% of their objectives N=38)



94.8%	n=27	Comprehensive understanding of the local business ways
94.4%	n=28	Building of a strong brand
93.8%	n=4	Quality control and management
92.9%	n=4	Quality and qualification of the management team
91.7%	n=28	Company reputation in China
86.1%	n=28	Competitiveness of your product/service in the market (product/technology/service over price ratio)
85.3%	n=28	Strategy and concepts
85.0%	n=28	Sales/marketing support from the parent company
84.5%	n=1	Human Resources Management (selecting, training, retaining employees)
83.3%	n=1	Choice of customers and market segment
81.0%	n=9	Superior organizational efficiency (e.g. quality and cost efficient operations)
80.6%	n=29	Adaptation of marketing instruments to the local market
80.2%	n=29	Discussing openly, carefully and thoroughly all issues with agents, partners and/or other stakeholders (Government, clients, suppliers, etc)
79.3%	n=26	Own network of contacts (private and business)
79.3%	n=9	Action plans
78.4%	n=9	Comprehensive understanding of the local Chinese culture
76.9%	n=28	Localization of management (hiring local management)
75.9%	n=28	Choice of initial employees
75.9%	n=28	Comprehensive understanding of the relevant laws and regulations
75.0%	n=28	Carefully prepared and enforceable contracts and agreements
75.0%	n=4	Choice of initial partners (agents, licensees, franchisees)
75.0%	n=28	Location of your China subsidiary
72.4%	n=27	Presence of local infrastructure (utilities, telecom networks, production, transportation infrastructure, etc)
72.2%	n=9	Unique know-how advantages (patented or unpatented)
71.3%	n=29	Review of relevant laws and regulations applying to your China subsidiary business
68.8%	n=29	Choice of suppliers
68.8%	n=27	Strong cash reserves
66.1%	n=31	After sales services
66.1%	n=29	Local support from the Chinese Government
65.2%	n=29	Timing of your China market entry
64.3%	n=27	Strictly following legal requirements
63.9%	n=29	Market research and evaluation
63.9%	n=29	Quality of distribution channels
62.5%	n=29	Other sales services
62.1%	n=29	Knowledge of the Chinese language
60.3%	n=9	Presence of local services (banks, agencies, media/PR, accounting/auditing, lawyers, consultants, etc)
58.3%	n=29	Competitors research and evaluation
50.0%	n=9	Localization of materials and components (purchasing locally)
50.0%	n=29	Technical support from the parent company
49.1%	n=5	Support from consultants based in China
45.5%	n=29	Support from the Swiss Embassy/Consulates and Government
45.5%	n=9	Local R&D or engineering
43.8%	n=9	Supplier research and evaluation
43.8%	n=28	Suppliers training and management
43.8%	n=4	Support from the Swiss Chinese Chamber of Commerce
42.9%	n=9	Financial support to customers or suppliers
24.1%	n=29	Support from consultants based in Switzerland

How important are the following factors to be successful in China?

Source: Swiss China Survey, 2005

14 Logistics in China

by Richard Brubaker, Director of China Strategic Development Partners LLD

14.1 Logistics as a key to supply chain management

According to Wang Yang of Georgia Technical Institute, the next battle for corporate competitiveness will be about supply chain management. This battle has already begun, and the Chinese logistics industry, in keeping with China's broader growth trends, has displayed and is expected to continue to display exceptional growth.

According to Transport Intelligence's report China Logistics 2004, the Chinese logistics industry is expected to expand at a compound annual growth rate of 33% through 2007. Partly due to the industry's previously underdeveloped state, growth, especially coming from third party logistics firms (3PLs), is expected to be derived from the growing numbers of multinational corporations in China and an increasing number of domestic firms outsourcing their logistics functions.

According to Hong Kong's General Chamber of Commerce, China's logistics spending, including both outsourcing and corporate in-house logistics expenditures, is nearly 20% of GDP, roughly twice that of developed countries such as the U.S.A. **Total logistics costs in China are estimated at as much as four times that of developed countries, due in large part to the high cost of moving cargo in China**, which President of the China Merchants Group Fu Yuning contends could be 40%- 50% greater than that of developed countries.

Clearly, despite underdevelopment and barriers that have historically been very high, **current liberalization and the opening of China's logistics sectors, combined with the immense size and momentum of the Chinese market, make the Chinese logistics industry ripe with opportunity for those with the right knowledge, resources and expertise**.

14.2 China logistics development strategy

As a key pillar of China's 10th five-year plan (2001- 2005), the development of China's logistics industry in now a central part of China's continued stable opening policy. As part of the central government's broader plan emphasizing development by capitalizing on the size of the Chinese market and low cost of Chinese labour, the Chinese government has given high priority to the development of the logistics industry and continues to push for infrastructure development in a concerted effort to facilitate the formation of a nationwide transportation and distribution network.

Recently, Chinese support for the logistics industry was articulated by the State Council in its Opinions on Promoting the Development of a Modern Logistics Sector in China (5 August 2004). Most significantly, these opinions set out special registration, tax, finance and customs policies to encourage the development of logistics enterprises in China. Importantly, the opinions also encouraged major foreign logistics enterprises to establish subsidiaries in China and pushed domestic logistics enterprises to take advantage of foreign capital, equipment and technology.

Even before the opening of China's logistics industry to foreign companies in 2006 under its WTO commitments, the Chinese government is relying on foreign competition, participation and expertise to help lower costs, address inefficiency issues and hasten consolidation.

14.3 Key growth area: third party logistics firms

The most significant driver of future growth within the Chinese logistics market is expected to come from Third Party Logistics Firms (3PLs), or those firms offering specialized management of all or most of a client's supply chain needs. Because of the historical tendency among Chinese firms to manage their own supply chains, 3PLs in China have historically been left to service multinational clients choosing 3PLs to reduce costs, improve service levels, or because of the difficulties associated operating their own logistics operations in China; however, a growing willingness among Chinese firms to outsource their supply chain activities and continued growth in the number of multinational corporations operating in China has lead to very strong growth expectations for the 3PL sector.

According to Fu Yuning of the China Merchants Group, in 2003 there were an estimated 10,000 to 15,000 3PL providers in China; however, revealing the sector's enormous development potential, Fu highlights that despite the large number of firms in the sector, in 2003 3PLs accounted for only 2% of total logistics activities in China and no single 3PL firm had secured more than 2% of the Chinese market.

14.4 Regulatory developments

Many of the previous equity restrictions on foreign investment in transportation and logistics companies in China have been or are in the process of being lifted. Increasingly, foreign investors are no longer required to do business with joint venture partners and are allowed to establish new forms of businesses, including wholly owned foreign enterprises (WOFEs), engaging in an ever broader range of activities. Foreign investment is now increasingly permitted in nearly all unprotected logistics sectors and many areas are opening up well ahead of WTO commitments. (see figure 1 below)

Though still challenging in many ways, the approval process for the establishment of particular types of logistics related companies in China has become more transparent and the requirements for approval more clearly defined, presenting new and tangible opportunities for foreign companies seeking to enter China's markets.

14.4.1 Licensing requirements

There are essentially three entities by which logistics companies can enter China [1]

- WOFE: cost USD10-12,000 using international law firm plus government fees
- Equity Joint Venture (EPV): cost USD20-25,000 using international law firm (depending on time)
- Cooperative Joint Venture: cost USD20-25,000 using international law firm (depending on time)

Option 2 has been the most prevalent with many companies seeing option 1 as the future and planning to unwind an EJV once allowed to WFOE.

Option 3 is rarely used unless it is for infrastructure as the assets will return to Chinese control
Survey chart V - chart 13

WTO schedule for licensing requirements of logistics companies entering China.

14.4.2 Requirements for Class A and class B operators[2]

On June 23, 2005, the Chinese General Administration of Customs ("GAC") issued Decrees No. 129 and No. 130, which allow foreign investment enterprises to set up and operate customs bonded logistics centers in China. The Decrees became effective on July 1, 2005.

According to decree 130, a logistics provider that wishes to receive grade A rating must

- have a minimum registered capital of RMB30 million (USD3.7 million)
- sign a lease for 4'000 square meters of warehouse space in East China or 2,000 in West China
- generate an annual turnover of USD200 million (East China) or USD50 million (West China)

Service Area	WTO-Accession	2002-12-11	2003-12-11	2004-12-11	2005-12-11	2007-12-11
Transport Services						
Maritime Services (freight & passengers)	Minority FIEs allowed; Chairman and GM appointed by Chinese party					
Maritime Cargo handling Customs clearance Agency services	Majority FIEs allowed. Majority FIEs allowed. 49% FIEs allowed					
Railway Transport	Minority FIEs allowed			Majority FIEs		WFOEs allowed
Road Transport	Minority FIEs allowed.	Majority FIEs allowed. *75% FIEs allowed from November 2002		WFOEs allowed		
Freight Forwarding	50% FIEs allowed; Foreign party needs3 years' experience; Minimum registered capital = $1,000,000; Branches allowed after 1 year of operation,with $120,000 capital per branch	Majority FIEs allowed.*75% FIEs allowed from Jan 2003	National treatment for branch capital (500,000 RMB);Second JV can be set up after two years of operation(reduced from five years). *Second JV allowed after two years from Jan 2003	National treatment for minimum capital requirement (2 million to 5 million RMB)	Wholly owned FIEs allowed	
Warehousing	Minority FIEs allowed	Majority FIEs allowed. *Provided for under road transport, freight forwarding and maritime rules		WFOEs allowed		
Packaging	Minority FIEs allowed	Majority FIEs allowed*		WFOEs allowed		

Logistics	No commitment. *50% FIEs allowed for international logistics services; JVs allowed for thirdparty logistics services from July 2002					
Loading and Unloading	No commitment					
Processing	No commitment					
Delivery Services	No commitment					
Information Processing	No commitment					

for grade B rating:

- Registered capital of 50 million RMB
- minimum warehouse of 100,000 meters (east) or 50,000 (West)

14.5 Key Agreements

The Chinese have been taking significant steps to liberalize their transportation and logistics markets. The three key agreements in this context are China's WTO commitments, the Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA), and the U.S. / China Aviation Liberalization Agreement.

14.5.1 WTO

Under its WTO commitments, China has or will soon open its key transportation sectors to foreign ownership. Most notably, trucking and warehousing sectors opened to 100% foreign ownership in December of 2004. Courier and forwarding services are set to open from December 2005. By the end of 2007, foreign enterprises will in theory be allowed to compete freely with domestic enterprises in the majority of China's logistics sectors, though some protected sectors including cross-border trucking, water transport, rail freight and postal services will remain closed to foreign enterprises.

Notably absent from China's WTO agreements are provisions with regard to business scope restrictions, approval requirements and minimum capital requirements. As a result, some scope exists for regulatory authorities (particularly at the local level) to use such measures to protect local business interests and deny foreign investors entry into certain markets.

14.5.2 The Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA)

The Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA) opens the Chinese logistics market to companies from Hong Kong and Macao above and beyond China's WTO commitments. Effectively, this agreement gives Hong Kong and Macao firm a one-year advantage over other foreign firms gaining WTO entry.

14.6 Major modes of transport

14.6.1 Ports

In 2004, Chinese container ports handled roughly 70.5 million TEUs (Twenty-Foot Equivalent Units), up from only four million TEUs in 1995 [3]. To keep up with growth in trade, the government has been forced to invest heavily in ports, roads, and rail to keep goods flowing.

Since the central government opened Chinese ports to overseas investment in March of 2002, Chinese Port facilities have received massive amounts of investment and have taken huge steps towards significantly increasing capacity. In 2003, the total investment in Chinese port development and construction was USD2.2 billion, and in 2004, the Ministry of Communication has reported this figure was to reach nearly USD4.3 billion in 2004 [4]. Currently, China's coastal cities, most notably Dalian, Tianjin, Qingdao, Shanghai, Ningbo, Guangzhou and Shenzhen, are all competing to complete new berths and establish themselves as dominant regional logistics centers.

In Shanghai for example, the world's third busiest port, over 2800 personnel in 43 offices porcess the 7.5 million declaration forms required for throughput of 11.28 million TEUs in 2003 (14.5 million TEUs in 2004) [5]. With massive expansion already underway. In addition to expansion that will add more than 2 million TEUs of capacity in 2005, Shanghai's massive Yangshan deepwater terminal is also under construction and will eventually handle 25 million TEUs at a cost of Euro1.5 billion.

Despite such massive investment and expansion, and the improvements brought by increasing use of foreign terminal operators, Chinese ports are still struggling to keep up with demand as recent developments accommodating greater numbers of larger ships are only just beginning to come online.

14.6.2 Road

Heavy government investment and the unreliability of other options such as rail and inland water have made road transport China's most popular choice for the inland distribution of goods (particularly perishable goods) in China. Beijing has already embarked on a serious plan to double China's expressway mileage. By 2005, as China's new inter-provincial highway system nears completion, almost 200,000km of new roads will have been completed, bringing the national total to roughly 1.5 million km. Among the most significant of these developments are the new 2,000 km Shanghai-Chengdu Highway and the 2,500 km Beijing-Zhuhai Expressway.

However, at present the trucking industry in China remains extremely fragmented regionally and is not organized on a national basis. The largest of the nearly 3 million trucking service providers in China is Sinotrans, with a registered fleet of 3,000 trucks specializing in long-distance service. Short-distance trucking services in China are generally provided by local operators who offer relatively cost effective and competitive services. In spite of national policies, this separation between local and long distance trucking operators is in part due to efforts by local and city authorities to protect local businesses.

For example, in Shanghai, trucks greater than 1.5 tons are only permitted to enter the city center between 7 p.m. and 7 a.m., and only on even or odd days, depending on their license plate numbers. Significantly, joint ventures by large state owned and domestic firms including Sino-trans are leading to increased consolidation in this sector. Beginning in 2006, as a result of WTO liberalizations, international logistics providers will also begin investing more heavily in China long haul carriers. The resulting consolidations and forming of national networks will allow international logistics providers to offer stronger and more reliable service.

14.6. 3 Rail

China's Railway infrastructure has received relatively low levels of investment when contrasted with that received by China's road and port infrastructure. Finally resorting to allowing foreign investment to spur growth, the Ministry of

Railways has relatively modest plans to increase China's existing rail network from 72,000km to 100,000km in 2020. Use of the Chinese rail system increased 6% year on year between January of 2003 and January of 2004, though it would appear that this relatively modest increase can be less attributed to weak demand than the limitations posed by serious under capacity.

Railway bottlenecks and the inability of the railway system to transport the requisite amounts of coal were in large part responsible for the power shortages of the summer of 2004. This has since led to the prioritization of coal shipments leaving other commodities and cargoes sitting on docks. Many importers, most notably China's steel mills have been struggling to find enough railcars to carry cargo and now often resort to barges and trucks at much greater cost. Poor handling practices, delays, unpredictable delivery times, bulk shipment requirements, theft, minimal shipment tracking, the lack of inter-modal facilities, and a general lack of infrastructure all plague the Chinese railways. However, despite these issues heavy subsidization still makes rail China's cheapest form of overland transport for shippers.

14.6. 4 Inland waterways

Traffic on inland waterways, most significantly the Yangtze River, increased 8% between January 2003 and January 2004. Rivers such as the Yangtze can handle ships of up to 6,000 tons and are generally decongested; however, canals and low bridges can be problematic and projects such as the recently completed 3 Gorges Dam can serve to prolong dry seasons and keep water levels low.

14.6.5 Air

Aviation agreements, most notably the recent agreement between China and the U.S., promise to open the skies of Chinese cities to foreign carriers within the next few years. In the mean-time, major Chinese carriers are both consolidating and developing their cargo businesses. Though domestic air cargo in China is still in its infancy, most international airlines provide cargo flights in and out of China and the presence of international courier companies in China is also growing. UPS, FedEx, TNT and OCS all having joint venture operations providing international service to and from China and a DHL venture with Sinotrans has even launched a domestic parcel courier service.

14.6.6 Warehousing

Most of China's warehousing facilities are older or old-style facilities with a range of associated issues. Many facilities do not have computerized stock supervision systems in place. Single and multi-story warehouse designs limit efficiency by preventing the use of multiple racking levels and by modern forklift trucks. Cross contamination is an issue as are unsealed loading platforms at refrigerated facilities, which expose food products to ambient air temperatures during loading and unloading.

The shortage and shortcomings of existing facilities as well as the opening up of the Chinese warehousing under its WTO commitments by the end of 2005, have led to considerable investment and anticipation in this sector. For example, in Shanghai, several foreign logistics services providers hoping to invest in the future and capitalize on preferential policies and proximity to port facilities (including APL Logistics, DHL and OOCL Logistics) have or are planning to establish massive logistics centers in Shanghai's Waigaoqiao Logistics Park / Free Trade Zone. The park has been established as an "international transit, delivery, sourcing and transshipment hub" to promote and coordinate the development of Shanghai's sea and air transport, warehousing and logistics industries.

14.7 Key challenges facing the logistics industry in China

14.7.1 Infrastructure

China's history of state ownership has left the Chinese logistics industry and Chinese domestic logistics corporations with a legacy of poor management and weak infrastructure geared toward the movement of bulk commodities. Though rapidly improving, Chinese transportation networks, IT standards, systems integration, training, warehousing and distribution facilities are in many cases lacking in quality, efficiency and/or technical competence. Beyond limiting capacity and creating dangerous bottlenecks, underdevelopment in these areas also has direct implications for the ability of the current system to do things like handle perishable or sensitive goods, track shipments and handle containerized shipments.

14.7.2 Regulations

Although slowly opening up to outside competition, the Chinese transportation and logistics market is one of the most highly regulated in the world. Regulatory barriers in China exist at the national, regional and local levels and do much to hinder consolidation. Even after 2006, when China's WTO commitments come into full effect, local governments may continue to protect local companies through WTO compliant non-tariff trade barriers such as licensing requirements, fees and inspection requirements, and by the costly and complicated licensing system for logistics companies.

14.7.3 Bureaucracy & culture

Doing business in China, in many cases, still requires strong contacts and personal relationships within the Chinese bureaucracy. Approval for many projects is often still dependent on the strength of these relationships. Enlisting the expertise of those with strong local knowledge and experience can be invaluable in forging the partnerships needed to succeed in China.

14.8 Outlook and conclusion

Despite the aforementioned challenges posed by infrastructure, regulatory and bureaucratic hurdles, market liberalization, and massive investment in infrastructure are helping the Chinese logistics market to realize its enormous potential. While inadequacies in the current infrastructure present short-term challenges for those looking to distribute in China, from China or to China, they also provide new opportunities for foreign companies doing businessin related products or services within the logistics industry. Already, companies such as Prologis have begun buying land to provide forward staging distribution points, UPS has recently announced their intentions to build their Shanghai hub for 2007 and has match that with a large investment in Sinotrans, and truck manufacturers like Volvo have begun manufacturing and selling trucks that will be used for long-haul trucking.

The opening up of China's logistics markets, combined with the continued absence of large domestic logistics firms capable of competing with foreign companies in most logistics arenas, offers huge opportunities in the near-term for foreign companies and smaller more developed domestic companies with the right expertise and resources. In the medium-term, the outlook for the logistics industry in China is dependent both on the successful development of logistics infrastructure in China, and on the continued and sustainable growth of the overall Chinese economy. As always, the success of any individual firm in China will depend on due diligence, strong local knowledge, and expertise in forging the right partnerships necessary to implement a well-developed China strategy.

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VI Setting Up A Production

In order to compete globally, eventually setting-up a production in China may become necessary, for all international companies including SMEs. (Also see 'The Emergence of China, Consequences for Swiss Economy and Strategies for Enterprises', in the introductory pages.)

A China production may serve the local market and the rest of Asia competitively, while it may also support the parent company with cheaper materials, components and lower range products than those made at home. Producing with the local advantages may also deter local Chinese producers from growing into challenging competitors going on international markets.

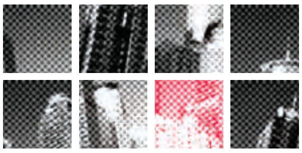
The set-up and operation of a production requires the complete set of China skills for a success as well as project management and financial resources.

As such it is the most demanding activity, the one with most long term promises but also the most difficult in China terms. It needs research and preparation for a right strategy, human resources selection and management skills, purchasing knowledge for localization of components, project management for the physical setup of a facility and the design/implementation of production and operation systems that fit to the Chinese situation.

Technology transfer need to be carefully planed to avoid the loss of intellectual property.

Yet, if pitfalls are avoided, a local production is the ultimate strategy in China operations and it offers the best long term advantages.

Due to the comprehensiveness of local operations, this Chapter is a capstone that refers extensively to most of the others. It includes the detailed steps to setup a production operation in China.



1 Reasons for producing in China and success factors

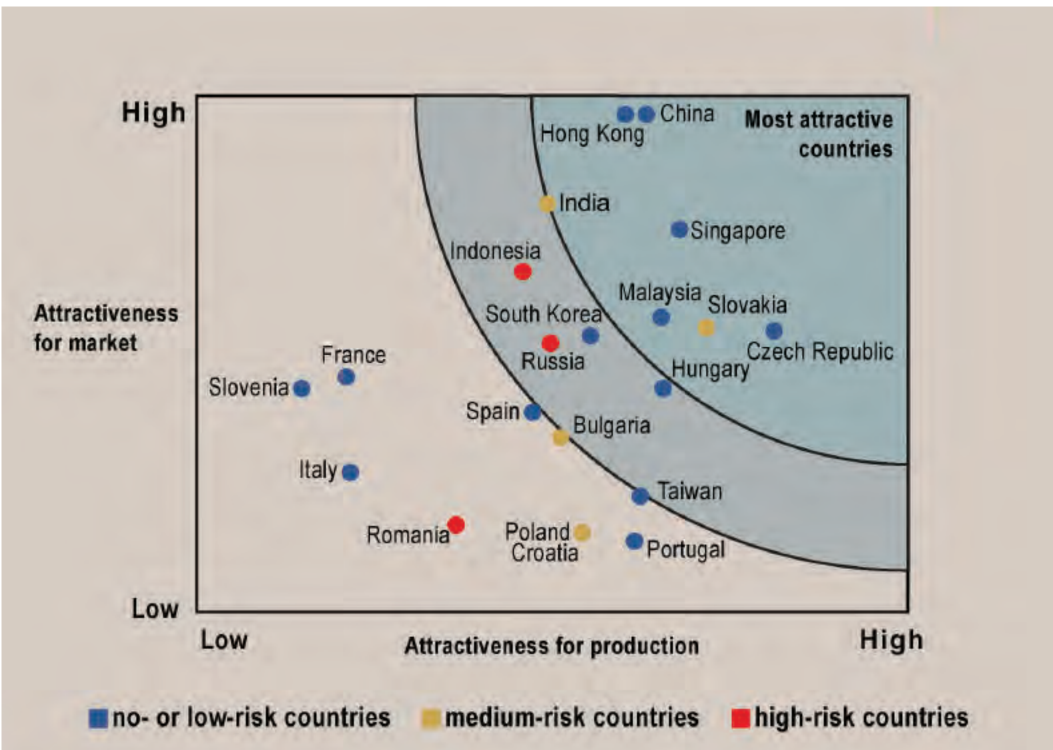
by Nicolas Musy, Vice Chairman SwissCham China, Managing Partner CH-ina

China, the Workshop of the World for the 21st Century, is certainly a very interesting option for production. The low costs, the excess labor and the huge potential market indicate that a large number of goods will most probably be 'Made in China', for China. Selling into China, unless in special cases (luxury goods and very high-tech, for instance) will usually need to be complemented by a local production to keep the large, growing market in the long run.

1.1 Attractiveness for production

As is shown in the figure below, China combines low risks and an important attractiveness, both for production and with respect to the market.
The main reason to establish a local production is the attractive combination of a large potential market on the demand side and low production costs.
(See Chapter VIII Sourcing & Purchasing, 'Purchasing criteria' for an understanding of the local production quality, cost levels, flexibility and other advantages and disadvantages. Chapters IV Exporting & Office Setup, 'Export & selling opportunities' and Chapter V Market Types & Logistics provide an understanding of the market.)
Other Asian countries also offer this double opportunity (India and south-east Asia via Singapore), while eastern Europeans are attractive for production, but much less in terms of markets.

Fig VI - 1
Attractiveness for production



Source: Roland Berger Strategy Consultants

Indeed, Asia – lead by China – is the largest fast emerging region of the world; it will most certainly be the best opportunity for new markets in the coming decades. However, Asians have already acquired the ability to produce a large amount of the goods consumed in the west. With time, they shall also be able to produce for themselves at lower costs more and more of the goods that developed countries sell to them today.

Eventually, due to the extent of the markets and the local cost attractiveness, most of everything sold in Asia will be produced in Asia. Exceptions will include luxury goods, high-technology and some of the very capital intensive productions for which low cost may not bring much of an advantage. (Also see Chapter VIII Sourcing & Purchasing, 'Purchasing criteria', 'What not to purchase in China'.)

For the rest, Western producers may sooner or later face the only alternative of producing in Asia for Asians or lose that most attractive market.

1.2 Proximity to the clients and product adaptation

Product competitiveness is a key to conquer Chinese markets and it is clearly rated so by Swiss subsidiaries in China. (See Initial Chapter Swiss China Survey, 'Factors of success' and also Chapter IV Exporting & Office Setup, 'Strategies: unique products and dominating the market'.) However, proximity to the client is actually the top rated reason of Swiss companies to setup a local production (see Chapter III Preparing for China, 'Reasons to enter'). In cases where production costs are not lower in China it is the only one. (See Chapter V Market Types & Logistics, 'Chemical industry: Ciba case study', for an example.)

Proximity to the clients for pure commercial purposes and relationship can be managed with the setup of an office, however a local production has the additional advantages to:

- Offer better and faster after-sales services, with staff trained in all technical and production aspects and spare parts made faster locally. Clients in China have also more confidence to receive the right service when local production is available.
- Better understand clients' needs in terms of product adaptation to the market and how these adaptations can be effected. Local R&D (or application adaptation engineering) is however needed to benefit most from the China localization to gain market share.

1.3 Reducing the development of global competition and protecting IP

Fig. VI - 1 above clearly shows that among production locations in Asia, China presents the strong attraction of the most interesting market. India, however, is not very far in market attractiveness and will certainly need to be considered carefully, particularly since low costs in India will also endure due to the very large population.

Yet, when compared to India, China additionally presents a threat which has not yet materialized in other Asian sites:

While serving their local market and the foreign multinationals that have settled there, Chinese producers are reaching the quality levels and softer marketing skills that are allowing them to expand internationally. Indeed, they are acquiring all the know-how to produce with international quality levels at the local low costs while also developing the understanding of the western markets. (Also see Chapter VIII Sourcing & Purchasing, 'Purchasing criteria' for an understanding of the local production quality and cost levels.)

As a result, faced with a choice of different production sites, establishing in China and serving the local market may have the additional advantage to prevent more dangerous potential competitors to develop.

(Actually preventing competition – foreign and Chinese - to acquire the market is a key reason stated by Swiss companies for their China entry. Also see Chapter III, Preparing for China, 'reasons to enter'.)

Though there is no reason why Indian producers, like Chinese, would not become very cost efficient for a large range of products in the future, China is probably a decade ahead (with the notable exception of outsourcing services and possibly pharmaceutical production). As a result, threats from India will come only later.
Moreover, it is also reasonable to serve the Indian market from China competitively: indeed, Indian outsourcing companies have started to setup some of their operations in China, clearly indicating China's current competitiveness in relation to India.

Some will fear that by setting-up in China they will contribute to the transfer of their know-how and therefore accelerate the competitiveness of Chinese producers.

In reality, the opposite may well be true, at least for industrial goods. The risk of counterfeiting is usually higher when goods are imported at high production and import costs, thereby providing a high margin opportunity to copiers. On the other hand, should a western producer be established locally, counterfeiters may not have much incentive to copy: potential profits will be low at local prices while efforts and risks to copy the know-how (protected and not) will be high and without guarantee of success.
(See Chapter IX Intellectual Property Protection and R&D, 'Bringing intellectual property in China, risks and countermeasures' for a detailed description of these elements and the results of the Swiss China Survey on IP protection.)

For the above reasons, while considering Asia, it will make most sense for many international western enterprises to decide for a China production first. (Also see The Emergence of China, Consequences for Swiss Economy and Strategies for Enterprises, in the introductory pages of this guide.)

Moreover, the local production subsidiary can source or produce additional materials in China for the parent and generate additional margin for the group.

1.4 Factors of success

Survey Chart 1 shows the individual factors of success ranked by Swiss subsidiaries who only produce in China (production centers). Indeed, we expect that these operations focus on production only, therefore provide the priorities that need to be considered for setting up a production.
Supplier, quality and technical elements come highest as can be expected. Still, 'understanding of the local business ways comes second, evidencing the importance of adjusting a production operation to the local environment.

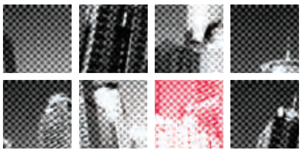
For reference, the factors of success as rated by Swiss subsidiaries selling and producing, as well as those who announced being active in purchasing, selling and producing are also provided in the charts below. Expectably, market related factors come high up in the priorities when a company adds a sales function to a production subsidiary.

Survey chart VI - 1

Factors of Success:
Producing for the group
(Companies Producing only in China - Production centers, which achieved at least 50% of their objectives)

How important are the following factors to be successful in China

Source: Swiss China Survey chart, 2005



Survey chart VI - 2

Factors of Success:
Producing and selling in China
(Companies producing and selling in China, which achieved at least 50% of their objectives)

Source: Swiss China Survey chart, 2005

Survey chart VI - 3

Factors of Success:
All activities
(Companies purchasing, producing and selling in China, which achieved at least 50% of their objectives)

Source: Swiss China Survey chart, 2005

2 The localization of production

While establishing a production in a different industrial and cultural environment, most aspects need to be adjusted. Yet, one of the key elements is the localization of production materials, since importing them will reduce, sometimes considerably, the cost advantage. More complicated logistics and longer delivery times create other important, supply chain disadvantages when importing production materials.

2.1 Technology/design transfer and re-designing/engineering

Experience made in very different industries (garments and power tools) show that the main problem for a successful localization is managing communication for the technology transfer between the mother company and the subsidiary: Foreign designers and engineers do not easily realize that there are different ways to make their products in China, while achieving the same quality and performance as well. This is understandable as the staff involved with the mother company does not have the experience of working with China's production base.

The problem is compounded by the traditionally low-assertive attitude of Chinese and their respect for what they assume is superior, more modern technology. As a result, many companies try to replicate technical processes in China and spend considerable, unproductive efforts finding suppliers that work in the Swiss way.

The solution to these problems is conceptually simple: mother company engineers or designers need to travel to China regularly to assess and qualify the supplier base and actual parts or materials ordered. In this way, they get to understand what can be done on the spot as well, they become able to re-design or re-engineer in order to facilitate local production. For example, one part made in Switzerland maybe more easily split into two for ease of production while the additional assembly cost in China is much less than what is saved by producing two parts instead of one.

Such logic is difficult to grasp when the overriding goal of engineering or design in western countries is the reduction of manual work. By experience it takes time until engineers find the time to travel or the management sets it as a priority for them to visit the subsidiary and suppliers.
One visit is not enough during a process: most efficient is for the designers/engineers to travel regularly and be on the spot whenever prototypes are made in order to discuss corrections on the spot and with the suppliers.

Alternatively, it is also possible to send Chinese designers/engineers to the mother company to participate in the adjustment of designs abroad. The personal and technical qualities of the Chinese selected for such a mission are important, since he or she would need to be involved in a new project in a new country and play a decisive role.

2.2 Avoiding imported production equipment

In-house production processes need also be adjusted to fit Chinese circumstances: low salaries and different local equipment provide opportunities to work in different ways, (up to 24 hours and 7 days) with more employees in order to ensure a smooth and efficient running of the operation.

Adjusting production processes to Chinese circumstances can generate considerable cost savings. After having operated a setup equipped and organized according to European ways, a power tool company was able to save 80% on equipment purchases for its second production site, by adjusting processes in order to produce with locally made equipment.
As a - counter-intuitive - rule of thumb, production in China is almost always more cost efficient when labor can re-

place imported equipment and technology.
This situation is most certainly going to last for a decade due to the surplus of labor in China or until efficient locally made automated equipment is available. (Also see Chapter VIII Sourcing and Purchasing, 'Are China low costs here to stay?')

2.3 Finding and managing suppliers

This aspect has been described in details in Chapter VIII, sourcing and purchasing. High quality low quantity procurement of materials is usually the problem faced until production quantities grow with the market and suppliers understand the potential volume they can make with the new company.

3 Steps for the set up of a production operation

3.1 Strategy and concept

The first step is the establishment of a concept.
The elements detailed in Chapter III, Preparing for China provide a suitable guideline and details on entry strategy, location & management selection as well as a number of other important elements. In addition, a technical analysis to ensure that local procuring of materials is possible is important. Chapter VIII Sourcing and Purchasing offers insights in this respect.

The company operations strategy and **the subsidiary processes need to be reviewed** and fine tuned to the different environment. It is important to consider key elements:

- legal rights and restrictions of foreign companies
- accounting, import/export & currency administration
- local government, local regulations & environmental protection standards
- human resources particularities and practices
- local people's psychology and cultural differences.
- communication and other infrastructure, particularly IT and ERP systems as well as electricity and utilities
- costs, availability of supplies and logistics
- business plan, based on the actual market and costs circumstances

See Chapter I General Environment & Trends and Chapter II Legal, Tax & Finance for a description of the local circumstances and Chapter IX, Human Resources Selection & Management for details on the human resources circumstances.

An analysis of the **risk of losing intellectual property** (IP) and a concept to minimize IP loss is worth establishing in all cases when technology is transfered. For more information see:

- Chapter VII, Intellectual Property Protection and R&D
- Chapter IX, HR Selection and Management to understand legal and softer options for the protection of IP.

In case of **import of second hand equipment**, a detailed review need to be carried out, since strong restrictions are in place, some of them requiring the inspection of the old equipment before shipment from the mother company.
While transferring old equipment, it is useful to ensure that spare parts and maintenance for old equipment will

be available in China. (See Chapter IV, Exporting to China, 'Import of old mechanical and electrical equipment'.)

Financing possibilities and restrictions are described in Chapter III Preparing for China, 'Obtaining commercial loans in China' and 'Relevant Swiss and international funds & risks guarantees'

3.2 Implementation

While the establishment of a concept or 'doing the right thing' is a key element and a necessary step to ensure success and convince oneself that a success is well prepared and that the actual setup can go ahead, implementation or 'doing things right' is as necessary in China, where the difficult environment provide so many chances to go wrong.

A **project management team** need to be established, containing both:

- management and technical personnel from the mother company
- project manager in China, responsible and able to handle the setup locally

Local project management needs a considerable amount of expertise in comprehensive aspects of China's business fields and life. As a result it is highly recommended to use managers with the right expertise. Such project management can be acquired in the following ways:

- by entrusting project management to a local partner. It usually implies the setup of a joint-venture, which is rarely a good option. (See Chapter III Preparing for China.) Yet, in the case of joint-venture, the partner may make decisions for the setup to further his own interests, so that independent project management is of high value.

- by hiring a local general manager to be entrusted with the setup. While it may appear to have cost advantages, it actually entails a number of risks which will generate other costs:
  - Local managers have a tendency to 'cut corners' and establish operations the way they would for a Chinese-owned company, without taking into consideration the needs and culture of the mother company. This may include not paying taxes whenever possible and saving on the setup of many reporting systems (particularly accounting and IT) that are necessary for the running of an operation in cooperation with a parent company.
  - They may make decisions for their personal convenience or advantage, as such decisions may not be easily checked by a mother company without sufficient understanding of the local situation. For example, they may be reluctant to hire best human resources, as they may see good people as a potential challenge to their position, therefore as a personal risk.
  - They may also make decisions emotionally motivated, based on their feelings towards places and people, selecting a location or business partners based on the relationship they may have in such a area or with such partners, whereas these partners and places may not be the most suitable. This also makes an operation dependant on the relationships network of an employee rather than on market and legal forces.

- by hiring project management professionals active in China. This will save management time and travelling costs from the mother company, ensure an independent setup and be usually very cost effective.

3.3 Checklist: Setting up a production operation

The following list of elements should be fulfilled for a setup. Others may be added in special cases.

3.3.1 Legal Registration

3.3.1.1 Premises search, evaluation and selection, establishment of rental contract (English and Chinese)

3.3.1.2 Company name proposal and registration (English and Chinese)

3.3.1.3 Preparing all registration documents and information for registration

- Business license of investing Co. (Copy of the "Handelsregister" of the investing Co.)
- Bank Certificate to confirm creditworthiness of Investing Co.
- Feasibility study for registration in English and Chinese acc. to local rules and regulations
- Articles of Associations, optimized to fit Investing Company and meet local rules and regulations (Chinese & English)
- Resume of the proposed Chairman for the Chinese Co. (English & Chinese)
- Passport copy of the appointed Directors of the Board and General Manager (Front page (photo), prolongation of the passport (if any), visa.)
- 3 portrait photos of the appointed Chairman of the Chinese Co. (two inch-size)
- Letter of appointment of the Directors of the Board and of the General Manager (English and Chinese, signed by the investing co. legal representative)
- Powers of attorney (English & Chinese) for:
    - Investing Company legal representative and
    - Directors of the Board of the Chinese company

  to a representative available locally
- English & Chinese rental contract
- Joint-Venture Contract (as needed)
- Technology Transfer and/or Licensing Agreement (as needed)

3.3.1.4 Application for Chinese Company Approval & Registration

- Company name submission and approval
- Chinese company establishment approval and certificate
- Issuance of temporary business license of the Chinese company
- Opening of foreign exchange account and paying in of the first portion of registered capital
- Register with taxation, customs and other necessary official departments to obtain
    - enterprise code certificate
    - foreign exchange registration certificate
    - taxation registration certificate
    - RMB account opening certificate
    - customs registration certificate
    - quarantine and inspection registration certificate
    - finance registration certificate
    - statistics registration certificate
    - general VAT status certificate
    - Obtaining final business license
- Obtaining and safe keeping of company stamps

3.3.1.5 Foreigner registration procedures for work and local residence

- Alien employment and residence permit application and obtaining work permit and residence certificate
- All foreigner compulsory registration with authorities

3.3.2 Application for encouraged status for duty/VAT free import of equipment

3.3.2.1 Documentation and explanation of products to be produced in China, including type and model of machines to be invested

3.3.2.2 Visit authorities to apply for tax free import of equipment for best chances

3.3.2.3 If positive, do all formalities to obtain duty & VAT free certificate for import of equipment

3.3.3 Project Management Follow-up & Reporting

3.3.3.1 Establish business plan in details for the setup period and the first year of operation.

3.3.3.2 Project accounting, ensure adherence to investment budgets and implementation plans on a regular basis during setup

3.3.3.3 Ensure timing (adherence to action plan)

3.3.4 Management and Human Relations Setup

3.3.4.1 Search and hiring/appointing of suitable local executive personnel and staff for the Chinese company:

- Advertising, searches, selection and 2-3 rounds of interviews
- Negotiation and establishment of employment contracts and employment manual as per local rules and regulations.
- Ensure suitability in terms of abilities and character for the positions of CEO, Sales Manager, Admin Manager/CFO, Production Manager, Sourcing & Purchase Manager and others as necessary.
- Supervise the recruitment of the rest of the staff by CEO and managers acc. to organization chart and financial business plan

3.3.4.2 Organize training in Europe with Investing Company. (Request and obtain passports and visas for Chinese staff, prepare parent company training program)

3.3.4.3 Target and performance evaluation systems

3.3.4.4 HR management processes

3.3.5 Financial & Controlling

3.3.5.1 Budgeting, accounting, internal reporting and controlling system

- setup of chart of accounts
- processes to meet local regulations financial reporting needs
- Definition of non-financial data to be reported
- Adjustments mechanism to bring official financial reports in line with international/Swiss practices.
- Internal reporting system and processes to match mother company policies with minimal work
- IT accounting system, controlling system and processes

3.3.5.2 Payments authorizations

Regulations for investments and operations to minimize risks of funds misappropriation, including:

- Signatures system to minimize use of Chinese stamps/chops (equivalent to signatures)
- Physical controlling of stamps to minimize risks
- Limits for payments and investments and related cash transfer authorizations system

3.3.6 Processes & Administrative Setup

3.3.6.1 Establishment or review of company initial processes and regulations:

- Sales
- Production and IP protection, incl. non-disclosure agreements with stakeholders
- Quality Control
- Administration
- Integrate finance, IT and HR processes as possible

3.3.6.2. Company information and documents storing and sharing processes and regulations

3.3.6.3 Company corporate identity manual (English & Chinese)

3.3.6.4 Company safety & security regulations (English & Chinese)

3.3.7 China Manufacturing Physical Setup & Commissioning

3.3.7.1 Workshop Design and Installation

- Review the physical operation planning & design, including:
    - the processes & workflows (goods and materials),
    - detailed staff & organization chart,
    - utilities & equipment positioning, power capacity calculation and application
- Establish bidding documents for contractors for interior installation design and execution; review bidding results and select contractor
- Obtain necessary approval for physical setup (including environmental impact assessment and fire safety approval).
- Supervise the premises interior installation, ensure that design and quality are respected for company image

3.3.7.2 IT Setup

- Supervise application for phone and IT lines (incl. lease lines as needed), numbers and connection to the site
- Supervise purchasing of IT hardware and software, as well as phone/IT cabling.
- Supervise computer and phone network installation and ensure conformity acc. to plan and Investing Company requirements
- Supervise setup of ERP to suit managerial information needs and tax accounting needs; ensure that ERP can handle Chinese characters and run locally (internet connections are not reliable enough for real time remote running)
- Supervise website setup and hosting

3.3.7.3 Purchasing of local equipment/services

- Evaluation/coordination with Investing Company of equipment to be sourced and purchased locally.
- Establishment of sourcing, approval and purchasing system, including evaluation of a few suppliers for each important item.
- Local equipment sourcing & purchasing supervision; ensure purchasing at best quality/price ratio to the purpose.

3.3.7.4 Import of foreign equipment and initial components lots

- All foreign equipment/initial components lots import planning and formalities
    - import equipment/initial components lots list review, incl. age, HS code, needed quota and licenses
    - establishment of import restrictions (second hand or special equipment) and lead times for application and import formalities

- Coordinate transportation and import processes of foreign equipment/initial components lots as necessary with forwarder and import agent, review shipping documents locally to ensure efficient and on time import.
- Liaise with foreign equipment agent in China for physical installation.

3.3.7.5 In-house bonded warehouse and exhibition equipment application (as needed)

3.3.7.6 Homologations

- Supervise all official homologations of the Chinese Company to start operations.
- (Including products homologations, environmental, security, fire, labor safety homologation.)

3.3.8 Opening Ceremony

4 Timing and costs

Standard projects based on the rental of a workshop (no construction) usually take 9 months from decision to be up and running. Should a building need to be specially constructed, 3 to 6 months need to be added.
Costs of the setup itself vary a lot. Services needed for managing the project go from USD100’000 to USD300’000.

5 Operations management

Once the project is setup, operations start. Many elements need to be followed up at the beginning, particularly in terms of:

- Human Resources management (also see Chapter IX, Human Resources Selection and Management)
- Accounting and IT, particularly the data management (ERP) to fulfill needs of tax and foreign exchange authorities as well as to fulfill parent company requirements
- Production efficiency and quality control
- Ongoing materials localization process

Operating successfully in China requires considerable experience, below are a few points and recommendations, among many, to pay attention to:

5.1 HR and business management

- Keep close contact with the management in order to generate trust and understanding from the beginning of the relationship. Adequate human resources management brings efficiency and ensures keeping the local staff (also see Chapter IX, HR Selection and Management)
- Targets and action plans need be established and regularly reviewed jointly with the local management. Responsibility and the related competences should be delegated for best results. (Most Swiss companies in China are autonomous profit centers, also see Chapter I, General Environment, Switzerland in China)
- Establish performance evaluation and corresponding incentive systems for the managers. (At least, one third of remuneration should depend on performance, performance need to be measured on collected money, not sales.)

5.2 Financial controlling and legal

- Ensure adequate local supervision of accounts so that no misunderstanding on use of financial resources may occur: mistrust may quickly be generated as misunderstandings on use of resources can be interpreted by the mother company as misuse of money
- Establish clear, legally valid contract with clients and stakeholders

5.3 Support of local professionals

Management support at the beginning minimizes risks and ensures best possible start. (Also see Chapter X, Support for China)

6 Constructing or renovating production & commercial premises

by Daniel Heusser, dipl. Arch. ETH SIA, GM of Virtuarch

6.1 Developments in investment

With the growing importance of China in the world economy, more and more companies are making a strategic entry into the Chinese market, setting up their own production facilities, regional headquarters or research and development centers. This article describes how construction projects in China are organized. It provides an overview of the structure of the Chinese construction market and the players in it and gives valuable tips on how to organize projects there.

During the last decade we have seen changes in many aspects of foreign investment in China, especially in respect to construction projects realized for foreign companies. While ten years ago investments were often done in joint venture structures, where the Chinese partner provided the facilities, more and more investment is now done by Wholly Foreign Owned Enterprises (WFOEs). Our experience also shows that the focus of projects has shifted from basic requirements, where a building just had to suit basic needs, to increasing awareness for working environments, efficiency and sustainability. This is, amongst other reasons, due to the assessment that production facilities opened today in China will be there for the long term, whilst ten years ago, the risks of investing in China were considered to be much higher.

6.2 Two basic misconceptions

Even though more and more companies are now gaining experience in China, we still quite often come across two basic misconceptions which affect the success of construction projects there.

One of them is: 'In China, everything is different!' There may be business partners who tell you so and you may hear this sentence from time to time from Chinese counterparts when they complain that 'you do not understand China', but be cautious about believing in differences if things seem to be strange. We have seen funny and often rather tragic results of deals done under the misconception that things are different in China, such as companies 'buying' land plots and entering into contracts with unknown legal entities, project managers doing project budgets and schedules based on industrial zone advertising brochures, and headquarters believing that local managers of their companies could just cast aside their daily role to then manage a new factory project without support. Needless to say, many of these experiments would never have been done in Switzerland and the results have often been disastrous in terms of finance, construction quality and scheduling.

The other misconception is: 'In China, everything is the same!' Of course, nobody will really tell you that or believe that, but still a lot of problems encountered during projects in China have their origins in the fact that the roles, definitions and behavior of the players are expected to be the same as they would be in Switzerland. There are, however, quite important differences. One of them, for example, is the role of the architect: while architects in Europe normally carry out a wide range of services on behalf of the Owner, the capabilities of Chinese architectural institutes are much more limited.

6.3 Organizing your project in China

The key to the success of your construction project in China lies in how you organize it. There is no standard way to do this, but in our experience, the best solutions arise when first the time is taken to really understand the requirements of the Owner. Following this, the goals of the project are then carefully balanced against the measures needed to achieve these goals.
There are different ways to achieve your physical presence in China, such as:

- Renting or buying a standard building ('Landlord')
- Renting or buying a built-on-demand building ('Investor')
- Constructing your own building on your own plot of land ('Owner')

Already the decision between these three models needs a careful assessment of your needs and a clear definition of your goals. The three versions are very different in terms of investment cost, individuality, the quality of the building, realization time and project organization. If investing 'from scratch' ('Owner'), there are again several ways to realize your project:

- Turn-key (Design and build)
- Design and General contractor
- Other setups

While the first option is very popular with interior design projects, the second method is the most commonly-seen way to realize construction projects.

6.4 The players:

6.4.1 Owner:

A good project has a good Owner. This golden rule applies not only in Switzerland, but also in China. Generally, Swiss Companies prepare themselves well when they want to realize construction projects. This starts with knowing what your needs are, to define those needs and then to transform them into a Program of Planning and Construction Requirements, and will often involve a request for additional resources. While in Switzerland, architects normally provide these services, in China, however, design institutes are not necessary able to offer the depth of services required. Therefore, it is worthwhile in the early stages to involve companies that can combine the knowledge of how to collect the Owner's requirements with that of how to translate these requests into 'realizable form' in China.

Furthermore, it is essential that the Owner appoints one person (or, for more complex projects, a group of people, such as a construction commission) to act as the co-ordinator on his side. During the design phase, this person can be located in Switzerland, but for the construction phase it is recommended that the person be available in China.

6.4.2 Authorities:

Authorities and utility companies are often a tricky part in the process. To manage communications with the authorities, we recommend involving the design and project management companies from the very first contacts – even when starting to acquire land use rights. Our experience shows that a lot of trouble can be avoided by addressing the critical items early and trying to fix the conditions not only for the granting of land use, but also for the provision of utilities. Many industrial zones try their best to support companies when setting up in China; however, they often underestimate the expectations of the Owners and thus quite a number of misunderstandings can arise. Often the Owners greatly underestimate the time-consuming and resource-intensive tasks of authority handling and ensuring that all the necessary utilities are available in due time.

6.4.3 Mandatory parties:

Realizing construction projects in China means involving several mandatory parties. The main mandatory parties are:

- a licensed design institute
- a licensed supervision company
- a licensed construction company

The number of mandatory parties varies according to the form of your investment. The role of the mandatory parties is defined by regulations that govern the realization of construction projects in China. These mandatory parties do not, however, cover the entire scope of services needed to realize a construction project. The main gaps are in the preparation phase , the architectural design and engineering phase, the project management and especially in the construction management, as well as in the work done on behalf of the Owner.

6.4.4 Consultants:

These gaps are filled by specialized companies such as ours, who guide the Owner through the project process to ensure that the overall result of the project reaches an optimum balance between investment and fulfillment of the requirements and goals of the project. It is also worthwhile to have additional consultants involved for special tasks, such as lawyers, for the review of contracts.

6.5 The project steps:

Construction projects involve a lot of parties and have many steps that have to be carefully coordinated and fine-tuned. In particular, the sequence of getting authority approvals, licenses and certifications is essential for the timely completion of a project.

6.5.1 Preparation phase

Many failures in construction projects have their basis in the preparation phase. As explained above, preparing a construction project in China requires special knowledge about the situation and practices in the 'Wild East'. For more details about the content of this and other phases, please refer to the list of services on page 17 of this guide.

During the preparation phase it is essential to define the goals of the project in terms of requirements, budget, schedule and quality. The main steps and results of this phase are the room program (a detailed list of rooms requested to be available in the new facility), the detailed Program of Requirements (a description of the functions and the technical and construction requirements) and a master plan for the selected site. Depending on the requirements of the industrial zone and of the Owner, a conceptual design study with perspectives and bird's-eye views will also be carried out in this phase.

6.5.2 Design phase

During the design phase, a Local Design Institute (LDI) is involved. The selection of the LDI is critical in several respects and is best done through an evaluation process managed by a consultant familiar with the scene in China. The design process normally has several phases - among them, preliminary and detail design - which are linked to approval procedures. In some industrial zones the approval process is facilitated by having fewer steps of approval and the design steps can therefore be amended. One crucial difference from Europe is that the detail design is not as detailed as European investors might think; often some very important design work is left to the contractors and their subcontractors in the process of realizing 'workshop drawings'.

6.5.3 Tendering phase

Based on a full set of plans and specifications, tendering among several construction companies is most effective. It is essential that the tendering process is managed in a professional way, as this is one key step in defining the price, quality and time schedule of the project. A well-prepared tendering done, in the necessary depth with clarification meetings and detailed negotiations, makes a big difference. Not only will prices be lowered during such a process, but the relation between price and quality will reach an optimum.

6.5.4 Construction phase

During the construction phase, the main challenge is to ensure the quality of construction, together with tight control of the project budget and schedule.

6.5.5 Handover phase

At handover, it is recommended that the facility management setup of the project is in place. Intensive testing and commissioning will have been finished by this time, and the goal is to have most of the defects rectified by handover, in order to reduce disturbance of the production process.

Depending on the type of investment, the management of the installation of production equipment is very critical, and it is essential already during the planning phase to clearly define the battery limits of the different planning and installation companies.

6.5.6 Operation phase

Operation of the building is, of course, handled by the Owner via his facility management organisation. Together with the facility management, the project management will enforce the warranty services during the warranty time as stipulated in the construction contract.

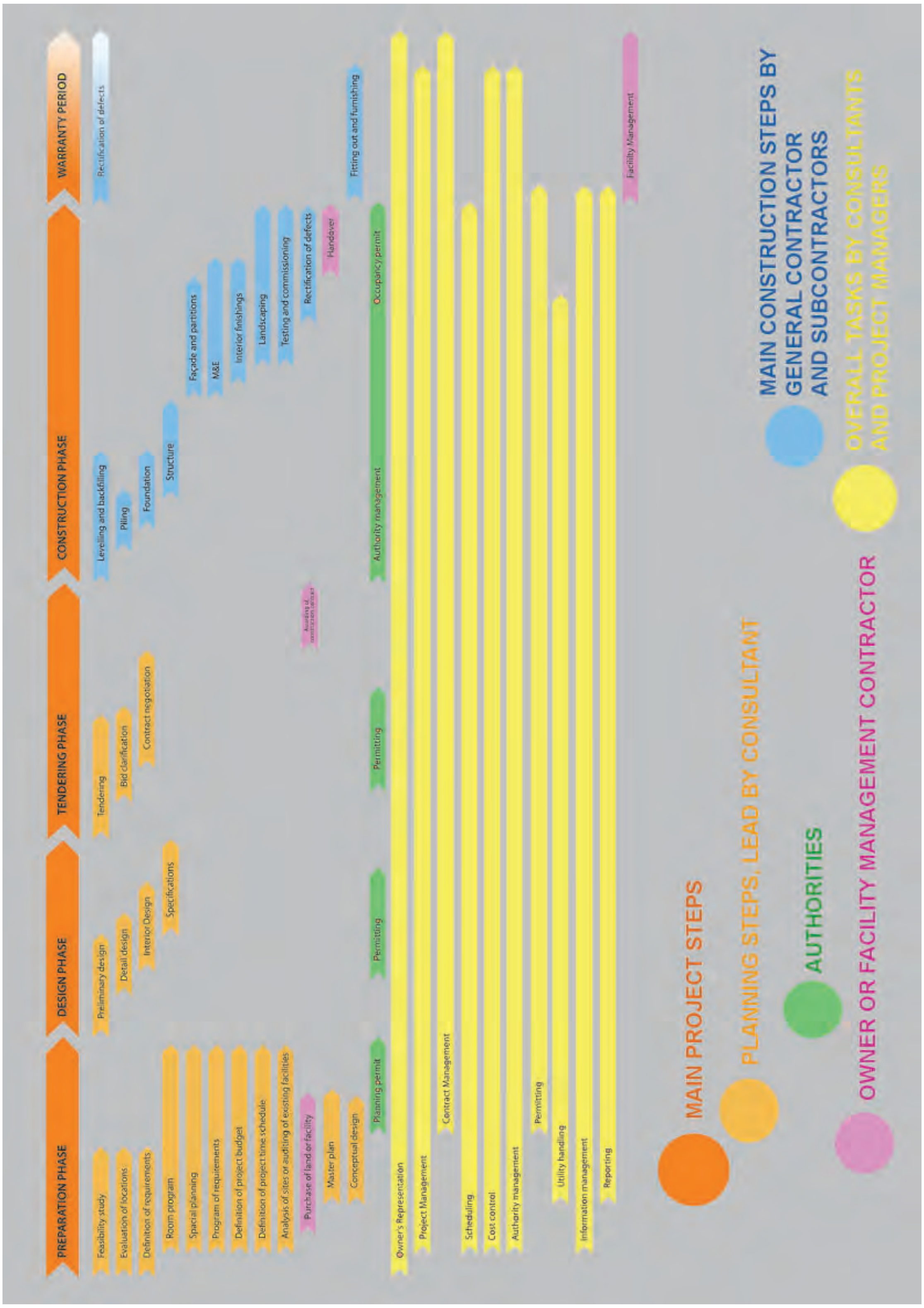
During the operation phase, the real qualities of the project will be revealed. Good planning and construction quality will lead to a significant reduction in maintenance and operation cost. These cost influences, in particular the energy cost of operation, will increase dramatically in the future.

6.6 Conclusion

Realizing projects in China is a challenge, but it offers many opportunities. Not only can projects be realized in shorter times than in Europe, but they can also be done at significantly lower cost. Quality, as everywhere in the world, has its price. In China, the price difference between low quality and high quality is normally larger than in Europe, not least because the quality level described as 'low quality' in China does not even exist in Europe (where even the basic quality standard is significantly higher).

As architects and project managers, we encourage companies to optimize their investment over the time horizon they envisage for their specific projects. By taking this step of optimization, companies often decide to realize proj-

Premise construction process



Source: D. Heusser

ects of higher quality, knowing that the higher cost of implementation will have a rather short payback time in terms of productivity, operation cost and soft factors such as binding key staff to the company due to the good working environment.

Contributed by Virtuarch

Virtuarch is a Swiss wholly foreign owned company with 25 staff providing architectural design, interior design, project management and engineering services. Among Virtuarch's projects are several industrial projects in Beijing and the greater Shanghai area as well as the new French and German School in Shanghai.

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SWISS MADE

VII Intellectual Property Protection and R&D

Loss of intellectual property has made more than one international businessman sorry to have ventured in China.

Yet, lawyers strongly recommend registering patents and trademarks as they are convinced that the legal situation has improved in such a way that filing and disclosing patents is more a strength than a threat.

Syngenta won a law suit against pesticide counterfeiters in the summer of 2005. Prada, Chanel and other luxury brands made headlines in December of that year by winning important reparation from a landlord renting space to a shop selling counterfeited goods. Swiss companies indicate that they are successful in fighting IP infringements in more than 50% of the cases, on average.

The considerable increase in R&D activity from multinationals in China also shows a growing level of confidence in managing IP rights in China.

Besides, whereas multinational companies' attractive products and trademarks are regularly counterfeited, few reports of SMEs show that they are losing know-how in China.

Risks are however much higher than in the traditional Swiss business environment. Indeed, advertising (as a measure to protect trademark) and avoiding bringing critical technology in China to protect know-how are rated almost as high as legal measures.

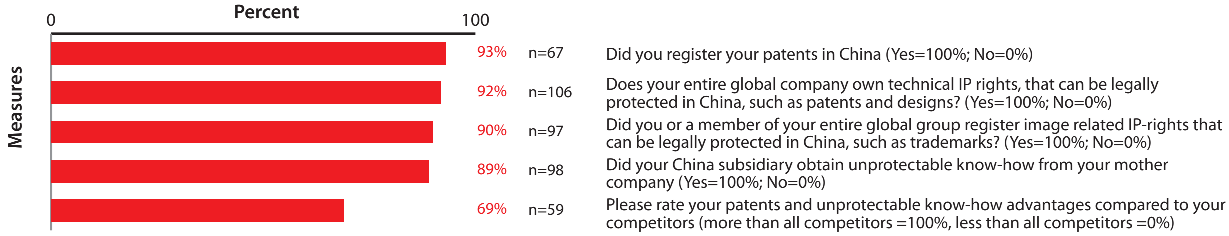
As a result, management of IP as well as careful preventing of access to technology and know-how must be ensured.

1 China IP Strategies of Swiss companies

Swiss companies in China own considerable intellectual property rights, often more than their competitors and register them locally. Besides, successful companies state that they own more IP rights when compared to competitors than less successful ones do.

Survey chart VII - 1

Intellectual Property rights of Swiss companies
(All companies in China N=111)

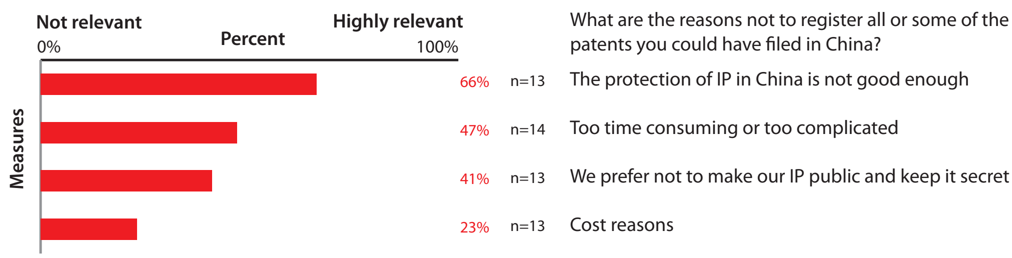


Source: Swiss China Survey, 2005

Few companies do not register their IP in China, those who follow that strategy avoid registering mainly because they do not trust the IP protection system of China.

Survey chart VII - 2

Reasons not to register patents
(Companies which did not register their IP right in China)

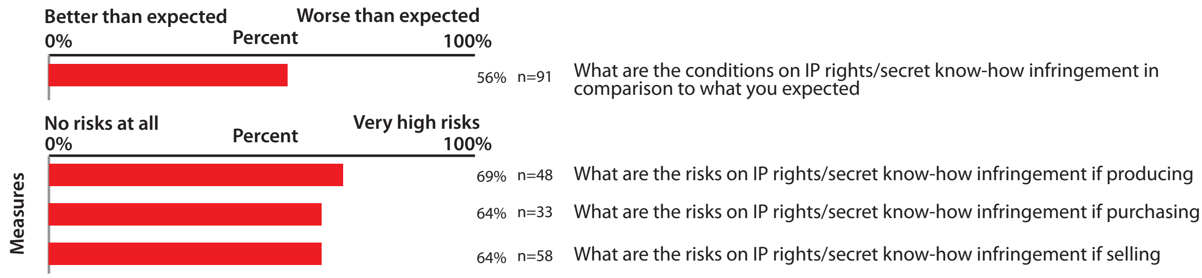


Source: Swiss China Survey, 2005

Swiss companies are quite concerned about Intellectual Property protection in China: IP conditions are found a bit worse than expected and risks are considered generally high for all activities. Producing is considered slightly more risky than purchasing or selling.

Survey chart VII - 3

Intellectual Property risks evaluation
(All companies in China N=111)

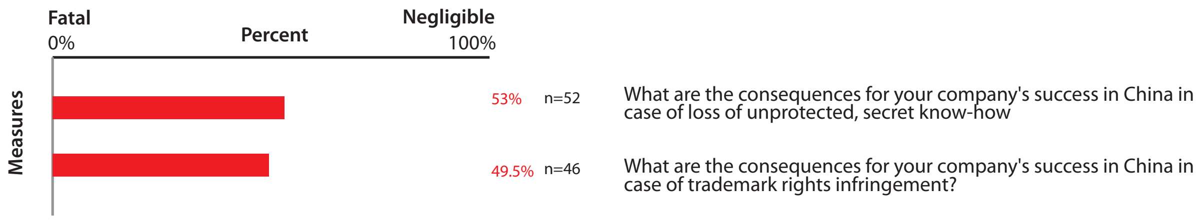


Source: Swiss China Survey, 2005

As a result, probably, Swiss companies refrain from transferring know-how or IP rights whose loss would have grave consequences:

Survey chart VII - 4

Consequences in case of IP loss
(Relevant companies in China)



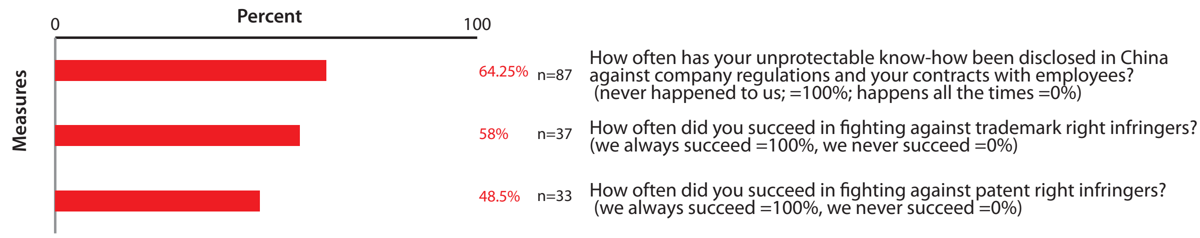
Source: Swiss China Survey, 2005

Actions against IP infringers and level of success

Though Swiss companies find a risky situation in China, their success in countering IP infringers is actually higher than generally perceived. Particularly, loss of know-how through employees is not as serious an issue as is generally imagined. In terms of trademarks and patents infringement Swiss succeed against infringers for more than half the cases, on average.

Survey chart VII - 5

Success in countering IP infringers
(Relevant companies in China)

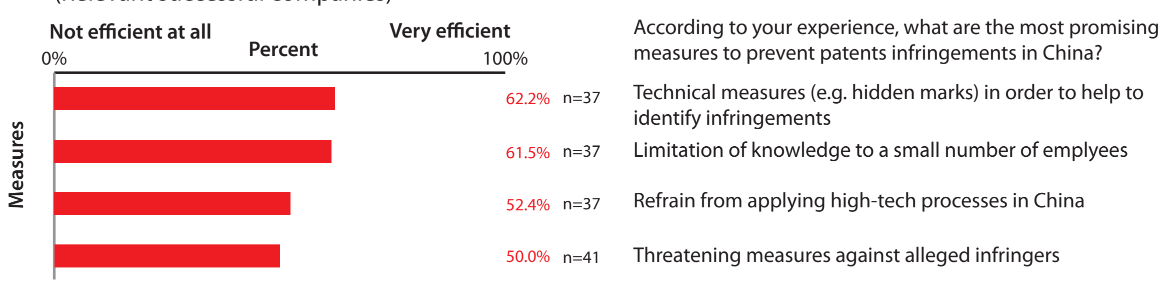


Source: Swiss China Survey, 2005

Besides, most efficient measures against intellectual property rights infringement are not the legal ones:

Survey chart VII - 6

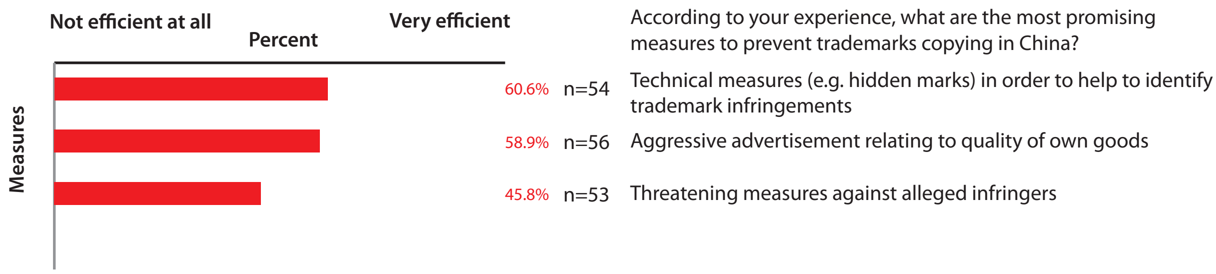
Measures against patent infringements
(Relevant successful companies)



Source: Swiss China Survey, 2005

Survey chart VII - 7

Measures against trademark infringements
(Relevant successful companies)

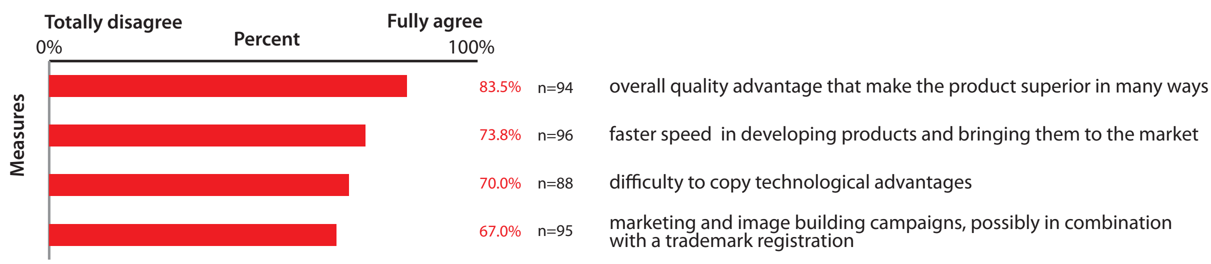


Source: Swiss China Survey, 2005

Should they not rely on IP rights over potential infringers, companies prefer speed and product performance to keep ahead of infringers:

Survey chart VII - 8

Your China subsidiary would not rely on technical IP rights over competitors/potential infringers but rather on:
(All companies in China N=111)

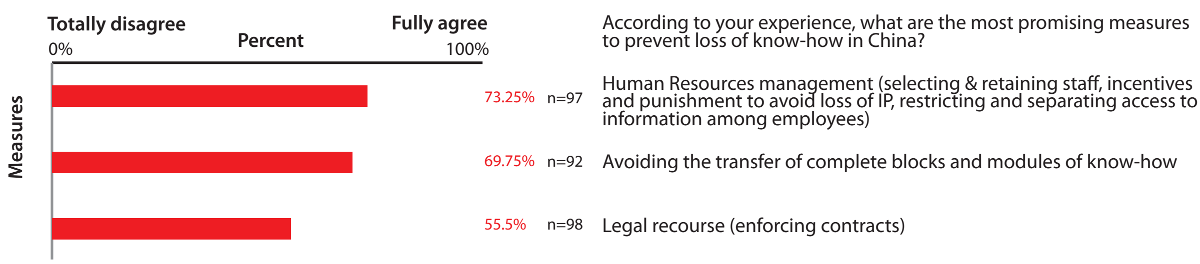


Source: Swiss China Survey, 2005

Human Resources management is the most efficient tool against know-how loss

Survey chart VII - 9

Measures against know-how loss
(All companies in China N=111)



Source: Swiss China Survey, 2005

2 Bringing Intellectual Property into China: risks and counter-measures

by Nicolas Musy, Vice Chairman SwissCham China, Managing Partner CH-ina

2.1 Lower risks than perceived for Swiss companies

Despite the strongly negative perception of China's handling of IP rights internationally, Swiss companies are managing the issue more successfully than one would expect while reading the international press.

In the fields where Swiss companies are active, at least, **doing business with China certainly does not mean the automatic loss of intellectual property**.
This is particularly highlighted by the fact that Swiss companies succeed in their fights against **IP infringers** in about 50% of the cases, on average. (See also 'Actions against IP infringers and level of success', above.)

On the other hand, not doing business with China may slow down but obviously not prevent counterfeiting to take place in China.

Moreover, successful Swiss companies in China tend to have more intellectual property than less successful ones, indicating that IP supports success in China. (See 'China IP Strategies of Swiss companies' above.)

Finally, a majority of Swiss companies are not the best targets of counterfeiters and copiers.

2.1.1 Targets for copying

Infringing on IP rights makes sense only when the chances for profit are high and copying is relatively easy.

This is the case when there is a possibility to produce and sell considerable amounts of a well-known, easy to copy products while quality can be quite similar, DVDs, for example. (Software is similar, yet users bear the risk of additional bugs in their copies and may want after-sales service. Branded consumer electronics are also a target of copiers) The profit is derived from not paying licensing fees for the development of the product. There are very few Swiss companies offering such mass market products. In a similar case, though Swiss companies in the power tool **industry** sell large numbers of relatively simple tools for the construction industry. They are regularly copied at poorer quality levels, sometimes with the trademarks.

Copying luxury goods and their trademarks without having to pay for the marketing costs is less easy, since the fake must at least look exactly alike. But this may generate even better margins per unit. Swiss watches are the regular target of more and more capable pirates, like all fashionable apparel brands. Though, buyers know that the products are fake, they do not care about the intrinsic quality as long as they may display the brand and get themselves associated with the high recognition it brings.

Producing chemicals, pesticides, pharmaceuticals or food at cheaper costs (often without respecting environmental standards or using banned technologies) while using a well-known competitors' brand can also generate high profits. Most, if not all, Swiss multinational companies in these fields face such infringements in China, to a degree or another.

2.1.2 Technology intensive industrial goods

In this field (in which the biggest number of Swiss companies is active in China) copying is not easy. Patented processes may be difficult to reproduce, but so, or even more so, is know-how - difficult to track and record. The brand itself is rarely a reason for a product to be purchased, since it is rarely a reason to show off. (Though some factories may want to impress clients with branded equipment.)

More important is the capacity of the equipment or component to produce the desired results in a durable way. Besides, after sales-service is often critical since productivity losses may cost much more than the savings made on purchasing cheap imitations.

Most cases of technology copying are either joint-venture partners stealing or copying the technology or cases where the industrial goods are imported and sold at very high prices when compared to local production costs.

2.1.2.1 Risks of Intellectual Property loss through a Joint-Venture (JV)

Indeed, in the case of a JV, the technology and know-how are made easy to copy for the partner due to the access to the technology and, particularly, the personnel. (The JV staff is traditionally hired from the JV partner, as part of JV contract negotiations; as a result JV personnel may often keep their loyalty towards their previous managers.)
Additionally potential buyers are likely to trust that the Joint-Venture partner is able to deliver quality and service due to its involvement with the foreign partner.

2.1.2.2 Copying of imported industrial goods and counter-measures

Imported equipment or components are often copied when the price difference with a local production is considerable - 4 to 5 times the price, for example. Imitations are usually of much poorer quality, durability and productivity.
When such an imitation is successful, the buyers see a bigger advantage in having low cost, low performance products than in paying the high price for state of the art technology. Besides and in the case of production equipment, it may also provide the buyer more flexibility to have more machines or lines, each producing less at a time.

Additionally and particularly when the equipment unit cost is large and requires important amounts of capital (printing machinery or machine tools, for example), the buyer may not want to wait until he accumulates sufficient funds to increase production capacity.
(Leasing possibilities and financing from banks are usually not sufficient, also see Chapter II, Legal, Tax and Finance, 'Obtaining commercial loans in China'.)

The extra costs of having more people handling the equipment and of using more space for the same productivity does not compare to the potential losses in extra sales (and the loss of market position to the competition) while waiting to increase capacity.

When know-how only is copied (i.e. patents or trademarks are not infringed), the imitator is not doing anything illegal. As a counter-measure, the foreign equipment manufacturer may consider providing financial support to clients to help growing their business. Yet, it entails risks of payment default and it works only if the final performance of the equipment is economically acceptable at the multiple of the price.

Paradoxically, when copied equipment or components are produced in the mother company and imported into China a better counter-measure may be to establish a local production. Indeed there are clear advantages:

- With lower production costs and no import taxes, the equipment can be sold at a much lower price (typically 50% of the original price) and after sales service (parts, manpower) is also cheaper and often more efficient. (Parts are made locally therefore available faster and service engineers have access to production staff and more know-how.)
- As a result, copiers end-up with equipment whose price/performance ratio is not competitive or yields a much lower margin, so that the incentive to copy is much less. If the copier is not well established he may look for more interesting prospects, otherwise he is forced to try and improve rapidly, hopefully without being able to do so.

- Local production has the additional advantage of adapting the machinery to the particular circumstances of the market. (Also see Chapter V, Market Types & Logistics, Machinery.)

It also gives considerable confidence to clients, who see the possibility to establish a long term relationship with a technological leader and the chance to have the right equipment at the right price with a locally efficient after sales-service.
Finally, in terms of additional risks due to local production, once a product is already copied, making it locally will not importantly increase the risk of IP loss, as the Swiss China Survey shows. (See Survey chart VII - 1 'Intellectual Property risks evaluation' above: the risk of producing is not much more than selling.)

2.1.2.3 Overestimated risk of know-how loss

The fact that IP loss risk does not increase considerably with local production is consistent with the finding that respondents to the survey believe that their employees disclose confidential company information quite rarely. (87 companies answered this question, see Survey chart VII - 5 above, 'Success in countering IP infringers'.)

The fact that multinationals companies are now setting-up R&D centers in China in considerable numbers also indicates that loss of IP through employees is not considered to be a major threat by large companies, who also happen to have been in China longest. (See section 4 below: International R&D in China – Opportunities and Risks.)

In China IP issues, the perception abroad is that know-how loss is much worse than local subsidiaries report.
The reason for it maybe the fact **companies exporting technology to China actually bear a higher risk of copying than those producing locally**.

2.2 Local production as a deterrent to IP infringement in China

2.2.1 Measures to protect against intellectual protection

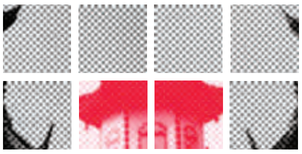
Respondents to the survey in China clearly identify non-legal ways as more effective for the protection of their IP (see Survey chart VII - 9, above 'Measures against IP loss'). This is consistent with the general perception that the legal protection of IP rights is still very much lagging behind in China.
These measures are the traditional defensive and offensive ones: compartmentalization of knowledge and information within the company, keeping critical IP out of China and being faster on the market with better, more competitive products.

Clearly, these softer measures can be brought to best efficiency with a local production.
Additionally, it is generally understood that having a local operation allows for better relations with authorities and, ultimately, relatively better legal protection.

2.2.2 Local production risks

As mentioned, risks of know-how loss through human resources can actually be minimized efficiently. As well, survey respondents evaluate producing in China at only a slightly higher risk than selling or purchasing.
As a result, establishing a local production in China actually provides better ways to counter IP infringements without generating additional risks than selling

This in turn naturally deters competitors to copy a product or new companies to establish themselves by copying a product that is not locally made.
Indeed, trying to compete with a foreign company whose product is already on the market - made with the local production advantages - is certainly of limited potential. Besides, faced with the additional risk of prosecution from a locally entrenched company, the potential copier or counterfeiter may very well look for other, more fruitful opportunities.



2.3 Carefully implementing all IP protection and prevention measures

All the above, however, does not reduce the fact that China presents serious IP loss risks and **Swiss respondents to the survey actually find the local IP circumstances slightly worse than expected, though there is ample warning about China's negative IP record**.(See Survey chart VII - 3, above 'Intellectual Property risks evaluation')

As a result, all of the above must be understood in the light of a constant effort of successful companies to protect intellectual property, with all the ways at their disposal (Also see 'An introduction to IP protection in China: law and best practices' below). These include:

- Having an early, well thought-out IP protection strategy, taking advice from specialists
- registration of IP rights
- Making use of all commercial advantages, including considering local production
- Keeping crucial IP out of China and splitting the locally transferred knowledge among employees
- Paying special attention to local human resources management and contracts
- Being ready to enforce IP rights, therefore establish well prepared contracts and non-disclosure agreements with every relevant stakeholder

2.4 Trends for the future

Progress is generally steadily reported in IP rights protection in China, as well as in law enforcement in general due to China's integration in the world economy and its commitment to the World Trade Organization. One may therefore expect that the local IP circumstances will continue to improve.

A further, stronger argument may yet be provided: China is on a path to develop its own intellectual property. Indeed, local patent filling is growing at rates of 20 to 30% per year, while the growth in scientific discoveries is also accelerating. This trend is illustrated by the 400 start-ups settled in the last five years in one Industrial Park in Shanghai (Zhangjiang).

But, most importantly, the central government and the Ministry of Science and Technology have made it a strategy for the next 15 years to develop local innovation in cooperation with the Chinese economy. As a result, Chinese companies will develop more and more intellectual property and will want it to be protected.
Not so long ago, Japan was considered to be the worst international pirate. The award moved then to the 'Asian Tigers', (Taiwan, Korea) as Japan turned into a creator of technology. China has almost naturally taken over this infamous role, while becoming the workshop of the world.

The current situation in China is more understandable if one keeps in mind that the world's pirate (and the workshop of the world), in the early 1900, was … the United States. Switzerland was no exception either, it acquired quite some of its chemical know-how from the Germans in the 1870s.

The surest guarantee of improvement in IP protection in China certainly comes from its drive to develop its own technology.
Yet, this will bring new, very commercial and probably more serious challenges to developed economies in the future. Indeed, a technology innovative China will challenge Swiss enterprises at their core competence: the development of new products and technologies.

Contributed by CH-ina (Shanghai) Co. Ltd
CH-ina provides the integrated set of services needed for the establishment and operation of Swiss businesses in China.

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3 An Introduction to Intellectual Property Protection in China: Law & Best Practices

by Peter A. Neumann, Partner Faegre & Benson LLP Shanghai Office and Jackson Guo, paralegal and PRC lawyer

3.1 Introduction

In the space of few short years, China has evolved from being primarily the land of unlimited cheap labor to an increasingly popular site for research and development centers. Many Global Fortune 500 companies (such as GE, United Technologies and Lucent, to name a few) have followed suit, and have gone far beyond support engineering to conduct truly cutting edge work in their China R&D centers. International consumer brands proliferate as companies seek growth beyond mature western markets. Even technology and creative industries such as computer games and animation and software development are entering and prospering in China. Looking beyond hawkers of cheap counterfeit DVDs and counterfeit goods flea markets, we see an economy that is now embracing the importance and value of intellectual property rights (IPR) and their creation.

While the threat of infringement remains a fact of life, China's legal system does in fact provide comprehensive protection for IPR. Vigilant foreign business firms willing to take a pro-active role in protecting their IPR in China can and do effectively manage these risks and prosper in China's burgeoning market economy.

This article will focus on IPR issues of greatest interest to most manufactures: patent, trademark and trade secrets. Copyright – particular as it pertains to computer software – will also be of interest to many technology companies, as will domain name rights, although they are not addressed at this time.

3.2 IP Law in China

3.2.1 The Basic Legal Structure

3.2.1.1 Foundations of Chinese IP Law

From a nearly blank slate in the late 70's, shortly after the anarchic Cultural Revolution, the Chinese government has adopted a comprehensive legal regime for protection of intellectual property, including:

- Trademark Law (1982).
- Patent Law (1984).
- The General Principles of Civil Law (1986) (comprehensively recognizing IPR and confirming that individuals could own copyright).
- Copyright Law (1990).
- Regulations for Protection of Computer Software. (1991; revised 2001)
- Anti- Unfair Competition Law (1993) (prohibiting infringement of trade secrets).
- Border Protection of Intellectual Property. (1995; revised 2003).

3.2.1.2 International Treaty Membership

China has also joined or signed most of the important international treaties on IPR protection (accession dates appear below):

- Convention Establishing the World Intellectual Property Organization (1980).
- The Paris Convention for the Protection of Industrial Property (1985).
- Madrid Agreement Concerning the International Registration of Marks (1989).
- Washington Treaty on Intellectual Property in Respect of Integrated Circuits (1990).
- Berne Convention for the Protection of Literary and Artistic Works and the Universal Copyright Convention (1992).
- Convention for the Protection of Producers of Phonograms against Unauthorized Duplication of Their Phonograms (1993).
- Patent Cooperation Treaty (1994).

3.2.1.3 WTO and Fuller Adoption of International Standards

On December 11, 2001, China officially became a member state of the World Trade Organization (WTO). As one of the WTO agreements, the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPs") became binding on China. In order to join the WTO and fully perform its obligations under the WTO agreements (especially TRIPs) China revised most of its IPR laws and regulations issued various new rules to enhance the IPR protection. One of the most significant developments is the availability of preliminary injunctions at the commencement of legal proceedings to halt threatened or actual infringement.

3.2.2 Overview of IPR Enforcement In China and Best Practices

Since China's legal system is still a work in progress, and even the best-intentioned central government authorities must contend with local protectionism and corruption out in the provinces, **it is crucial that foreign business take a pro-active and hands-on role in protecting their rights**.

3.2.2.1 Key Government Players in IPR Protection

Foreign business should be aware of the various government players and their roles in IPR enforcement in China.

3.2.2.2 Administrative Enforcement

Among these are the Administration of Industry & Commerce (AIC) and Technical Standards Bureau (TSB) in each locality. They have the power to conduct administrative seizures and raids, impose administrative fines and collect evidence, but do not have the power to commence criminal proceedings or conduct arrests. Customs is responsible for border protection.

3.2.2.3 Civil Remedies

Civil remedies, such as money damages, preliminary and permanent injunctions and declaratory relief (where ownership of IP is in dispute) are obtained through the People's Courts. Typically, the Intermediate People's Court in each city has jurisdiction over actions to which foreign companies are parties. In recent years IP tribunals within the court system have been established and staffed with judges who have received specialist IP law training.

3.2.2.4 Criminal Enforcement

The Economic Crimes Investigation Division of the Public Security Bureau (PSB) commences investigations of criminal IPR violations. As discussed below, criminal violations are typically triggered when the value of counterfeit goods exceeds certain thresholds. Criminal indictments and arrest warrants are issued by the Supreme People's Procuratorate and the Supreme People's Court jointly.

3.2.2.5 Overview of "Best Practices"

A number of simple steps will greatly reduce IPR infringement risk in China:

- **Register, register, register! Trademark and patent rights generally go to the first party to register; software copyright registration (although not required) makes it much easier to prove ownership in legal proceedings**.
- Consider separating components of key technology, and leaving "crown jewels" at home. Make it extremely difficult for a potential infringer to walk off with the whole package.
- If your operation will involve sensitive technology or trade secrets, ensure that all employees sign confidentiality agreements, conduct background checks on key employees, control facility access and track the movements of departing employees, if possible. Watch the competition to police technology "leakage".
- Avoid joint ventures if possible, especially with potential local competitors.
- Line up enforcement resources in advance; interview well-connected private investigation firms; consider hiring a full-time IP manager once your China operation reaches critical mass.
- Join IPR organizations with a strong enforcement network, such as the Quality Brands Protection Committee.

3.3 Patent Protection

3.3.1 Basic Legal Provisions

In China, **all qualifying inventions, utility models and designs satisfying the requirements of novelty, creativity and usefulness may be the subject matter of patents**. Under the PRC Patent Law, "Invention" means any new technical solution relating to a product, a process or improvement thereof, for example, the "inlet manifold assembly for a multi-cylinderinternal-combustion engine" (CN94194560.X) of Audi AG and the "filtration apparatus" (CN86107248) of Swiss Aluminum Ltd. "Utility model" means any new technical solution relating to the shape, the structure, or their combination, of a product, which is fit for practical use, for example, the "electric lace cutting machine" (CN01271205.1) of Swiss-Bolite Mechanical Mfg. S.A. and the "bathtub with mixing arrangement" (CN86200130) of American Standard INC. "Design" means any new design of the shape, pattern or their combination, or combination of color with shape or pattern, of a product, which creates an aesthetic feeling and is fit for industrial application, for example, the "combine tap" (CN94305132.0) of American Standard INC. and the "wristwatch" (CN99309945.9) of Gucci. The duration of patent rights for inventions is twenty years and the duration of patent rights for utility models and designs are both ten years, calculated from the date of filing [1]. Where a foreigner or foreign enterprise that has no habitual residence or business office in China files a patent application in China, the application should be handled under the PRC Patent Law and in accordance with any agreement concluded between the country of the applicant and China, or in accordance with any international treaty to which both the applicant's country and China are member states, or on the basis of reciprocity. The foreign applicant should appoint a patent agent authorized by the relevant department of the State Council to represent them in patent filing procedures [2].

For an invention, utility model, or design made by a person in the course of their employment or mainly by using the materials and technical resources of his employer, the right to file for a patent belongs to the employer, and the employer will be the patent owner. For inventions or creations not made in the course of employment, the patent application right belongs to the inventor or creator and the inventor or creator will be the patent owner. However, **if employer and employee have an agreement with respect to patent filing rights and patent ownership of the inventions or creations made using resources of the employer, such agreement will govern**. Where two or more applicants file patent applications for identical inventions or creations, the patent will be granted to the applicant whose application was filed first[3]

Where an invention or other innovation occurred outside of China, and the primary patent application occurs outside of China it is essential that the applicant file in China within one year (for designs, within 6 months), or priority of patent rights may be lost in China. If the overseas applicant has the expectation of exploiting the technology in

China, it should include China in its initial filing. **If the delay between overseas and China filings exceeds eighteen months, then the right to obtain patent protection in China will be lost**. If a Chinese patent is not issued, the overseas owner will have no right to prevent infringement in China.

3.3.2 Legal Liabilities for Patent Infringement

3.3.2.1 Civil Liability

When a patent owner or interested party has evidence that someone is infringing or will infringe its patent and is likely to suffer irreparable loss, it may apply to a court for a preliminary injunction to stop the infringement or preserve assets. [4] However, a formal civil lawsuit must be filed within 15 days or else the injunction will be lifted. **The compensation for infringing a patent will be determined by the losses the patent owner suffered from the patent infringement or the benefits gained by the infringer** [5]. If this cannot be determined, other compensation measures may be imposed by the court. [6] The court may also impose punitive civil fines on the infringer if the patent administrative authority does not separately impose administrative penalties in a separate administrative enforcement action[7].

3.3.2.2 Administrative Liability

In the case of infringements involving passing of as one's own a patent owned by another party, the patent administrative authorities may order the infringer to cease and desist, publicize the violation, require the infringer to forfeit illegal gains, and may also impose a fine of up to three times the illegal gains or up to RMB 50'000 (USD 6'183) if there are no illegal gains. Penalties also apply to misrepresenting unpatented technology as being patented.

3.3.2.3 Criminal Liability

In cases of serious infringement, repetitive administrative violations (also known as the "three strikes" rule) or illegal turnover exceeding RMB 500'000 (USD 61'834), the offender may be sentenced to up to three years of imprisonment, and may be required to pay a criminal fine.[8]

3.3.3 Best Practices for Patent Protection

Although China's laws and regulations already provide a full range of protection for patents, the following measures will enhance the chances of obtaining effective patent protection and legal enforcement:

- **Sign confidentiality agreements with employees or other parties that my have access to the technology that will be the subject of the patent application**. Before being granted patent protection, a technology is purely unpatented know-how and should be kept confidential.
- Sign labor or IP/invention ownership contracts with provisions stating that ownership of any invention created by employees during their employment belong to the employer (or the parent company, if possible), and that the employer will have the right to apply for and own the patent.
- File patents in the name of the overseas parent company (but note that the primary filing "window" should be the China Patent Office if the invention occurred in China).
- **Consult with patent counsel to monitor and maintain effectiveness of patents after filing, and prosecute infringements as necessary**.
- File patents with Customs for border protection, if import or export of infringing goods is suspected, alert the relevant Customs office of the shipping window.
- Work with experienced, well connected private investigators or other advisers who can manage the administrative enforcement process (investigations, raids).
- Apply to courts for preliminary injunctions to stop the infringement, seize assets, or preserve relevant evidence prior to filing a civil suit if possible.
- Report serious patent infringement to Public Security Bureau (PSB) Economic Crimes Investigation Division (ECID) to facilitate prompt initiation of criminal prosecution and prepare for civil action for compensation at the same time.
- Establish good relationships with relevant government authorities, e.g. Administration of Industry and Com-

merce (AIC), PSB, Technical Standards Bureau (TSB), intellectual property bureaus, Customs, to help obtain effective assistance when encountering patent infringement problems.

3.4 Trademark Protection

3.4.1 Basic Legal Provisions

Chinese law grants trademark rights to the first party to file, and not the first party to use a qualifying mark. Product marks, service marks, collective marks, and certificating marks are all recognized [9]. In China, trademarks are granted for renewable ten year terms calculated from the date of being approved [10]; however, if a trademark is not used in commerce for three years, it may be subject to cancellation. While there is no time limit on initial trademark filings (as in the case of foreign patents), it is considered good practice and "cheap insurance" to file as soon as possible. Foreign companies with no presence in China may obtain Chinese trademark registrations for their marks. As in the case of patent applicants, foreign trademark owners should also file trademark applications and/or handle other trademark procedures through qualified trademark agents [11]. **Regulations also provide for procedures to obtain recognition and enhanced protection for "famous marks", which status also entails the power to stop competitors from using a famous mark on different goods or in a registered company name**.

3.4.2 Liability for Trademark Infringement

3.4.2.1 Civil Liability

As in the case of patents, trademark owners or interested parties may seek preliminary injunctions to halt actual or threatened infringement in court immediately prior to filing a formal civil action [12]. In principle, compensation payable to the injured trademark owner will equal unlawful benefits received by the infringer, or the loss suffered, including reasonable expenses incurred to stop the infringement. If such gains or losses are difficult to determined, then the court may order compensation of not more than RMB 500'000 (USD 61'833) [13]. The court may also order the infringer to halt the infringement, compensate for the loss, etc. and can also impose such civil penalties as fines, forfeiture of infringing products, forged trademark labels, materials and tools used for manufacturing infringing products [14].

3.4.2.2 Administrative Liability

Trademark authorities will impose a fine of up to three times illegal turnover from the infringing sales, or if this can not be calculated, a fine of up to RMB 10'000 (USD 12'367) [15].

3.4.2.3 Criminal Liability

For using identical trademarks on identical products without permission of the registered trademark owner, the offender may be sentenced to up to three years of imprisonment, payment of a fine or both. For serious offences, the offender may be sentenced to three to seven years' imprisonment and subject to fines. [16] A range of fines and prison terms may be imposed, depending on the nature and severity of the infringing conduct.

3.4.3 Best Practice for Trademark Protection

The following measures will help foreign business firms to minimize and manage trademark infringement risk:

- **File trademark applications for marks in intended goods and services categories as early as feasible, even before conducting business in or trading with China, to minimize the risk of other parties filing first**. Keep records of business discussions with Chinese parties to provide a basis for challenging hostile registrations as being made in bad faith.
- **Establish good working relationships with the relevant Administration of Industry and Commerce (AIC) to facilitate quick and effective administrative remedies in case of infringement**. Identify private investigation/enforcement firms that can assist and facilitate this process.
- File trademarks with Customs for border protection; notify Customs when infringing shipments are expected.

- Apply to courts for preliminary injunctions prior to filing a civil suit against infringers.
- Report serious infringement to the PSB ECID and push for opening of criminal investigations and prosecutions; identify well-connected consultants who can assist with this process.
- If PSB finds serious trademark infringement and initiates criminal investigation, actively cooperate with PSB and prepare for concurrent civil action.

3.5 Trade Secrets Protection

3.5.1 Basic Legal Provisions

Trade Secrets are technology, know-how and other business information that is non-public, of economic value and useful to the owner, and in respect of which the owner has taken confidentiality measures [17]. Trade secrets can include designs, programs, formulae, manufacturing processes, management know-how, customer information, and un-patented proprietary technology, among other things. Infringement of trade secrets by the following means is forbidden by Chinese law:

1. obtaining another person's trade secrets by means of theft, inducement, coercion, or other illegitimate means;
2. disclosing, using, or permitting others to use trade secrets obtained by the means listed above;
3. violating confidentiality or other contractual obligations in respect of trade secrets or unlawfully permitting others to use the trade secrets;
4. in the case of employees of the trade secrets' owner, disclosure, use, or permitting others to use lawfully held trade secrets in violation of labor contracts or requirements of the trade secrets owner [18].

3.5.2 Legal Liability for Trade Secrets Infringements

3.5.2.1 Civil Liability

The basic civil remedies for trade secrets infringements are cease and desist orders and money damages [19]; preliminary injunctions are not generally available, however. The law does not stipulate a specific official standard for money damages for trade secrets, but according to the principles of China's civil law, the compensation to a trade secrets owner who suffers from infringement should be equal to the losses suffered. Even if losses can not be easily determined, as the case will often be, the court may still impose money damages within a certain range according to the severity of infringement.

3.5.2.2 Administrative Liability

If a person infringes trade secrets in violation of provisions in the PRC Anti Unfair Competition Law, relevant government authorities should order cessation of the infringement and may impose a fine of RMB 10'000 to RMB 200'000 (USD 1'237 to USD 24'733) [20] .

3.5.2.3 Criminal Liability

For infringing trade secrets and causing material loss to the trade secrets owner, the offender may be sentenced to up to three years imprisonment and subject to criminal fines. The offender may be sentenced to three to seven years' imprisonment and fines in the case of more serious violations [21].

3.5.3 Best Practice for Trade Secrets Protection

Trade secrets exist solely because their owners take measure to keep them from being publicly known. They are quite different from patents and trademarks whose protection is obtained by filing with relevant government authorities.

The best practices for protecting trade secrets include:

- **Enter into tightly worded confidentiality agreements with employees or other parties that may have access to the trade secrets**.
- Including provisions in labor contracts clarifying that the ownership of any technology created by employees in

the course of their employment belongs to the employer.

- Imposing post-severance non-competition periods on employees (although this will require the payment of additional compensation) in labor contracts.
- Take all feasible physical measures to safeguard confidentiality of trade secrets, such as facilities access control, and separating R&D from general production facilities.
- Periodically give employees who have access to sensitive trade secrets IP protection training and make them aware of the importance of trade secrets protection and the serious attitude of the company toward confidentiality violations.
- As with protection of other IP, establish and maintain good relationships with relevant government agencies, directly or though consultants.
- Monitor competitors' products and services to identify possible trade secret infringement; track movement of departing key employees to identify association with infringement, if possible.
- Actively prosecute infringers with civil or even criminal actions to send out a message that infringement will not be tolerated.

3.6 Conclusion

Admittedly, China has a long way to go before achieving a Western European standard of IP protection, but it continues to make great strides. However, to monitor the latest developments and to evaluate their specific rights in China, foreign IP owners should always consult qualified professional advisers. **If foreign business operators take pro-active measures to safeguard their IP – rather than passively waiting for government protection that may never come – they can greatly reduce IPR related risks and enhance the success and profitability of their China operations**.

3.7 Information for General Reference

State Administration for Industry and Commerce (Trademarks)
San Li He Dong Lu No. 8,
Xicheng District, Beijing, PRC 100820
Tel: +86 10 68052266
Fax: +86 10 68052266X3129
SAIC Web: www.saic.gov.cn
SAIC Trademark Office Web: www.ctmo.gov.cn or http://sbj.saic.gov.cn

State Intellectual Property Office (Patents)
Jing Meng Qiao Xi Tu Cheng Lu No. 6
Haidian District, Beijing, PRC 100088
Tel: +86 10 62083384
Web: www.sipo.gov.cn

National Copyright Administration (Copyrights)
Dong Xi Si Nan Da Jie No. 85,
Beijing, PRC 100703
Tel: +86 10 6512 7869
Fax: +86 10 6528 0038
Web: www.nac.gov.cn

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4 International R&D in China – Opportunities and Risks

by Zheng Han, Max von Zedtwitz and Oliver Gassmann

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4.1 International R&D in China

At the early stages of China's economic liberalization, production-based FDI was the main driver of China's economic growth and modernization. Foreign firms investing in China engaged only in limited levels of R&D activity. However, this trend has become more significant in recent years. While between 1988 and 1992 only an average of 0.8 new R&D units per year were established in China, from 1998 to 2002 this number had grown to 8.4 units. [1] The latest statistics of the Ministry of Commerce has counted over 700 international R&D centres in China. According to the Xinhua News Agency (2005), 298 R&D centres are said to have been established in China in the first nine months of 2004 alone.

Characteristics of MNCs' R&D activities in China

Until 2004, more than 4 billion USD has been invested into R&D in industries of electronics, telecommunication, transportations, medicine, and chemical materials. Major sources of foreign based R&D funds in China typically come from the triad regions i.e. U.S., European Union and Japan and Greater China (China S&T Statistics, 2003; People's Daily, 2004). The computer and telecommunications industries are driving R&D investment in China. Microsoft ranks number one with 750 million USD investment followed by Lucent (400 million USD), Alcatel (150 million USD) and Motorola (90 million USD) (Zhang, 2005).

The regional distribution of foreign R&D activities reveals a clear concentration in the two most economically important cities of China, Beijing and Shanghai (Greatwall, 2002; People's Daily, 2004; von Zedtwitz, 2004). In terms of concentration of MNC's R&D centers, Beijing and Shanghai may become the leading cities in the world. While IT and telecommunications companies prefer Beijing as R&D site, Shanghai attracts more consumer electronics, pharmaceutical, and engineering companies (Greatwall, 2002; von Zedtwitz, 2004). Since more Chinese cities and regions are trying to capture the attention of MNCs by various incentives, a recognizable amount of newly established R&D centers have been founded in the so called second-tier cities (still often with populations exceeding 3-4 million people). For companies that locate in second-tier cities, there is generally less competition with other foreign companies and there are lower employee turnover rates. Furthermore, one can observe a rapid cost increase especially in salary in the top tier cities such as Shanghai and Beijing. This also helps to explain the trend of more and more MNCs settting up their R&D centers in large second-tier cities such as Nanjing, Hangzhou, Shenyang, and Xian. [2] In addition, relations with Chinese government officials are easier to establish and closer. For example, Motorola has established a new integrated circuit center in Suzhou, in the eastern Jiangsu Province (90 km from Shanghai) where Microsoft also has its third R&D center in China after Beijing and Shanghai. In 2005 Nokia established an R&D center for mobile infrastructure in Chengdu focusing on mobile applications based on 3G and IP Multimedia Subsystem (Nokia, 2005).

In general, MNCs implement R&D activities in China in three ways. Many foreign R&D activities rely on organic growth of MNC's Chinese investment. According to the survey of China Science and Technology Statistics (2003), 65.9 percent of the 82 surveyed R&D centers are embedded in MNCs' subsidiaries in China, while the remainder of the MNCs' R&D sites is registered as separate wholly-owned legal entities. Not surprising is that the tendency for wholly-owned R&D centers is positively related to the technological sensitiveness of MNCs' business field, since wholly-owned R&D centers offer a higher protection of knowledge and prevent unwanted technology transfer (China Science and Technology Statistics, 2003). R&D Joint Ventures appear more often in industries where the state control remains strong e.g. the automobile industry. [3] The third option of carrying out R&D in China is cooperation with local universities and research institutes. However this kind of R&D activities usually complements the other two and often serves as a mean to 'test the water' for future R&D investments.

Most foreign R&D endeavours have clearly delineated specific missions predetermined by their parent company. For some of the international R&D centers, their mission goes beyond solely supporting the company's local activities and has important charters within the global R&D network of parent MNC (von Zedtwitz, 2004). It is worthwhile mentioning that some foreign R&D centers are not doing R&D by traditional definitions but rather focus on technology monitoring and corporate R&D representation. Some of them even may have a very strong public relation mission, as Chinese government officials may be more inclined to approve business licenses for other MNC activities if "face" is given via the establishment of a local R&D center. Also, local innovation may benefit via spillover channels such as reverse engineering, human resource turnovers, and supplier–customer relationships. To date, emphasis of foreign R&D centre lays clearly on development rather than on research. Nevertheless, more and more foreign companies have added adequate resources to build leading-edge platforms, transforming the lab into a competence centre for the entire global enterprise, dedicated increasingly to fundamental research (e.g. Microsoft, Sun Microsystems, Nokia, Roche).

4.2 Opportunities and Risks

4.2.1 Meet the market demand with higher speed

One main reason why so many companies are establishing development bases in China is to locally develop products specifically for the Chinese market, since selling products without paying attention to the needs of local markets is bound to fail. Locating R&D activities in China allows MNCs to adapt and tailor their products and services to the local culture, market needs and industry regulations. A typical example is adapting IT user interfaces, telecommunication or car infotainment products to be used with the Chinese language. Moreover, specific local conditions in which products are operating require appropriate modifications and redevelopment. For example, in China some automotive components such as air conditioning and combustion engines need to be redeveloped according to local climatic conditions and local fuel quality (Gassmann and Han, 2004). A leading European specialist in sanitary technology had difficulties to sell its products at the beginning of their China engagement due to differences in construction layouts between Europe and China. Furthermore, many foreign companies have followed their long term business partners into the country. These customers have to modify their product and release new products on a regular basis, so do the suppliers. Local product development teams at both sides will guarantee smoother cooperation along the supply chain.

Speed is one of the most important competitive advantages in a dynamic market. Customers in China are getting demanding and competition is getting fiercer. Localized R&D allows for a shorter R&D cycle time especially for products that require customer and market-specific accommodations. For R&D centers which have been integrated into the global R&D network of the MNC, the Chinese R&D site is an important brick to achieve a 24-hour development cycle. For pharmaceutical companies such as Novartis and Roche, the availability of large patient pools in all therapy areas and rapid and uncomplicated patient recruitment for clinical trials enable pharmaceutical companies to accelerate their research process (Wang and von Zedtwitz, 2005).

4.2.2 Building new capabilities

There is an additional benefit for foreign companies to operating in different cultures and countries such as China. Some managers do believe that products that satisfy the requirements of the most difficult consumer and market environments are likely to succeed anywhere in the world. Microsoft Research Center in China is tackling problems associated with computing in Chinese due to the difficulty in inserting Chinese characters on a Western keyboard. Besides the improvement in software suggestion and error-checking system, researchers also examined data entry methods such as speech and handwriting recognition. The result will make computers more user-friendly in Chinese, but finally will also benefit all computer users (Gelb, 2000). The elevator and escalator company Schindler established an R&D center in Shanghai in the late 1990s in recognition of China being one of the most booming and sophisticated markets in the construction business. Chinese customers could be more experimental than Western customers, which is typical for super-fast emerging economies. In 2003 Schindler conducted a field study for a new web-based personalized infotainment system in the elevator cabin – an advanced experiment that would be less likely to be accepted in Europe or the USA. Based on that study Schindler has planned to multiply the system requirements for the product launch worldwide (Gassmann and Han, 2004).

4.2.3 Cost saving potential

The lower cost structure of doing R&D in China attracts MNCs' R&D activities as well. According to Li and Zhong (2003), running similar R&D facilities in China costs about only one tenth of what it would in the USA. Although the wages of highly qualified Chinese R&D staff is high and soaring fast compared to Chinese domestic level, it is still between 1/3 and 1/5 of that of R&D staff salary in the triad regions. Not included in this calculation, however, are higher training costs, higher management costs, and different salary/staffing structures. Companies in the software industry that moved to India are now starting to evaluate China (Gassmann and Han, 2004). Additionally, Chinese policy makers believe that one of the effective ways to bridge the international technology gap is to intensify the linkage with the international R&D community. [4] Therefore, China has enacted a series of preferential policies to encourage the establishment of foreign R&D activities which provide further cost advantage potentials for doing R&D in China, such as foreign R&D centers in China that can import certain equipment duty free. In case the foreign company is going to establish an R&D center in a high-tech park it can expect incentives such as free rent, low tenancy costs, favourable lease terms, and tax relief.[5]

4.2.4 High quality human resource

Along with further investment, the Ministry of Education has focused on the steady expansion in the scale of higher education and in the mean time significantly raised its quality. In 2002, 14,000 PhDs graduated in China, ranking third behind the USA (approx. 40'000) and Germany (approx. 30'000) (Ministry of Education PRC, 2003a). Between 1998 and 2004, the number of graduate students has quadrupled to over 270'000 students. In 2005, the total on-campus student population exceeded 20 million at over 2000 Higher Education Institutions (HEIs) (China Internet Information Center, 2005). By 2010, the Chinese government aims to provide access to higher education to 23 percent of college-age population (People's Daily, 2003). Many top-flight universities such as Tsinghua, Beijing, Zhejiang and Fudan produce highly qualified graduates in disciplines such as mathematics and natural sciences.

Aside from domestic graduates, more than half a million Chinese students were dispersed among 100 countries and regions worldwide for studying purposes between 1978 and 2002, (Ministry of Education PRC, 2003b). The majority of these students chose to immigrate into other countries after graduating. Hence, China has suffered from an outflow of talents (brain drain) to a great extent. In recent years, Chinese governments, at both national and local level, have introduced policies to induce highly skilled overseas Chinese to return to China (OECD, 2002). Increasing numbers of scientists and graduates have returned from abroad thanks to the enduring economic growth and improved opportunities in China. In 2002, more than 18,000 of the so called 'returnees' came back to China, an increase of 47 percent compared to 2001 (Ministry of Education PRC, 2003b). These returnees represent an additional pool of uniquely qualified human resources, and bring experience and knowledge from around the globe.

4.2.5 Information access through networking

In China, business success depends greatly on strong informal networks and relationships – the frequently cited 'GuanXi'. The establishment of a local R&D centre enables a company to build and maintain informal networks with universities and local scientific communities, which can help MNCs to establish strategic partnerships and secure high quality human resources for the long term. In addition, China's industrial development is at an emerging level and the economy is undergoing a transition from a planned to a market based system. Hence changes in industrial regulations, legislation and policies are more dynamic. Their on-site R&D activities and proximity to the government, state research institutions, universities, industry associations and standard-setting authorities, help MNCs to keep pace with and even influence changes in the dynamic Chinese environment, while also allowing them to achieve critical competitive advantages (Gassmann and Han, 2004).

4.3 Potential risks and challenges

4.3.1 Challenges of HR management

As a common phenomenon, many R&D departments in China are plagued by high staff turnover rates, particularly those located in large cities such as Beijing and Shanghai, where sufficient new opportunities are available. Working for a foreign company provides Chinese graduates not only with higher salary and practical experience; it also makes them familiar with Western management practices and provides them with possibilities of advanced on-the-job training. Foreign companies are often used as career springboards. The worst case scenario is that they can use this experience to get hired by competitors; and indeed many Western-trained Chinese managers defect to work for another foreign MNC in China. Building long-term staff loyalty is a challenge for human resource managers in China. It is particularly relevant for R&D labs, given that know-how travels with people. Company culture, compensation package and working environment are having the foremost impact on turnover rate. The turnover rate could be significant high between the third and the fifth year of the employment. A simple explanation is that from the third year on, the learning process of the R&D staff begins to slow down. The more ambitious Chinese R&D staff starts to seek new challenges and better perspectives. This indicates that in order to dampen down high turn over rate of R&D staff, MNCs should increasingly pay attention to the career development of employees. Worth mentioning, in general the more research focused the job is, the lower is the turnover rate, since the learning curve of R&D staff in research focused areas arises much slower than in development oriented areas and the degree of specialization is much higher. However, the damage to an MNC caused by losing a researcher is more severe (Han, 2005).

The majority of local R&D staff in MNCs is recruited from China's leading universities. It is commonly known that Chinese graduates have a solid education and are highly skilled in solving certain well-defined tasks. On the other hand, Chinese graduates lack practical experience and individual initiative. It could be argued that this phenomenon is attributable to the Chinese education system, which is characterized by a narrow curriculum design and very little development of individual initiative (Gassmann and Han, 2004). To a greater extent, an R&D staff member's individual initiative is decisive for creativity and innovation. As Walsh (2003) stated, developing a more innovative mindset among Chinese staff is a primary concern of foreign R&D managers at this stage. Management and development of R&D staff in China require much attention.

Given the general lack of experienced indigenous local R&D managers, a great portion of top R&D management is staffed by foreign expatriates. As the overall English language skill of Chinese graduates is continually improving, the language barrier is becoming less significant. Nevertheless, to overcome the cultural differences e.g. communication style, 'face saving', to name a few, remains a large obstacle for Western managers during the daily interactions. A Western manager may have done everything correctly according to his understanding of good management. Lack of experience and sensitivity to the Chinese mentality and culture will usually translate to managerial inefficiency, wrong decisions and inadequate leadership.

4.3.2 Risks of IPR infringement

China started to build up an intellectual property (IP) protection system literally from scratch less then 25 years ago. China's WTO accession and the country's ambitious goal to become one of the leading economies through advancement in science and technology have leveraged the fast development of the IP protection system in China, yet the Chinese environment reveals comparatively serious deficits in different areas of IPR protection. For instance, more than 90 percent of software used in China is counterfeit (Weinstein and Fernandez, 2004). According to estimations, foreign pharmaceutical companies lost 10-15 percent of annual revenues in China due to increasing counterfeit (United States Trade Representative Office, 2005).

Due to multiple ecological and managerial uncertainties, managing IPR within the Chinese context remains a challenge for international companies and their R&D activities in the country. One major reason for IP related concern is weak IPR enforcement in the country. Starting and winning a patent case in China is still difficult and definitely time and energy consuming. Additional concerns of foreign companies regarding IPR include a long patent application procedures and a lack of public acceptance of IPR legislation (OECD, 2003). Many underlying reasons such as weak social awareness, lack of IP related experience, insufficient IP personal, loopholes in IP administration and legislation systems, protectionism and corruption are beyond the control of MNCs. Nevertheless, executives and R&D manager of MNCs could overcome the discussed barriers or diminish uncertainties by heeding and integrating the following implications (see Han, 2005).

Awareness of uncertainties – Executives and R&D managers of MNCs need to first make themselves aware of the existing uncertainties and build up a thorough understanding of the Chinese IP environment. Having experienced professionals handle IPR is necessary but not sufficient. Regular and coordinated communication between R&D managers and IP experts enable R&D organisations to always step on solid ground during the whole R&D process in terms of IP protection. Potential IP leakages can also be detected previously. MNCs should keep track of ongoing developments of the dynamic environment of China regarding regulatory and legal changes. For example, some local cooperation partners, especially the (former) state owned enterprises, are part of a network in which unwanted and non-transparent knowledge/technology transfer could occur. Thus, an effective IP infringement monitoring mechanism is the key to minimize damage.

Robustness of IP ownership – Protecting IP in a less mature environment asks for higher robustness of IPR to withstand different kinds of uncertainties. First, MNCs must have protectable IPR. In other words, IPR needs to be built on legal foundation e.g. through registration of patents. Second, IPR must be robust which is crucial to fend off potential attacks. Solid IP ownership also means that there are no IP leakages. For IP such as trade secrets (e.g. knowledge on specific need of customer) which can not be filed or registered, foreign companies need to carefully enforce technical, contractual, educational means to prevent leakages. Usually not technical reasons but people are major sources for IP leakage. Thus, loyalty building of R&D staff will be the key to prevent leakages. External partners need to be carefully selected and monitored. Spreading or holding back core part of sensitive knowledge and technology is also considered an effective means against IP leakage.

Relationship building – To a certain degree, a close relationship with Chinese authorities can compensate structural deficits. Especially for foreign R&D activities, it is less complicated to get into fruitful dialogue with local government and IP administration agencies. An MNC who has invested in R&D in China has thus shown its trust in the country is highly acknowledged by the official side. Executives and R&D managers should take advantage of the official support and try to build up a trustful relationship with authorities and key officials. Through direct interactions, MNCs will have the chance to talk about their concerns and problems. In many cases, they are very likely to receive direct support. Being a part of the local community, MNCs are also expected to share their experience for further improvement of IPR protection in China.

To a certain degree, foreign investors still have suspicion in IP protection when conducting innovative research in China at present and, as a result, truly innovative results in China will continue to take time. Nevertheless, the number of foreign applications for patents attributable to high tech industries has continued to rise. This is mainly due to increased competition and a governmental policy that transfers technology to China. IP management in China is intricate but achievable if enough effort and resources have been put into it.

4.3.3 Fast regulatory changes

Due to a lack of transparency in Chinese policymaking to foreign parties, China's industrial, political, legal, technological policies and strategies are difficult to discern. This provides more uncertainty for foreign R&D activities in China. For instance, in the automobile industry, China sees Europe as a role model with regards to industry norms and regulations. As a result, the Chinese Government ambitiously follows the European automotive norms (e.g., emission norms (EURO III, IV), airbag obligation, tire pressure control, brake power control). The validity of such norms for automotive products will be left up to the government's discretion (Gassmann and Han, 2004). Twelve policies concerning the automotive industry have been issued by the Chinese government since 2004, which never happened in this industry's 50-year history. This kind of unpredictability will make conducting R&D more challenging.

4.4 Conclusion

Accompanied with China's WTO accession, the country is increasing its integration in the global economy. The emergence of foreign R&D activity in China is a recent phenomenon and will continue in the future, particularly in mid-tech industries and among SMEs. The Chinese government has made many attempts to accelerate foreign R&D investment inChina through available political and fiscal means. However, rather than those government mechanisms it is the business opportunities that attract foreign R&D. The discussed opportunities such as meeting market demand with higher speed, potentials of cost saving, availability of qualified human resource and networking opportunity will, especially in the medium and long term, outweigh the risks of foreign R&D investment in China. The success of R&D endeavours in China depends strongly on a realistic estimation of its opportunities, and on the awareness and the proper handling of identified risks such as human resource management, IPR protection and fast regulatory changes. MNCs intending to establish R&D sites in this country should cautiously set local R&D activities in accordance with their internal strategy of R&D internationalization and, more importantly, with their long term corporate strategy towards China.

Notes

1 These statistics may not reveal the exact dimension of foreign R&D activities in China. For instance, Motorola, which is counted only once in the statistics, has 18 R&D centers and 7 more under construction

2 Although it could cost even more than in Shanghai and Beijing to lure or keep top graduates having suitable skill, attitude and working experience with MNCs to second tier cities, however, newly established foreign R&D centers are soaring especially in these cities due to undoubtedly low average salary level of technical graduates. The cost advantage only pay off through economy of scale, i.e. if the company aims to set up a large R&D center. For example, Infineon, the fourth largest semiconductor manufacturer in the world and IC design enterprise, has set

up an R&D center in Xian in 2003. It will become the second largest R&D site in all his R&D Centers. Cost advantage is one of the major motivations behind this investment.

3 For example, already in 1997, General Motor has established the Pan Asia Technical Automotive Center (PATAC), a 50 million USD R&D joint venture with their local partner Shanghai Automotive Industry Corporation Group (SAIC). Nissan is currently building a 40 million USD joint R&D lab with Dongfeng Motors in Guangzhou.

4 'Revitalizing the Nation through Science and Education', a strategy which was officially adopted in 1995 by the Chinese government to speed up Scientific and Technological Progress (OECD, 2002), has also led to the rapid growth of China's national science and technology activities. Between 1998 and 2003, China's gross expenditure on R&D nearly tripled from RMB 551.1 million to RMB 1539.6 million making up 1,31 percent of the GDP in 2003 (China Science & Technology Statistics, 2004). The 10th Five-Year Plan (FYP) for 2001-2005 has set an objective to increase overall spending on R&D to 1.5 percent of GDP (People's Daily, 2001). Most likely, China is going to achieve this goal. The rapid development in R&D expenditure let the developing country approaching the level of world's most developed and technologically advanced economies in the triad region which is characterized by 2-3 percent.

5 As an example, the Chinese State Council and Beijing municipality both offer start-up firms located in Beijing's high-tech Zhongguancun area tax-free operation for three years following their establishment, followed by a 50 percent reduction for the next three years, and a 15 percent discount from the seventh year onwards, along with other tax incentives.

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VIII Sourcing & Purchasing

Low costs and good quality are some of the key opportunities that China offers today. Strategic plans of international companies in terms of low cost production and purchasing indicate that China will receive 50% of investments made for this purpose in the years to come.

Yet, Swiss companies operate in China mostly for strategic reasons — to serve their clients and win the market before the competition. This certainly indicates an opportunity for the Swiss economy to benefit more from purchasing in China.

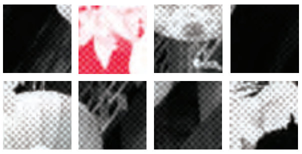
A question that is of key importance for making purchasing and other decisions is: how long will China's current low costs last? Probably for the next ten years, in terms relative to the rest of the world, allowing for a long term China strategy.

Good price/quality ratio is the most important element but there are disadvantages and difficulties in purchasing in China. They are highlighted together with purchasing criteria including most aspects of costs and time for transportation.

The choice of suppliers and their management is essential for a successful activity, so that suppliers' selection criteria and elements for managing supplier relationships are described.

To understand the complicated situation of international trade with China and the way successful companies deal with it, a set of purchasing models fitting the different purchasing cases are provided. These sourcing and purchasing situations are then illustrated through the case studies of two successful Swiss SMEs in China:

- Jesa SA, purchasing components for production in Switzerland and finished products to supply own customers within a cheaper segment
- Dolder AG, trading pharmaceuticals and fine chemical materials around the globe.



1 Purchasing in China: A Long Term Option?

by Nicolas Musy and Patrick Schaufelberger
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Patrick Schaufelberger, master of engineering and master of industrial management, Swiss Federal Institute of Technology Zurich, is in charge of research management, data collection and analysis for the Swiss China Survey.

1.1 The 21st century "Workshop of the World"

China's development in the last 20 years has brought about major changes in the country's ability to reach international quality levels in a wide range of consumer and industrial goods, often at unbeatable prices.

In addition to the Chinese-owned producers, a constantly growing number of foreign-invested enterprises (most of them based in Taiwan, Hong Kong or Singapore) have set up manufacturing branches on the Mainland. As a result, the services linked with the supply of products, along with the quality of manufacturing, are also reaching international standards among the best suppliers.

China is the largest producer worldwide of an increasing range of products — from textiles and apparel to tractors (80% of the world total), Penicillin and Theramycin (at least 60%), VCDs and cameras (at least 50%), mobile phones (33%), and watches and clocks (75%).

This trend of world production moving to China is particularly obvious in the sector of mass consumer goods, where China started its export activities. Wal Mart [i] provides an outstanding example. In 2003, this US retailer purchased USD15bn worth of goods from Chinese suppliers and 80% of its accredited suppliers were producing in China. Yet in 1995, Wal Mart's percentage of imported goods into the USA was only 6%. In 2005, this percentage is estimated between 50% and 85%.[1]

The trend is the same in the sector of industrial goods. In 2003, General Motors purchased USD200m worth of car parts from China for export and the figure is expected to rise to USD4bn by 2010 [1].

Although product design and, to a lesser extent, product development appear one step behind, R&D altogether shows constant progress. The Chinese market is different and large enough to elicit its own product development. Besides, R&D can be conducted more efficiently when located close to the production site.

Additionally, China is training twice as many engineers as the US every year. All these elements point to strong future developments in the country's R&D ability.

As a result, China will most certainly set up an efficient knowledge production platform in the coming decade to serve the "Workshop of the World" with world-class product development [ii].

1.2 Are China's low costs here to stay?

With the country's economic development, many believe that salaries, living standards and prices will rise in China as they did in Japan, Hong Kong, Korea and Taiwan. Eventually they certainly will. However, for decision makers today, the important question is when?

China is ten times more populated than Japan. It seems reasonable to forecast that the time it will take for the Mainland to mature into a homogenous, developed economy should be at least a few times the amount it took Japan to develop. That is a few times more than 30 years during which Japan caught up with the rest of the developed world (from the mid 40's to the mid 70's). This indicates that China's development process will certainly last for an important part of this century. Still, the important question is: when will costs and prices begin to rise in China?

To answer, it is essential to take into account the surplus of labor in the countryside. China's agriculture is currently extremely inefficient. One American farmer with modern equipment worth USD200,000.- does the work of twenty thousand (!) Chinese [1]. As a result, American soy beans imported into China are cheaper than beans grown locally. **For the Chinese farmers to become competitive, the Beijing National Economic Research Institute forecasts that 300 to 400 million farmers will have to leave the countryside in the next 10 to 15 years** [2].

Clearly, farmers are not able to take jobs requiring industrial skills or academic education. However, the fierce competition generated on the labor market by the influx of unskilled labor is spurring all parents who can afford it to provide their children with the best possible education. **As a result, the number of university students is increasing to the point that starting salaries in Shanghai for new graduates in 2004 were 30% lower than the year before.**

Keeping these examples in mind, it is difficult to forecast that salaries will rise (in Chinese currency terms) until China's workforce surplus is absorbed (300 to 400 million: as much as the entire population of the USA). Raw materials and energy costs may certainly go up and impact the cost of Chinese goods. However, this should not affect the competitiveness of China as the increasing costs of these commodities should equally affect all producers worldwide.

Meanwhile, the level of efficiency in China is generally very low. Quality is constantly improving in infrastructure, management and services, taping the potential for efficiency, potentially increasing margins and lowering prices.

The rush on Chinese goods has put high pressure for the revaluation of the RMB yuan, the non-convertible Chinese currency. As a result, in US dollar terms, the prices of Chinese products may increase by 5% to 10% until mid 2007 (also see Chapter II Legal, Tax & Finance, 'RMB exchange rate reform and RMB revaluation').

However, due to the fall of the US dollar, to which the RMB yuan is pegged, Chinese prices have gone down about 30% in Euro terms in the last three years. Therefore, even with (unlikely) multiple revaluation, Chinese products will most probably remain very competitive for Swiss enterprises in the next two to three years.

In summary, in the coming ten years, salaries may not rise in local currency terms though the Chinese currency might be revaluated of a few percent per year against the USD. Prices of Chinese goods will remain at their current price level, at least with respect to other prices worldwide (also see Chapter I General Environment & Trends, 'Trends as seen by surveyed companies', 'costs' for survey results).

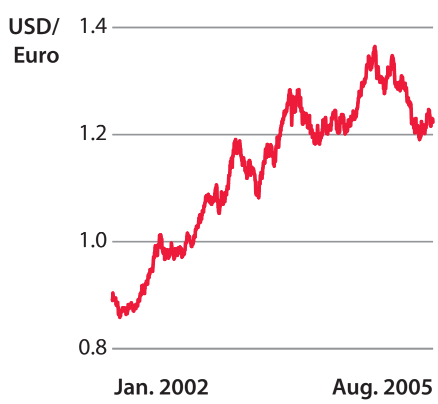
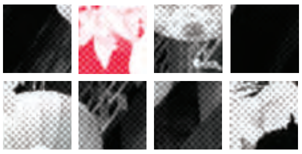


Fig VIII - 1
USD Exchange rate development
January 2002 to August 2005
(USD for 1.0 Euro)



1.3 Purchasing: A strategic imperative

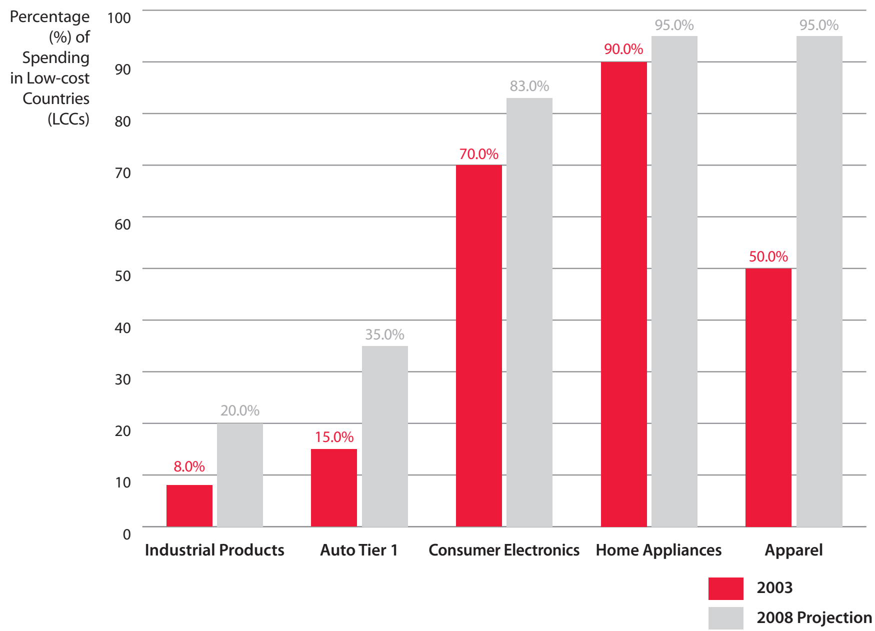
Global competition is pushing prices of manufactured goods down, while raw materials and energy costs are going up. (Many economists attribute the major cause of these paradoxical trends to China's rapid economic rise.) Indeed, China is producing cheaply, lowering prices worldwide. Yet the Chinese are also consuming more and more raw materials and energy pushing word prices up. Most enterprises are under pressure to reduce prices, thus costs. Achieving the most efficient way of purchasing components and materials has become an important part of the price reduction equation: production materials typically represent 30% to 70%[3] of the total cost of industrial goods.

By 2008, auto and industrial products companies will more than double their percentage of spending on components and materials in low-cost countries, according to a recent Booz Allen Hamilton survey of purchasing executives. Apparel companies, which currently spend 50% of their procurement dollars in low-cost countries say that within four years, these countries will provide virtually all of their material and supply needs (see Fig VIII - 2 for the sourcing levels of low-cost countries).

According to most of the companies interviewed in the Booz Allen Hamilton survey, more than 50% of the investments targeted for low-cost countries will flow into China.

Fig VIII - 2

Low-cost country sourcing levels



The data represent the average of multiple companies in each segment

Source: Booz Allen Hamilton Global Sourcing Survey

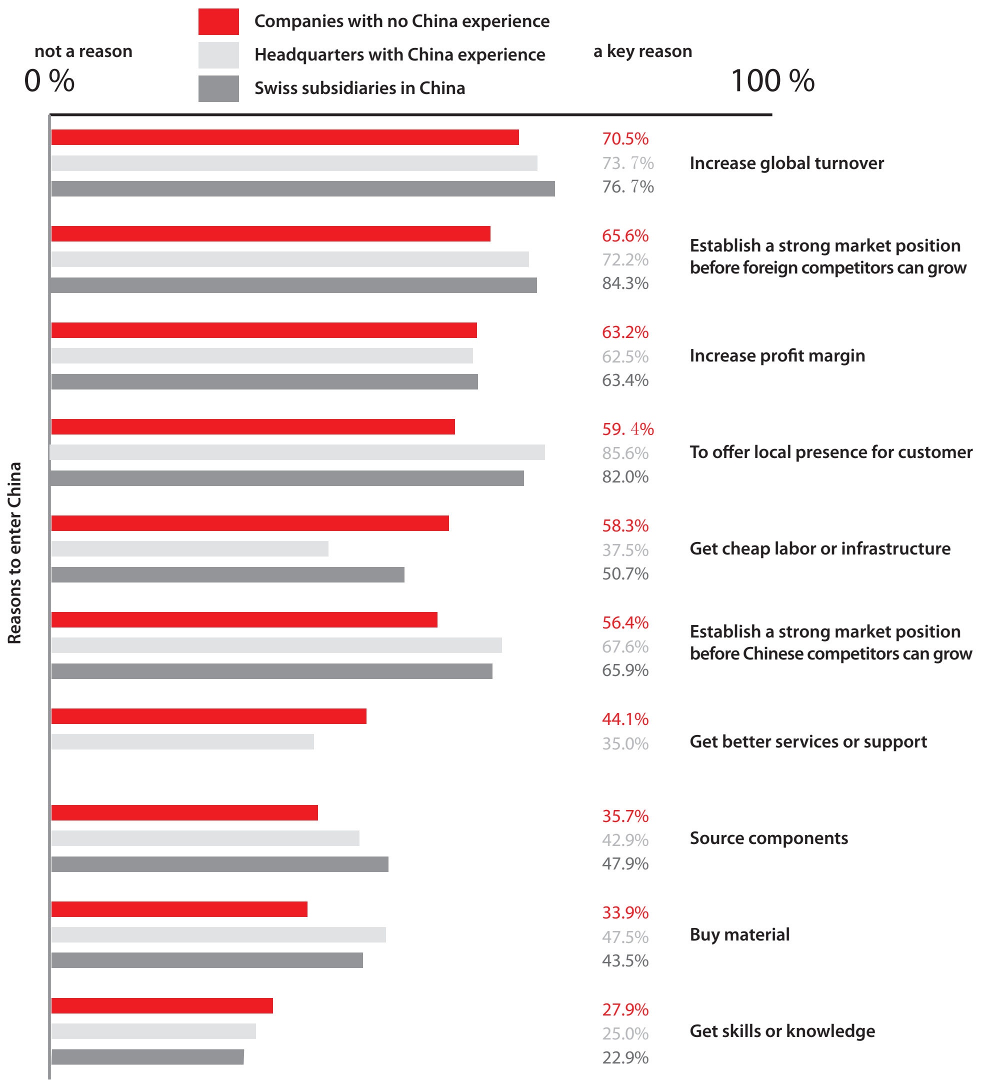
While most multinationals have already integrated China in their global supply chain, SMEs still have a largely untapped opportunity to catch in this purchasing market. That is, depending on the sector, purchasing 'Made in China' components or materials may give any company an important advantage over its competition who does not have access to similar quality/price ratio. The results of the Swiss China Survey show, however, that only 39% of the respondents in China are purchasing, while 55% are producing and 67% are selling.

Additionally, **the rating of strategic reasons of Swiss companies active in China** ('offering a local presence to customers': 85.6%, increasing global turnover': 73.7%, 'serving the market before foreign or Chinese competitors do': 72.2% and 67.6% respectively) **is much higher than 'getting cheap labor or infrastructure'** which rates only 37.5% (see also Chapter III Preparing for China).

Swiss companies that are not yet active in China show a much stronger interest in purchasing in China, rating 'getting cheap labor or infrastructure' at 58.3%. Likewise, the China subsidiaries of Swiss companies also recognize the purchasing opportunity with a rating of 47.9%. This may well indicate that Swiss companies requiring higher levels of quality and service have a strong potential to make good on China's potential as a purchase market.

Survey chart VIII - 1

Reasons to enter China for Swiss companies



Survey Question:What are the reasons for your company to enter China?

Source: Swiss China Survey 2005

Notes

i Wal Mart is the largest US retailer and biggest company worldwide, with USD260bn annual sales in 2003.

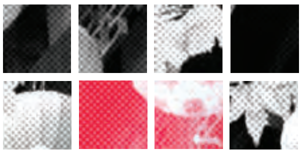
ii Zhanjiang Hi-Tech Park in Shanghai has settled 400 start-ups in the last five years, mostly in IT and biotech.

Sources

1 Fishman, T. C. (2005). China * Inc. . New York: Scribner

2 Chee, H. (2004). Myths About Doing Business in China. New York: Palgrave Macmillan

3 "Peeters, J. (2005). Purchasing and Cost Management in the Supply Chain": Limburgs Universitair Centrum, Belgium and internal survey results from Swiss Center Shanghai



2 Purchasing Criteria

2.1 Advantages and disadvantages of purchasing in China

Compared to other low-cost countries, **China's big advantage in purchasing is certainly its low costs and high quality supported by a rising level of service** (flexible production timing, ability to make quick adjustments required on samples, etc.). Machined casting, for example, may be purchased at 50% to 20% of the costs of purchasing in Italy. Metal pieces produced in machining centers usually cost only as much as 50% of the European production cost. The same goes for electromechanical assemblies and equipment.

To understand this (sometimes alarming) manufacturing competitiveness when compared to other low-cost countries, we need to consider the almost irresistible attraction of China's enormous potential market and the amount of foreign investment it is drawing in:

- Foreign companies' subsidiaries in China serving the local market need to compete with other Chinese manufacturers and minimize costs while maintaining quality — their major advantage. Doing so, they create an opportunity to supply their other operations with components and products from China at a favorable quality/price ratio.
- Conversely, while serving foreign companies in China, local suppliers come to meet higher quality and services requirements while starting from a low-cost structure. Additionally, if they manage to meet the required quality/price/service ratio, they have a good chance to be selected to supply the worldwide operations of their foreign client. In the process, these Chinese suppliers unavoidably acquire the ability to directly serve other customers abroad.

China's obvious disadvantage, on the other hand, is distance, both geographically and culturally. Geography makes shipments from China to Switzerland up to ten times longer than those from eastern Europe (30 days shipping from China versus three days trucking from eastern Europe).

Cultural differences are often an even bigger issue. Communication problems and potential misunderstandings (due to different mentalities, manufacturing and business ways) slow down processes, require more effort than expected and considerably increase the risk of unsatisfactory or late deliveries.

2.2 What not to purchase in China

Due to foreign investments in practically every sector of the economy, China provides a good sourcing opportunity for almost all possible consumer and industrial goods, with some notable exceptions however:

- Luxury goods
  Watches "Made in Switzerland" or wine "Bottled in France" will command a premium that outweighs the savings in production costs, at least as long as these locations and the brands they host can maintain their exclusive know-how and image.
- High-tech equipment or components that require utmost reliability
  China will try and probably manage to catch up in key hi-tech areas, such as IT and biotechnology [1]. Yet, developed economies keep the advantage in product design and quality/productivity where advanced technologies are required (microprocessors, for example). This advantage should be maintained in the long term by Swiss companies, as long as their innovation rates keep up with China's.
- Capital intensive operations (for which no other efficient production alternatives are available)
  For an example, Roche recently compared Shanghai and Basel for the set up of its new Vitamin E plant. Switzerland was found to be equally competitive as China and was selected as the site for the new plant location. (Also see Chapter V Market Types & Logistics, 'Chemical Industry: Ciba case study' for an example where low cost is not a reason to produce in China.)

2.3 Factors for success

The number of respondents that are only purchasing is too low to provide a valuable rating of success factors for this chapter. However, based on the case studies, it clearly appears that three elements are of major importance:

2.3.1 Human resources selection and management

Sourcing and purchasing operations are first service centers whose success depends on the quality of their staff. Persons of particularly good ethics are of special importance since suppliers may offer kickbacks to purchasing staff to secure business. Staffs who accept will not look for better deals or better suppliers and reduce the competitiveness of the purchasing.

2.3.2 Technical capacity and coaching

Suppliers, most of the time, need some training or support to meet specific technical requirements of the client. As a result, having sufficient resources for technical support and quality assurance at the supplier's site is key to a successful purchase.

2.3.3 Market information and supplier management

Selecting the most suitable supplier among the often enormous number of candidates is a challenge in itself. Managing the relationship offers then the possibility to generate competitive advantages through exclusivity or better conditions.

2.4 Meeting overall product needs

The first concern of a Swiss company that outsource components or materials to a low-cost supplier will usually be the overall quality requirements (product quality, quantity, service level and delivery times). No matter how good the price may be, should these quality requirements not be met, outsourcing shall not make sense. In China particularly, the following key elements need to be considered in terms of overall quality requirements:

2.4.1 Product quality

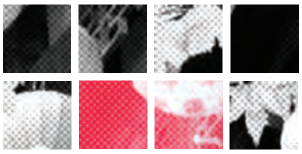
China's production base can reach international standards of product quality in practically every sector that is not extremely hi-tech or specific.

In fact, as evident in more and more cases, manufacturing in China enables producers to manufacture better quality products than in Europe and even Switzerland as they can afford more people for quality control at every step of the production process.

An electronic component and a precision turned parts manufacturer, both Swiss, have achieved better batches consistency and scrap rates with their China operations than in the mother companies after less than two years of operations (see also KUK case study, Chapter V Market Types and Logistics, Precision and Telecom Industry).

2.4.2 Service

Traditionally, the Chinese focus on specified, measurable hard factors (such as tolerances, delivery dates, prices) and may not understand the big picture of their clients. As a result, valuable information (about a shipment route or differences in unspecified quality attributes, for example) may not be perceived as important. Therefore, such information will not be mentioned spontaneously.



2.4.3 Production volume, batch quantities

Most Chinese manufacturers are used to producing large quantities in line with the domestic market size and China's most important export market: the USA. For this reason, **Chinese producers may not be able to manage low quantities at a high-quality level** or may not be able to produce them cost efficiently. Usually they refuse to provide prices when forecasted quantities are clearly too low for their operations or business targets. Although some may give quotations, they will refuse to provide samples or develop prototypes as sampling always means investment. Others may not know how to calculate prices for small quantities and will come up with extraordinarily high prices, or prices that are too low to cover the extra costs of small batches. In either case, quotes for unusually small quantities may not reflect the actual cost picture.

2.4.4 Production times

2.4.4.1 Capacity

Chinese producers have become very fast, with nimble mentalities, reliable infrastructure in developed areas, local availability of increasing number of production materials, the usually sizeable factories and the flexibility of the local labor force. However, large and flexible production capacities are only one element of speedy manufacturing. The lead times for procurement of production materials and components may very well be as important.

> To increase their income Chinese workers are known to be willing to work 10 hours a day, up to six or even seven days a week during peak times. This allows producers to reduce delivery times by squeezing orders in the production planning. Though many - possibly a majority of Chinese workers, particularly the migrant ones — wish to work longer than 40 hours a week to earn more, we recommend to verify that the producers follow legal labor requirements and that workers are not forced into illegal or unhealthy work conditions (see also "Suppliers Search and Selection" in the next section).

2.4.4.2 Availability of production materials

Due to local flexibility, when sourced locally, custom-ordered materials for production are usually available on shorter notice than in Europe. Indeed, Chinese manufacturers usually reduce risks and minimize scarce capital needs by producing on order only, as OEMs. As a result, they are reluctant to keep products on stock and may do so only with financial guarantees or for good and well-known customers.

As a consequence, should components or materials need to be imported or be available on stock in other production markets, the amount of time to have them available for production in China is generally longer than usual due to transportation and customs clearance procedures. Production materials sourced from Asian countries may be an exception as shipping times can be much faster than when materials come from Europe.

2.4.5 Shipping times

Short shipping times from China to Switzerland can only be achieved by air at the steep cost of about USD6/kg (including surcharges) for a minimum cargo weight of 50kgs to 99kgs. It takes at least six days for an air shipment from China to reach Switzerland, door-to-door. For seasonal or perishable products with short order lead times (e.g. fashion, flowers), air freight is the only solution.

Surface shipments take about six weeks door-to-door, for about 28 days on sea. For non-seasonal items, the long shipping time may be offset by larger inventories in Europe, should the cost savings be worth it.

A combination of air and sea shipment is sometimes a possible compromise — shipping cargo by sea either to the Gulf of Arabia hubs, to Hong Kong or Korea then air freighting at cheaper rates to Europe. These solutions may cut door-to-door transportation by at least one week compared to using sea shipping only.

Geographical distance is the hard factor in China's disadvantages as a purchasing destination. The day may come, however, when goods may be shipped in two weeks by train via Russia at an acceptable cost. When that time comes, China's competitiveness for European outsourcing will increase considerably (see Fig VIII - 4 for the comparative chart of shipping time and costs from China to Switzerland compared to transporting from eastern Europe to Switzerland).

2.5 What costs to expect?

Costs are a function of more aspects than what's normally thought of when dealing in China. In addition to manufacturing and shipping costs, relationship development and maintenance efforts are necessary to enable suppliers to meet all the needs of a particular purchaser and product. Technical support and on-the-spot quality control are often included to speed up product development and meet batch quality. Clients also regularly invite suppliers to visit their operations for them to better understand their requirements.

2.5.1 Labor

The low cost of China's disciplined, skilled and hardworking labor is one of her famed attraction. It is actually quite extraordinary and has far reaching implications on many other aspects (for infrastructure and equipment costs as well as yields on raw materials, see following sections). Including benefits and welfare, the average hourly compensation for production workers in 2003 [2] in low-cost countries were:

- China: USD0.80
- India: USD1.12
- Thailand: USD1.96
- Malaysia: USD2.09
- Mexico: USD2.45
- Czech Republic: USD3.64

(See also Figure VIII - 3 on how China's average hourly compensation compares with other outsourcing destinations.)

China's unskilled labor costs (including welfare and related costs) can be as low as USD0.25/ hour, while skilled labor goes between USD0.80 to 1.22/hour (or Euro0.65 to 1.00/hour, all included).

To benefit most from China's inexpensive labor force, it is worth looking beyond the single purchasing of a part and outsource additional operations or assembly. For example, when an automotive company attempted to purchase raw aluminum castings from China, the Chinese supplier offered savings of only 1% over the bid of a US supplier. By redrafting the bid to include finished machining of the parts, the automotive company realized a 15% total cost savings with the same supplier.

As mentioned above ("Are China's low costs here to stay?"), in local currency terms, these low costs may not increase considerably in the mid- or even long term. Yet, in given industries or for specialized functions where the needs grow faster than the workforce's skills, salary increases should be expected, at least on a temporary basis.

2.5.2 Commodities and energy

Raw materials in China follow international commodity prices. Energy is only marginally cheaper than in developed economies at an average cost of about USD0.08/KWh in China's coastal areas.

Cheap labor costs may provide manufacturers with the opportunity to use lower grade (therefore cheaper) raw materials to produce high enough quality end products. Parquet manufacturers, for example, are able to extract good quality flooring by using "C" grade lumber. They can afford their workers' time to optimize the cutting and to repair some of the defects in the raw boards. As a result, they increase the yield and indirectly reduce raw material costs.

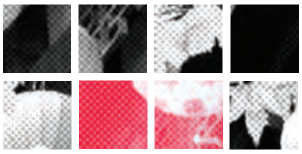
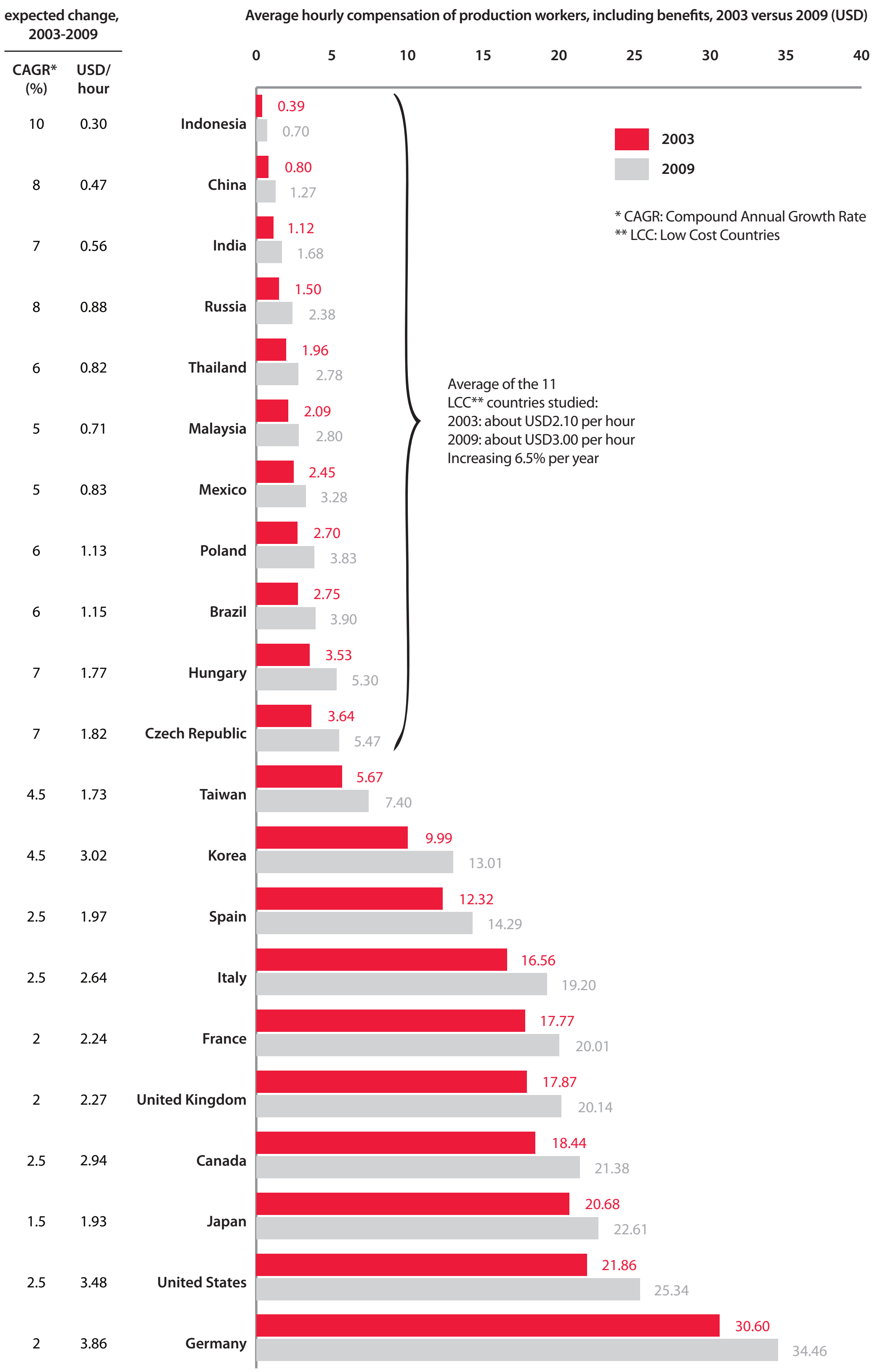


Fig VIII - 3

Average hourly compensation of production workers, including benefits, 2003 versus 2009 in USD.



Source: The Economist Intelligence Unit; Euromonitor; S&P DRI; U.S. Department of Labor; BCG analysis

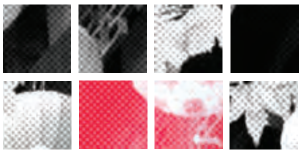
Transportation Time and Cost: China to Switzerland in Comparison with Eastern Europe to Switzerland

Origin-Destination	Transportation Method	Time	Cost									
			50-99kg 1)	100+kg	300-999kg 3)	1000kg+	20' Full container Load(Fcl) 4)	20' Less than Container Load(LCL)	40' Full Container Load 7)	40' Less than container	FULL Truck Load 8)	Half Truck Load 9)
			USD per kg	USD per kg	USD per kg	USD per kg	USD per container	USD per 1000kg 6)	USD per container	USD per 1000kg 6)		
CHINA to SWITZERLAND	Air(to Zurich Airport)	4-6 days	6.02 2)	4.27 2)								
	Sea-Air(via Dubai to Zurich Airport)	22-25 days			2.95	2.50						
	Sea-Air(via Korea to Zurich Airport)	9-15 days			3.60	3.30						
	Sea(to Basel Railway Terminal)	approx.31 days					2'314.-5)	120.-	4'300.-	120.-		
POLAND to SWITZERLAND	Land(via Czech Republic and/or Germany)	3-5 days									1'900.-	
		4-5 days										1'600.-
CZECH REPUBLIC to SWITZERLAND	Land(Germany)	3-5 days									1'230.-	
		4-5 days										910.-
HUNGARY to SWITZERLAND	Land(via Austria)	3-5 days									1'540.-	
		4-5 days										1'160.-
ROMANIA to SWITZERLAND	Land(via Hungary and Austria)	3-5 days									2'080.-	
		4-5 days										1'540.-

1) miminum freight:50kg
2) incl. surcharges for fuel and security ($0.77/kg in September 2005)
3) less than 300kg is as expensive as pure airfreight
4) cubic capacity: ca. 33cbm; payload: ca. 22'000kg
5) loads of more than 14'000kg cost an extra railway transportation fee of $150 from Hamburg to Basel
6) usually measured in cbm: max weight of 1cbm=1'000kg; should weight per cbm exceed1'000kg the amount will be charged according to the weight
7) cubic capacity: ca. 68cbm; payload: ca. 27'000kg
8) cubic capacity: ca. 70cbm payload: ca. 24'000kg
9) cubic capacity: ca. 30cbm; payload: ca. 10'000kg

Fig VIII - 4
Shipping time and costs of transporting goods from China to Switzerland compared with Eastern Europe to Switzerland.

Source: Go-Trans / Gondrand



2.5.3 Infrastructure

Buildings and general infrastructure (interior installation and partitions, office furniture, computers, etc.) are generally cheaper in China by a factor two on average in comparison to Switzerland.

Industrial buildings in the best locations, for example, go for about USD34.-/sqm/year, raw. Swiss standard interior installation will usually add about USD16.-/sqm/year. Far away locations may offer rates 30% to 50% cheaper, yet they generate other costs (also see Chapter III, Preparing for China "Selecting a location").

Land can only be leased for long term, not bought. As a result, land must be depreciated and may cost more than in Switzerland in the long term. In the best locations, land goes for about USD50.-/sqm for 50 years. In under developed areas, cost can be half or almost nil, should the local community want to attract its first foreign investment. Construction costs are considerably cheaper than in Switzerland, thus the cheaper rents. They go from USD150.- to USD200.-/sqm for industrial buildings in developed areas, depending on requirements.

2.5.4 Production equipment

Foreign and Chinese companies have purchased considerable amounts of expensive, Western-made equipment for production in China in order to meet quality standards. However, **with the improvement in skills and management, it is actually more economic to use labor or simple Chinese-made equipment, as long as quality levels can be maintained.** Many Chinese companies are working in very old-fashioned ways and saving on equipment costs. In so doing, they are able to achieve the required results at cheaper costs.

Foreign companies, under the push of local competition, are following suit. A European world leader in power tools has recently set up a new production site in China employing over 2,000 workers. All equipment has been purchased locally, thereby reducing the equipment costs by 80% compared to the operation it set up eight years before. Owing to this, European equipment manufacturers find themselves increasingly pressured to develop machinery specifically for China and low-cost countries that fulfill quality requirements without minimizing the use of labor. A European-made machine almost always costs more than the workers it would replace in China.

2.5.5 Shipping

At the time of printing, shipping from China (Shanghai) to Switzerland (Basel via Hamburg) including Cost Insurance and Freight (CIF) and freighting from Hamburg to Basel Rail terminal, is USD2,200.- per 20-foot container (Full Container Load) weighing below 14 tons. A "Less than a Container Load" (LCL) cargo from Shanghai to Basel terminal is USD120.- per cubic meter.

Transit time from Shanghai to Hamburg is approximately 28 days and railage from Hamburg to Basel is approximately three days.

Air freight costs from China to Switzerland are USD6.-/kg for a minimum weight of 50kgs up to 99kgs. For higher volume air cargos – 100kgs or more costs USD4.25/kg [3].

Sources

1 International Herald Tribune. (2005). China joins global race for fastest computers. IHT
2 The Boston Consulting Group. (n.d.). "China Report: Studies in Operations and Strategy China and the New Rules for Global Business"
3 Burgermeister, G. (2005). Go-Trans / Gondrand

3 Supplier Search and Selection

Directories of suppliers are usually easy to obtain, from yellow pages, search engines and specialized web sites (e.g. www.globalsources.com, www.alibaba.com). Evaluation of the suppliers and their selection are most of the time the determining factors to start a successful purchasing relationship.

We suggest evaluating the following aspects [1] for supplier selection:

- Ability to understand and relate to the purchasing company for supplier and service level. This may be evaluated through references and experiences while communicating in the early stages. Intermediaries, such as purchasing agencies or own staff hired locally may bridge some of the gaps in service and communication.
- Know-how, product development ability and technical capability, mostly evaluated through equipment at disposal, certifications, production samples, prototypes, trial orders.
- Size and production capacity, in order to evaluate ability to deliver required quantities on time.
- Flexibility and reliability of supply, evaluated through other client references, impression of and psychology of the management, financial situation, location and access (possible logistics bottlenecks or natural disasters, e.g. floods).
- Overall costs evaluation, also taking into account the shipping time and costs, technical support and relationship building efforts in relation to all of the above.
- Depending on the level of technology transfer to be effected; reliability in terms of intellectual property. This may be evaluated based on reputation and references, understanding of value of business ethics as well as local law enforcement and interpretation. It is also critically important to make sure that the supplier neither has a competitor as a client nor is a potential competitor himself. Local experts shall have more ability and experience to assess the psychology of the management and could be involved for a safe initial selection.
- Supplier's corporate governance, particularly in treating workers and sub-contractors. Purchasing from suppliers making use of child or prison labor can have disastrous effects on a company's reputation.

Sources

1 Quint, M. and Shorten, D. (2005). "The China Syndrome. Booz Hallen and Hamilton report.

4 Supplier Management

To guarantee or maintain a supplier's performance, the efforts put in managing the relationship are essential. Here are the key elements to pay attention to:

4.1 Win-win business relationships

A supplier's motivation will remain high as long as it can derive interesting profits from the relationship. Pushing prices to the lowest possible level may backfire, even if they are accepted. As soon as a more profitable customer becomes available, capacity may be assigned and priority be given to the more profitable business

4.2 Technical support and quality control (QC)

QC at the production site is usually necessary to ensure a successful purchasing relationship, at least at the beginning. It provides protection to the buyer and should be considered as part of the technical support brought to the supplier to ensure a proper understanding of all requirements.

QC by the buyer is usually welcomed by good suppliers, since it usually enables them to identify quality problems during the production process and therefore reduces potential losses. To be efficient, QC should be performed by technically-skilled staff authorized to work out solutions on the production site.

4.3 Adjusting processes

The different environments of China often provide solutions that are different from those we apply to known technical, production or business problems. For example, one component made in Europe may be produced more efficiently and easily as an assembly of two or three components without reducing quality or functionality. Or different materials may be used to reach same results. By understanding the local situation and adjusting overall requirements to the suppliers' abilities and ways of production, better results can be achieved to the benefit of both parties.

4.4 Trustful and personal relationship

Developing a personal relationship to bring about understanding and trust in a business relationship is not unique to China. However, as the legal system cannot quite be relied upon and more people do not have the education to follow all proper business ethics, personal relationships in China are the best guarantee of a sound business relation.

Spending social time on dinners and entertainment with partners is a natural way to develop such relationships. Professional handling, good morality and providing guarantees for payments (e.g. Letters of Credit) will foster the necessary trust and confidence.

4.5 Clear and legal contracts

Maintaining good relations is necessary, yet no reason to neglect the legal situation and establish clear contracts and requirements. These are key factors in professional handling and need to be addressed as much as personal relationships. Therefore, it is highly recommended to include every possible indication of each particular requirement and agreement in a thorough draft of each contract.

4.6 Using a purchasing agency or setting up an own office

The low-cost, high quality advantages of China are in proportion with the many difficulties. Using the services of a sourcing agency (or hiring own staff on the spot) to bridge the cultural and geographical gaps and improve supplier management is worth considering carefully. It is certainly efficient for products requiring technical communication and ensuring QC, at least in the early stages of a purchasing activity in China (also see Chapter IV for "Setting Up a Representative Office in China").

4.7 "Walking on two legs"

If quantities allow, it is always preferable to work with at least two suppliers at the same time to ensure back-up in case one of the suppliers defaults or is unable to produce. Moreover, this permits the benchmarking of one supplier against the other and ensures that overall quality and costs stand where expected.

4.8 Corruption and related risks

Should the business be a buyer's market, chances are that the purchasing personnel (whether employed by the purchasing company's agent or directly by its own sourcing office) will be offered personal retributions to purchase from a supplier with questionable business ethics. Should the purchasing company's agent have low business ethics or poor staff, they may even ask for such favors in order to select a supplier.

All in all, this has only very negative effects on the business:
- Costs go up along the chain.
- With growing costs, the supplier may deliver quality and/or service lower than expected.
- The purchasing staff's loyalty goes at least partly towards the supplier rather than 100% towards the company (depending on the amount of personal incentives received).

Accordingly, bad shipments may cause considerable losses not only in terms of payment effected for unqualified goods, but also in disappointing customers and possibly losing them. Therefore, **the process of selecting a proper agent, trader or good staff for an own sourcing office or trading company is as important as selecting suppliers**.

In terms of selecting agents or traders, elements similar to the process of selecting a supplier need to be taken into account:
- Track record of the potential partners and references from other clients.
- Evaluation of the management psychology for honesty and ethical business practices.
- Evaluation of ability to ensure proper supplier selection and management
- Financial strength and ability to pay suppliers quickly (in case of a trader)

Given the importance of such choice, using local experts who understand the local psychology in assessing and cross-referencing through reputation guarantees a safer start. About the process of selecting the staff for an own office, the case of Dolder AG is of particular interest (see also Chapter IV, "Exporting and Office Set Up").

5 Purchasing Models

by Patrick Schaufelberger and CH-ina

The Swiss China Survey has identified the following purchasing activities of Swiss companies currently active in China:
- Purchasing components for own manufacturing/processing, located outside of China, in order to lower costs.
- Purchasing finished products to complete the company's offer in the mid or lower market range
- Offering sourcing and purchasing services to third parties as a business of its own.
- Sourcing to localize a production for a company's manufacturing/processing subsidiary (or licensee) in China. Through the localization process, some of the suppliers and products may also be of use to the mother company or the rest of the group.

5.1 Purchasing for own manufacturing

- **a trading company** is defined as a company that has rights to purchase and sell, therefore takes ownership of the goods.
- **an office or agency** is defined as an entity that does not purchase and sell but acts as a commission agent.

Foreign-invested trading companies are restricted to set up in China's 12 Free Trade Zones located in Shanghai, Tianjin, Shenzhen, Zhuhai, Xiamen-Xiangyu, Fuzhou, Shantou, Dalian, Qingdao, Ningbo, Zhangjiagang and Haikou. In addition, minimum registered capital is usually USD200,000.-. Due to these restrictions, setting up trading companies has often been avoided. (Restrictions are currently lifted and minimum registered capital is being lowered to equivalent of about Euro50,000 or approximately USD60,400.)

A representative office can be registered in almost every city in approved buildings and is, therefore, an easier vehicle to set up. It does not require any registered capital and cannot take ownership of goods. It is often taxed on total expenses, usually about 10% (see also Chapter II, Legal, Tax & Finance on legal entities).

To source from China for a company's own operation in Switzerland (or elsewhere), the following are several purchasing options (see descriptive chart Fig VIII - 5).

- Purchase Chinese products or components in Switzerland from a Swiss trader/importer. The trader will add value to the chain by taking the title and risk on the goods and delivery time, handling all technical and cultural issues and possibly keeping inventory. However, the trader will refrain from disclosing the source of its supply (see Dolder AG case study for example). Trading margins depend on the products and volumes but should usually reach at least 15% (see "a" in Fig VIII - 5).

- Purchase from a China-located trader/exporter (most are Chinese, though some are foreign-owned). The China-based company acts as the Swiss trader (as in the option above), but may not keep inventory as the advantage of proximity to the client is lost. Quality of understanding and service may vary a lot among Chinese traders (they may be state-owned or privately-owned) and between Chinese and foreign China-based traders. Should a good one be selected, lower costs shall certainly be expected and, in many cases, better flexibility and reactivity – the general characteristics of good Chinese companies. Both Dolder AG and Jesa SA, the cases studied in this chapter, have set up their own trading company in China. They are examples of a foreign China-based trader (see "b" in Fig VIII - 5).

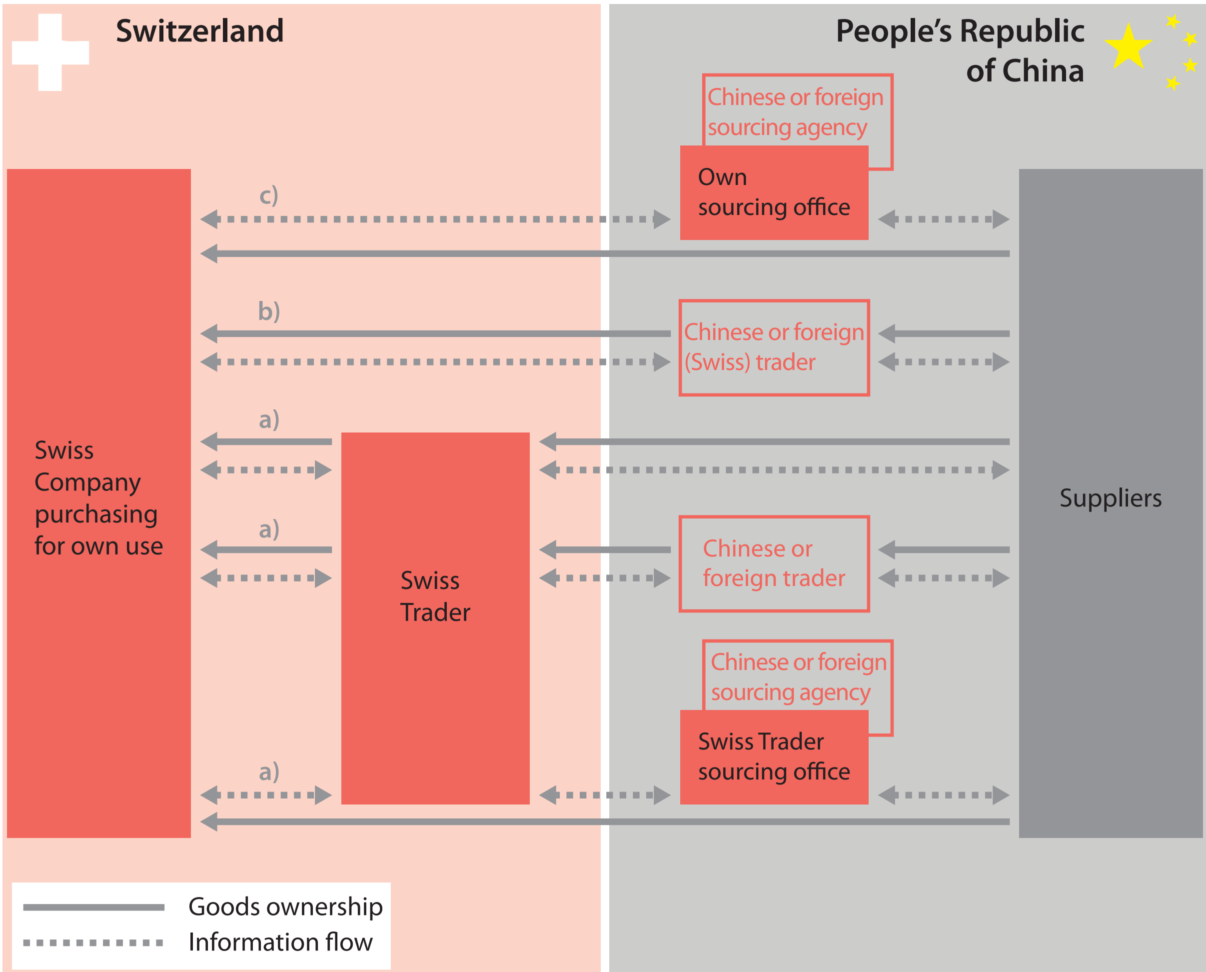
- Purchase directly from a supplier in China with the support of a sourcing office, acting as a purchasing agency. The agency does not take title of the goods and is usually paid on a retainer-plus-commission (or commission only) basis. It acts otherwise as a bridge, in the same way the traders do. The suppliers are known to the buyer, since they are exporting in their own names. With the higher transparency and lower cost of this option, also come the full risks on goods purchased. Agency commissions typically range between 5% and 10% depending on volumes and other arrangements (see "c" in Fig VIII - 5). In some cases, Chinese suppliers do not have export rights (see Chapter II, Legal, Tax & Finance, Legal Entities and Licenses, this is a disappearing case, however, with the implementation of WTO agreements). As a result, these suppliers appoint a trading company, acting (in this case) as an exporting agency only against a small commission (usually less than 3%, but also depending on volumes). Though the export agent has to take title of the goods to export, it will take no other function in the chain and push any responsibility onto the supplier and buyer in case of any problem.

- It is also possible to set up a daughter purchasing office to act as an own purchasing agency and buy directly from suppliers, as above. It is very much a question of having sufficient volumes and work to employ at least one or two staff. Such an office will usually generate a one-time cost ranging from USD20,000 to 30,000.- to set up (including equipment and installation). Yearly costs will be approximately USD40,000 to USD50,000.- all included.

- Finally, it is also possible to purchase directly from Switzerland without any local support to select and manage suppliers. This is a very risky approach, however, for all products that are custom-ordered (i.e. products that are not selected out of a producer's catalogue.) This option is not represented on Fig VIII - 5.

Fig VIII - 5

Purchasing for one's own manufacturing



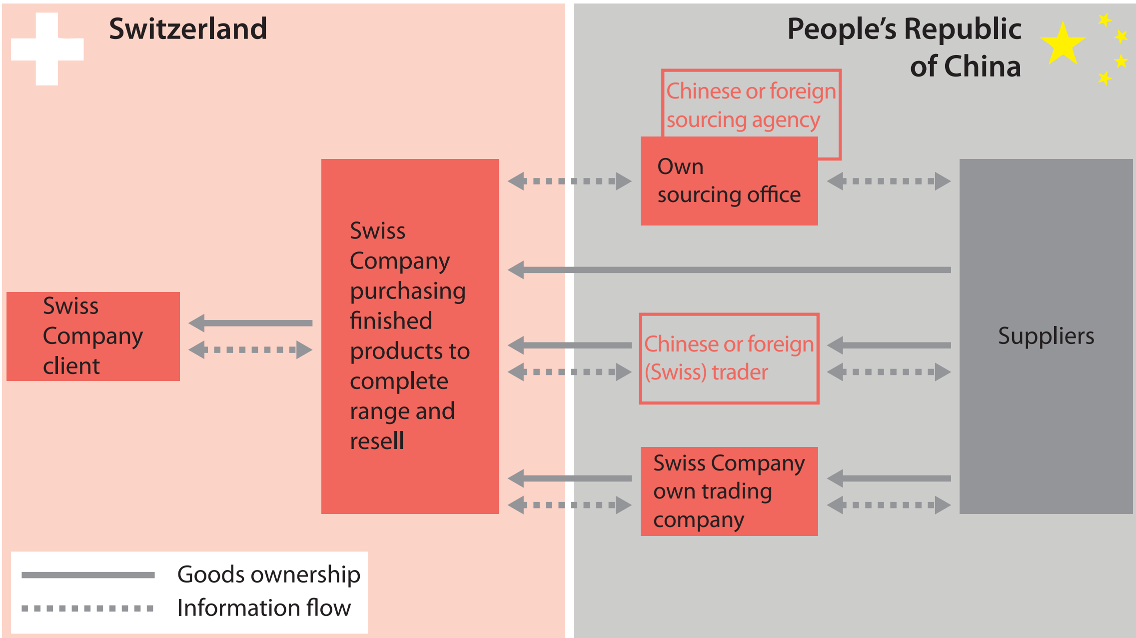
Source: CH-ina (Shanghai) Co. Ltd

5.2 Purchasing finished products to complete the company's range

In addition to the trading possibilities mentioned in the above section, the mother company may also set up a daughter trading company to buy finished products from suppliers and resell to clients. However, this is useful only in case the finished goods maybe re-sold directly to clients in China. In this case the China-based daughter trading company needs to be the seller in order to avoid giving the client the opportunity to purchase directly from the suppliers. Possibilities are illustrated in Fig VIII - 6.

Fig VIII - 6

Purchasing finished products to complete the company's range



Source: CH-ina (Shanghai) Co. Ltd.

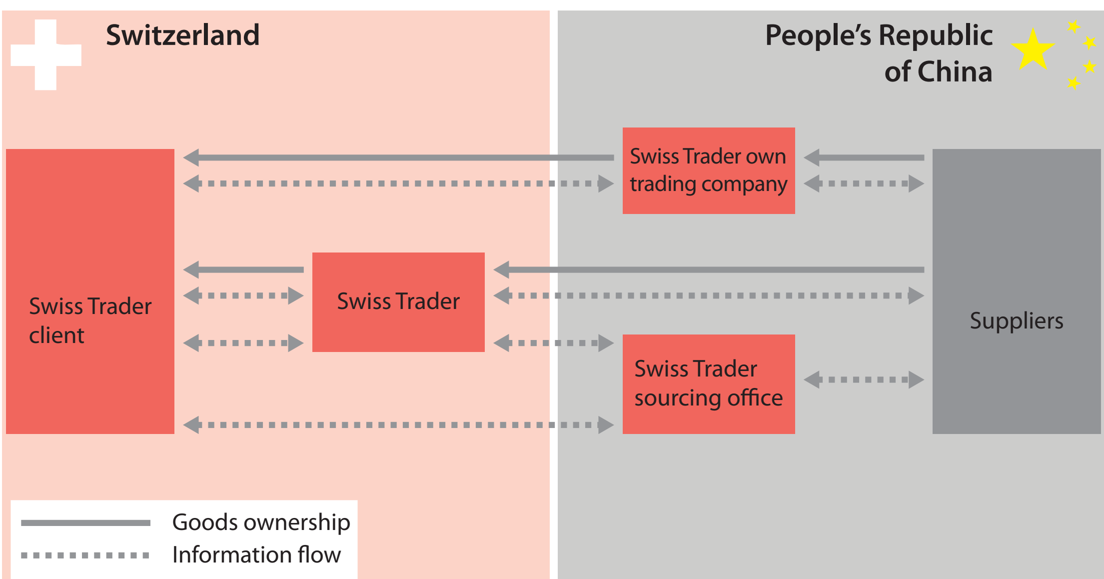
5.3 Offering sourcing and purchasing services

Two general options are available to provide such services:

- An own trading company registered in China will allow the sales of goods directly from China, without disclosing a supplier's identity
- An own sourcing office shall offer the possibility for the Swiss trader to:
  - buy from the supplier and sell to its clients in Switzerland or
  - offer sourcing and purchasing agency services to the client while disclosing the suppliers' identities.

Fig VIII - 7

Offering sourcing and purchasing services to third parties



Source: CH-ina (Shanghai) Co. Ltd.

5.4 Sourcing to localize production in China through a manufacturing subsidiary (or via a licensee)

There is an important difference when localizing a whole product in China, compared to the previous cases. When components sourcing is effected for use abroad, the flexibility in the requirements of the components to be sourced is relatively small – they must fit with the client's overall design and engineering requirements as the purchased elements will be incorporated in the product abroad.

However, when a product is localized, all its components are candidates for localization. It is therefore possible to optimize sourcing by modifying technical designs of the components while maintaining the overall specifications of the finished product. As a result, optimal localization requires close cooperation and interaction between product designers and engineers in Switzerland and the subsidiary sourcing department in China.

Such cooperation is difficult to establish practically at the beginning, as most Swiss companies going through this process don't have engineers trained in the Chinese environment. Besides, the authority on design modification is usually and reasonably kept within the mother company, as the subsidiary may not have sufficient know-how to take responsibility for a new product's technical adjustments.

Swiss companies solve this problem in two different ways:

- They appoint an engineer from the mother company to China to understand the local supply situation and take part in the product design adjustment with the mother company team. Know-how of China's production processes and supplier base is therefore transferred. Alternately, the design engineers and designers may regularly come to assess the local situation and confirm suppliers and parts. The drawback of this solution is that it takes considerable time for Swiss product designers to understand the local production environment.
- They hire a Chinese designer or engineer with good understanding and knowledge of the required technical fields to participate in the product adjustments in Switzerland. This allows the necessary know-how to be transferred to the mother company as well. Success, however, depends on finding a Chinese designer with adequate experience in China and the ability to transfer it to a team of Swiss designers and engineers who usually have no understanding of the Chinese environment.

5.5 Manufacturing subsidiary acting as sourcing office for the mother company

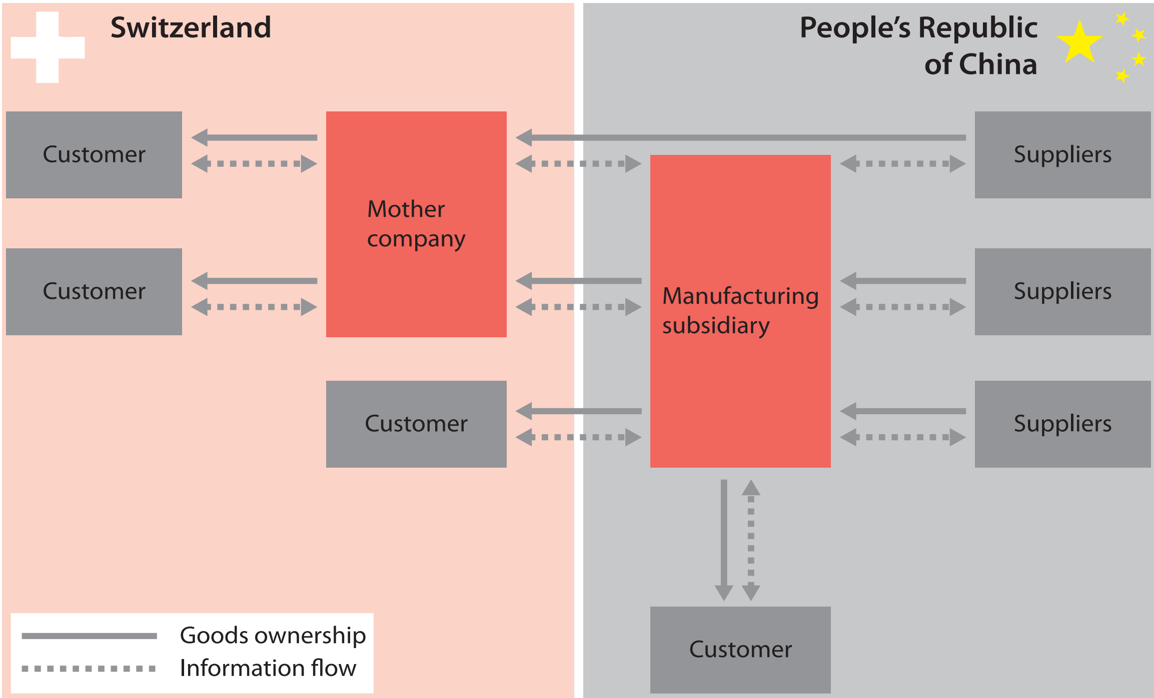
Obviously, the sourcing know-how developed in China in the subsidiary usually allows it to source parts and, possibly, assemble modules for the mother company. In that case, it may play the role of a sourcing office or supplier for the mother company.

While trading is a possibility offered by the new law on foreign investment for trading and distribution for manufacturing enterprises (see Chapter II, Legal, Tax & Finance on Trading, Distribution and Retail), most foreign-invested manufacturing enterprises do not apply for the trading rights as tax implications are unfavorable.

A manufacturing subsidiary without trading rights may still function as a sourcing office for the mother company. In this case, the goods are purchased by the mother company directly from the appointed suppliers. Handling and follow-up are taken care of on-the-spot by the manufacturing subsidiary. Fig VIII - 8 illustrates the above situation. It also integrates the possibility to use the subsidiary sourcing know-how for the mother company.

Fig VIII - 8

Manufacturing subsidiary acting as a sourcing office for the mother company



Source: CH-ina (Shanghai) Co. Ltd.

6 Protecting Intellectual Property (IP)

In all cases of OEM purchasing, a measure of IP is transferred to the supplier, be it only designs. There are legal ways to protect patented IP, yet they are known to not always be efficient (see Chapter VII, IP protection and R&D). China respondents to the Swiss China Survey report succeeding in fighting against patent infringers in one case out of two.

Preventive action against IP loss is always more efficient than resorting to court. Besides, in many cases, know-how cannot be patented and legally protected:

- Splitting different parts of the production process to different suppliers, if possible
- Purchasing and keeping physical control on tooling (e.g. moulds)
- Supplier selection and management: suppliers believing in long term business with reasonable income and prospects out of the partnership are less likely to jeopardize the relationship by stealing IP (see the following section for details on supplier management).

7 Difficulties and Recommendations

The growing number of privately owned plants and factories in China means more competition and flexibility from the suppliers, therefore, opportunities for foreign buyers in China. But the proliferation also presents risks for the unwary. Regulated industries may present a more level playing field; still, it is difficult to find the most suitable sourcing partner in terms of service, quality, price and financial health. State-owned sourcing partners possibly offer a safer financial situation, thanks to the state back-up. But dealing with a former communist culture most often brings more disadvantages.

The case studies clearly show that the sourcing process is usually painful, that suppliers rarely deliver properly on first order. Providing designs or engineering plans is far from enough to obtain the product in appropriate quality and time. Prototypes may need to be shipped back and forth up to five times before all requirements are met. On the bright side, the suppliers are very flexible, quick, hardworking and ready to make adjustments several times. Besides and also due to the low cost of labor, the degree of customizing one may get in China is much higher than in Europe.

Typical problems with deliveries are:

- Uneven batch contents. (For example, a chemical substance ordered at 97% purity might be shipped three times with 97.5% purity and one time with 99.5% purity, with justification that 99.5% is better than 97.5%.)
- Missing labels, unsuitable packaging, incorrect packing lists
- Change of materials (the supplier assumes the material is equivalent or similar to the one ordered while it is not) without prior discussions or agreement
- Forgoing quality to meet schedules

To make good on the China purchasing opportunity:

- Bridge the cultural and geographical gaps by having a local representation (purchasing agency or own sourcing office)
- Use a locally-based, reputable support organization to select a purchasing agency or to set up an own sourcing office.
- Select a location that offers proximity to the best cluster of suppliers and most suitable human resources.
- Ensure that your purchasing representation's business ethics are upright and reliable
- Pay particular attention to supplier selection and management
- Make sure to bind suppliers whenever they benefit from technology transfers
- Ensure to have sufficient technical capacity in the mother company to support the China sourcing. Ensure as well that technical support staff have an open attitude to understand China related technical problems
- Have a clear strategy to ensure long term competitive advantages as the environment improves

Contributed by CH-ina (Shanghai) Co. Ltd
CH-ina (Shanghai) Co. Ltd provides the integrated set of services needed for the establishment and operation of Swiss businesses in China.

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CASE STUDY

8 DOLDER SHANGHAI TRADING Co., Ltd.

Pharmaceuticals and Chemicals Industry

SUMMARY

Dolder specializes in the sourcing, purchasing, marketing and distribution of natural raw materials, intermediates, active substances and additives for the polymers, pharmaceutical, chemical and food industries worldwide. The company's subsidiaries in Europe are engaged in sourcing and distributing raw materials for the polymer and pharmaceuticals manufacturers while its subsidiary in China sources and purchases primarily fine chemicals from local suppliers for international pharmaceutical companies.

This case study highlights the following factors for the success of Dolder in China:

- strategic market entry using the expertise and business know-how of a market intelligence provider
- supplier relationship management
- methodical local recruitment process and people management

Figure 1:
Dolder's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing							
Purchasing	For own China operations						
	For mother company						
	For third party			Dolder			
Selling	SOE						
	POE					Dolder	
	FIE Global						
	FIE Local						

SOE -State-owned enterprises in China
POE -Private-ownd enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of Dolder in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of Dolder in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

Polymers

The versatility of plastic makes it valuable in markets as varied as packaging, building and construction, transportation, electrical and electronic components, and medical. The adaptability of plastics also offers manufacturers the freedom to focus either on exclusive markets or spread themselves out over a larger number of application areas. The global plastic applications sector is expected to grow as plastic influences applications ranging from daily life uses (i.e. packaging and internal wiring for houses) to highly specialized functions (i.e. automotive and electronics), thereby driving the global requirement for polymer raw materials up. Demand for flexible polymer [i] materials (e.g. flexible PVC) around the world is expected to grow approximately 18% from 2003 to 2008 [1].

Pharmaceuticals

IMS Health (a global business intelligence and consulting service provider for the pharmaceutical and healthcare industries) estimates that global pharmaceutical sales will have a compound annual growth rate (CAGR) between 8% and 11% through 2008 [2]. Figure 2 shows the breakdown of global pharmaceutical sales by region in 2003:

Global demand for pharmaceutical chemicals is expected to increase approximately 6% per annum to USD84bn before the end of 2005 [3]. The eight largest drug-producing countries – US, Japan, Germany, France, China, UK, Italy and Switzerland – will account for almost 80% of the total demand. Pharmaceutical fine chemicals production is generally moving towards Asia, with China and India as the biggest Asian manufacturers. However, the bulk of production still originates from developed countries, as pharmaceutical multinationals produce the biggest part of their raw materials.

Region	2003 Sales volume (in USDbn)	Market share	Change in sales volume from 2002
North America	229.5	49.0%	+11.0%
Europe	115.4	25.0%	+8.0%
Japan	52.4	11.0%	+3.0%
Asia (excl. Japan), Africa and Australia	37.3	8.0%	+12.0%
Latin America	17.4	4.0%	+6.0%
Rest of Europe	14.3	3.0%	+14.0%

Figure 2:
Breakdown of pharmaceutical sales by region in 2003
Source: IMS World Review 2004

MOTHER COMPANY – DOLDER AG

Company background and current situation

Dolder Group sources, markets and sells chemical and natural raw materials, intermediates and additives. Founded in Basel, Switzerland in 1898, the family-owned Dolder has since become an international supplier of raw materials and services for manufacturers in the fields of chemistry, pharmaceuticals, food and plastics worldwide.

Business units / product divisions

Dolder Group is divided into two main business units — Polymers and Fine Chemicals.

The Polymers division account for 75% of Dolder's activity. It provides customer-oriented services focusing on raw materials, semi-finished products and special compounds and distributes pellets, fibers, plastic film and special chemicals for the polymers processing industry. However, since Dolder is not active with its polymers unit in China, it shall not retain more attention for this case study.

The Fine Chemicals business unit sells raw materials for the pharmaceutical, chemical and food industry as well as for the chemotechnical operations and offers services for active pharmaceutical ingredients (API), food additives and active carbon.

Company size, extent and structure

Dolder Group has about 100 employees (70 are based in Switzerland) and a total of four subsidiaries worldwide. The Group's subsidiary companies in Switzerland, Austria and Italy are involved in supporting the certification of raw materials and distributing them.

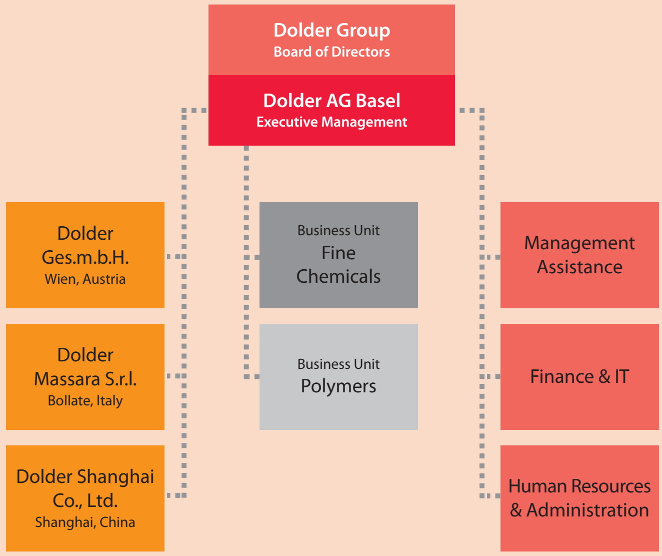
Meanwhile, the China subsidiary is active in sourcing and purchasing fine chemicals and natural raw materials from China for the mother company which subsequently sells to pharmaceutical manufacturers. The company's current global turnover is over USD100m, 25% of which comes from the fine chemicals business.

Targeted market segments and distribution structure

Dolder Group serves the business to business (B2B) market segment. For its fine chemicals division, the company targets mostly the middle-sized as well as some big pharmaceutical companies in Europe, Asia and Latin America.

Dolder deals in generic (off-patent) raw materials and sells directly or via sales agents to its pharmaceutical fine chemicals customers in ten nations including Turkey, Egypt, Brazil, Mexico, Argentina, Japan and the countries surrounding Switzerland.

Figure 3:
Dolder Group company structure
Source: Swiss China Survey, 2005



Competitive advantages

The following elements are Dolder Group's competitive edge over its competitors:

- exclusive rights on products in key markets obtained through granting certification support to suppliers. Each new product needs to be certified before it is permitted for use in Europe and the USA. Dolder's team of specialists in Switzerland and China supports Chinese manufacturers to obtain their market certification. In compensation, Dolder acquires exclusive sales rights on a product from its manufacturer in major markets or for certain clients.
- in-house experts for efficient technical support
- GMP-certified warehouses in Switzerland that facilitates high availability and timely delivery of products
- selective supplier choice and supplier qualification especially in China
- international distribution and sourcing network
- extensive knowledge of suppliers, customers and markets

ASIAN INDUSTRY TRENDS and OUTLOOK

Pharmaceuticals

Growth levels in Asian pharmaceutical markets are expected to go up as Asian tiger economies – characterized by economic growth, free market environment, developed industry and increased investment in health and health infrastructure – recover from the 1990's regional economic slump. The pharmaceutical markets of ten leading Asian countries: China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand; are estimated to have a combined annual growth rate of approximately 10% by 2006.

Consumption levels drive sales volume up while government-controlled prices and intense market competition hold prices down; hence, pharmaceutical growth in Asia is mostly driven by volume rather than prices. Pharmaceutical sales in the region are expected to exceed USD30bn by 2006 [4].

Production of pharmaceutical fine chemicals is expected to grow significantly in China and India. China's pharmaceutical fine chemicals industry has steadily developed for over 40 years following governmental policy in the 1960s to ensure the country's self-sufficiency in the textiles, agriculture and health care sectors. China currently hosts over 6,000 domestic manufacturers of pharmaceutical fine chemicals. With about 250 large and 8,000 small-scale producers, India meets around 70% of its requirement for drug intermediates, pharmaceutical formulations and chemicals. It is currently among the top five global manufacturers of active pharmaceutical ingredients (APIs).

Multinational pharmaceutical companies are also expected to begin shifting their production towards these two markets with the perception that it is far more cost-effective to produce pharmaceutical fine chemicals in China and India than in Western countries. With large pharmaceutical companies looking into substantially increasing their share of fine chemicals outsourcing out of China and India, the rate of total fine chemicals outsourced from these two countries could increase 20% to 30% by 2006 to 2007 [5].

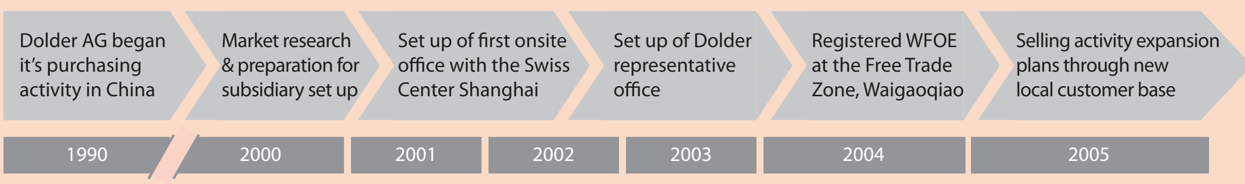
DOLDER in CHINA

Subsidiary background and current situation

Dolder Shanghai began sourcing fine chemicals and pharmaceutical raw materials from China for its mother company in Basel in the early 1990s. Its first office on the Mainland was set up in 2001 with the help of the Swiss Center Shanghai (SCS), a local support network. During its preparation year, Dolder carefully evaluated the form of its set up and potential candidates as local representatives. In 2003, it established its representative office in Shanghai to follow-up on the spot with existing suppliers, find new ones and manage them locally. In the middle of 2004, Dolder Shanghai Trading Co., Ltd. was officially registered as a wholly foreign owned trading company in the only area that allows such a set up within the Yangtze Delta: the Waigaoqiao Free Trade Zone, about 40Kms from downtown Shanghai. For convenience in receiving suppliers and clients, a representative office was set up in the city.

The wholly foreign owned trading company is set up to sell within China in addition to sourcing and purchasing. It also allows Dolder tax-exempt privileges in its purchasing activity. In the long term, the subsidiary may also export from China directly to its international customers.

Figure 4:
Subsidiary background and plans
Source: Swiss China Survey, 2005



Subsidiary size, branches and turnover

The subsidiary presently has seven local employees in Shanghai. Dolder Shanghai's purchasing value has increased 400% four years after setting up its first office in China in 2001. The China subsidiary has also significantly contributed to Dolder Group's increased overall gross income.

Local competitor and competitive advantage

Dolder Shanghai's competitors in China are international companies from the USA, European countries and local Chinese trading companies that offer very competitive prices through lower margins on large quantities standard business. These competitors arrived and set up their offices in China before Dolder came into the market. However, despite the time advantage of its competitors, Dolder Shanghai was better equipped with local knowledge and support before it set up locally. This eventually helped the subsidiary win the respect of local manufacturers and is highly regarded by its local sourcing partners.

Value chain

Dolder Shanghai sources and purchases fine chemicals and active pharmaceutical ingredients from Chinese suppliers and exports to Dolder AG. The mother company sells globally to pharmaceutical companies that manufacture generic medicinal products. The end products are distributed to consumers through retail channels such as hospitals, medical clinics, doctors and pharmacies.

CASE STUDY

Having succeeded in its sourcing and purchasing activities, Dolder Shanghai has recently begun test-selling pharmaceutical end products through two pharmacies in Shanghai. The subsidiary aims to further develop its customer base to sell end products locally within the next five years.

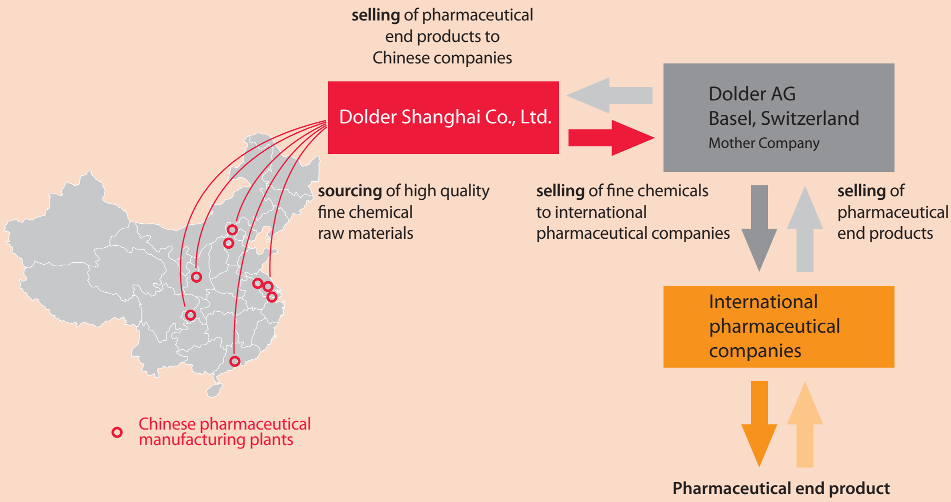


Figure 5:
Dolder Shanghai value chain
Source: Swiss China Survey, 2005

FACTS and ANALYSIS

Motivation and market entry strategy

China's participation in the World Trade Organization (WTO) compels it to integrate more completely into the global economy enabling the country to compete in the global market. China is now bound to WTO's fundamental principles such as improved transparency and access to market of non-Chinese suppliers engaged in the distribution of pharmaceuticals. To gain access to international markets, China also committed to the Good Manufacturing Practices (GMPs) standards of the pharmaceutical industry. To meet the global GMP criteria, stronger regulations have been enforced by the China State Food and Drug Administration (SFDA).

Chinese pharmaceutical companies are investing heavily on facilities and manufacturing plant upgrades which significantly improve their output quality and enable them to level up with European manufacturers. Dolder recognizes that China's entire pharmaceutical industry is moving towards higher standards making it a key production hub and marketplace for sourcing and selling pharmaceuticals. As a result it is of strategic importance for Dolder to ensure a privileged access to China's supplier base.

To define how to establish its presence in China, Dolder worked with the Swiss Center Shanghai (SCS) and its network of local experts. The initial step was devised at the immediate set up of an office in the SCS, staffed with one sourcing representative. The SCS support network provided the necessary business know-how and local people psychology to successfully assess, select and (initially) supervise Dolder's first sourcing representative.

With the development of activities, more employees were hired, making it worthwhile for Dolder to have an office independent from the SCS. With well-established purchasing activities, Dolder could spare some resources on developing its selling activities in China – yet another big potential but even more difficult to tap.

Recruitment and people management

In order to select suitable individuals to join the Dolder Shanghai team, the subsidiary follows a three-step local recruitment procedure:

- The first round involves the preliminary screening of applicants by the local General Manager and making the initial selection of candidates.
- At least one representative from Switzerland headquarters and/or the local General Manager and a second person will review the screened applicants and pick out candidates who qualified for the first interview.
- The third step is the second assessment and validation of the best applicant by representatives of the mother company and of the Swiss Center Shanghai support network.

Through this process, Dolder Shanghai obtains valid input on the candidates' qualifications from both the local and foreign perspective. This selection procedure also assures Dolder Shanghai of minimal staff fluctuation. In the long term, Dolder benefits from retaining employees who are loyal, expert and experienced.

Location

Shanghai, the communication hub on China's coast, has been chosen by Dolder due to accessibility from the city to other areas within China and abroad, in addition to the opportunity to find more highly-qualified staff in the city. Since foreign-invested trading companies are only allowed to set up their headquarters in Waigaoqiao Free Trade Zone, Dolder established a representative office in downtown Shanghai.

The subsidiary opened its downtown office using the following criteria in selecting the best site for the office:

- within close proximity to the city's metro line stations
- within the vicinity of residential and business districts with plenty of dining establishments
- easily accessible area that can be located by suppliers and customers without difficulty

Supplier selection and relationship management

Despite the increasing quality levels of local pharmaceutical suppliers, Dolder Shanghai is carefully choosing its local partners. It is important that the suppliers maintain high business ethics and provide the quality, service level and price that agree with the global standards set by Dolder Group. Dolder's supplier selection process narrows down the number of potential suppliers from several hundreds to a dozen.

Managing the local partners is the next big challenge once the selection is made. To ensure that high service levels are sustained, Dolder Shanghai audits its manufacturers on a regular basis. The company nurtures its partnership with the manufacturers by forging stronger ties through regular visits, open communication channels in all levels of management and spending social time with the executive members and owners of the partner companies. Dolder believes that relationship building with its Chinese partners requires a connection that goes beyond pure business dealings. By forming trust-based relationships, Dolder Shanghai does not only secure long term partnerships — the company can also reduce supplier quality control to save time and unnecessary costs.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

China has become one of the largest pharmaceutical-producing countries in the world growing in market value at an annual estimated rate of 17% over the last decade. The country's WTO membership comes with its commitment to tariff concessions, tightening rules on intellectual property and allowing market access to foreign companies engaged in the distribution of pharmaceuticals. Together with the local companies' improved quality of products and growing service levels, all these present a tremendous opportunity to Dolder as a foreign-owned pharmaceutical trading company to develop its sourcing and purchasing activities in China.

Moreover, China's aging population ensures that growth in drug use will not diminish any time soon. The country's population of 1.3 billion has a projected ageing rate [ii] of 3% per year. Five years ago, there were around 88 million people in China that were aged 65 or over. This vast market, therefore, presents a huge potential for rapid growth in consumer demand for pharmaceutical end products. With its own organization solidly established on the ground, Dolder is able to further identify specific opportunities in purchasing and distribution. This will also enable Dolder to define an efficient strategy for the company's future with respect to China's development.

Difficulties and risks

A vast and dynamic environment

With over 6,000 domestic pharmaceutical manufacturers in China (mostly with immature or unstable operation processes) and new manufacturers appearing regularly, it is not easy to get the right product from the right supplier at all times. Cultural differences, contrasting business practices and a constantly changing regulatory environment also make it challenging for Dolder to manage its sourcing and relationship with its local partners. Nevertheless, Dolder Shanghai provides a competitive advantage through superior management in comparison to international competitors.

Protectionism

As the difference in quality between Chinese and European products get smaller, local products are becoming increasingly attractive to international pharmaceutical companies in terms of price. This may drive European companies to safeguard their home market and to appeal to their government to impose higher taxes on imported Chinese products. This would render Dolder Shanghai's activities less attractive.

Growing Chinese competition

The downside of improving quality and service levels of pharmaceutical producers in China is that it attracts international companies with the necessary critical mass to do their own sourcing and manufacturing in the country. Many of these companies are Dolder Group's customers or potential customers. This shift of activities will impact the mother company's customer base. Furthermore, Dolder faces the risk of gaining new competitors as Chinese manufacturers may export directly to international pharmaceutical companies, at the same time, local pharmaceutical trading firms are learning how to support local suppliers to obtain certification in Dolder's markets. To address this, Dolder considers to either back-integrate (invest in the development of pharmaceutical fine chemicals and active ingredients) or forward-integrate (invest in facilities for the production of pharmaceutical end products) or both, to secure long term advantages for its current global trading and distribution network.

Success factors

The following key factors explain the success of Dolder in China, despite the subsidiary's late set up in the country:

- **Strategic market entry using the business know-how and expertise of a market intelligence provider**
  Even though many of its competitors came into China at an earlier time, Dolder Shanghai managed to secure its success in the country owing to a careful yet short preparation phase before it established its own operation in the country. By employing a local support network in Shanghai, Dolder was able to select the right initial staff at optimal cost to establish its presence step by step and earn a well-regarded reputation among the local manufacturing companies.

- **Effective supplier relationship management – effecting constant supplier performance appraisals and forming trust-based partnerships**
  Through a network of suppliers, Dolder Shanghai selected the best local partners in accordance with Dolder Group's corporate standards. Through proficient management of its relationships with the local suppliers and reinforcing the partnerships with trust and friendship, Dolder Shanghai has fulfilled its initial goal to successfully source and purchase in China. This same foundation may support Dolder Shanghai as it moves forward to its next step: building up its customer base in China for its selling activities.

- **Methodical local recruitment process and people management**
  As a global company, it is very important for Dolder to not just select the right team members. It is also as crucial for the company to motivate and retain the staff. Shanghai's population of approximately 17 million and the city being home to some of the brightest individuals in the country, indeed presents Dolder with a massive and skilled labor market. Although

finding the right people in the metropolis is not difficult, choosing the most qualified candidate out of the lot is most challenging. Dolder Shanghai's three-step local recruitment procedure (see "Recruitment and people management" above) provides the group with efficient means to select the individual who is most suitable for the position. Applicants are assessed by the local human resources administrator, a foreign representative from the mother company and local experts. Through this meticulous procedure and by projecting Dolder's image as a resourceful, serious and successful Swiss player, the company can expect ethical staff, low manpower turnover and benefit in the long term from its experienced and loyal team members.

Information on Dolder AG courtesy of:
Heinrich Berger - GM Pharmaceutical Division, Dolder AG
Zhu Tie Zhong - GM, Dolder Shanghai
Interview conducted by: *Marco Schueep*
Case Study written by: *Maria Luisa Dacera*
Approved for publication on: *September 2005*

Notes

i Polymer – literally means "many parts". A polymeric solid material may be considered to be one that contains many chemically bonded parts or units which themselves are bonded together to form a solid. Two examples of industrially important polymeric materials are plastics and elastomers. .

ii Aging rate – is defined as persons aged over 60 years old or over per 100 persons under the age of 15

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9 JESA SHANGHAI TRADING CO. LTD

Bearings Industry

SUMMARY

JESA produces and sells specialty bearing solutions from its Swiss factory and standard bearings sourced out of China, for machines, tools, automobiles, equipment and furniture. This case explains JESA's sourcing strategy in China, focusing on:

- the purposes of JESA's sourcing in China
- the business set up for JESA's China trading and the solutions applied
- the factors that account for JESA's success in China

Figure 1:
JESA's activities in China
Source: Swiss China Survey, 2005

		B2B				B2C	
		Industrial Component	Industrial Equipment	Raw Material	Services	Consumer Goods	Services
Producing							
Purchasing	For own China operations						
	For mother company	JESA					
	For third party	JESA					
Selling	SOE						
	POE	JESA					
	FIE Global	JESA					
	FIE Local	JESA					

SOE -State-owned enterprises in China
POE -Private-ownd enterprises in China
FIE Global - Foreign-owned international enterprises with operations in China that are clients of Jesa in the global scale
FIE Local - Foreign-owned international enterprises with operations in China that are not clients of Jesa in the global scale

GLOBAL INDUSTRY TRENDS and OUTLOOK

The global market for ball bearings has been going through an extensive consolidation which reduces the number of market participants. Production of standard ball bearings is expected to be concentrated among a few major players. As a result, smaller players focus on the specialized niche markets.

Region	2003 Sales volume (in USDbn)	Market share	Change in sales volume from 2002
North America	229.5	49.0%	+11.0%
Europe	115.4	25.0%	+8.0%
Japan	52.4	11.0%	+3.0%
Asia (excl. Japan), Africa and Australia	37.3	8.0%	+12.0%
Latin America	17.4	4.0%	+6.0%
Rest of Europe	14.3	3.0%	+14.0%

Figure 2:
Accelerating growth trend of demand for bearings in the Asia Pacific region
Source: The Freedonia Group

Market consolidation

The ball bearing market is a major part of the general mechanical engineering industry which is currently going through a recession due to intensive price pressure and relocation of production activities to low-cost countries. The worldwide demand for bearings closely follows the general economic cycles and is projected to grow on average at 5.7% per annum to reach USD35bn in 2007. It is driven by increasing Original Equipment Manufacturers' (OEM's) output for bearing-consuming products, especially in developing regions. The table below shows the bearing demand growth in the Asia Pacific region.

Currently, the ball bearing market is dominated by a handful of large groups operating on a multinational basis, both market- and production-wise. The part of the market that is not served by the few big players' market (i.e. SKF, FAG/INA, NSK, Koyo Seiko, NTN, Timken, Torrington and NMB) is very fragmented. The mid-sized and smaller producers of ball bearings are spread out all over the world. They are expected to continue to find business opportunities in specific market niches.

The market for standard bearings as well as for bearings in specific versions or even special bearings in large volumes, like hubs for cars, is mainly serviced by the big bearing manufacturers, either directly or through distributors. The market for specific versions of standard bearings in smaller quantities represents a small proportion of the overall market. It is serviced either by the big manufacturers with limited interest due to their lack of flexibility or by specialty distributors which either carry stocks or are able to modify standard bearings. Meanwhile, the market for special bearings in smaller quantities is serviced mainly by small manufacturers and a limited number of big producers.

In this complex and highly competitive market environment, the leading multinational bearing companies are struggling for market share and volume. Many rely on external growth through acquisitions of other bearing producers as a means to generate higher sales volume. These acquisitions also enable these companies to enlarge their range of products for their customers.

Market size

The world bearing market is estimated to be worth about USD28.3bn with the following segmentations:

Figure 3:
Product types
Source: JESA Shanghai

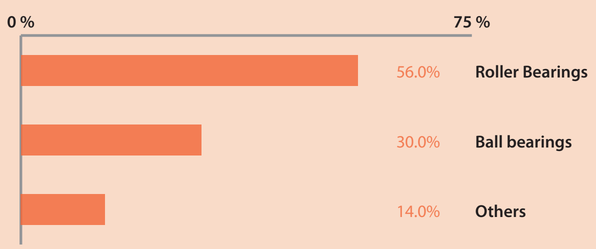
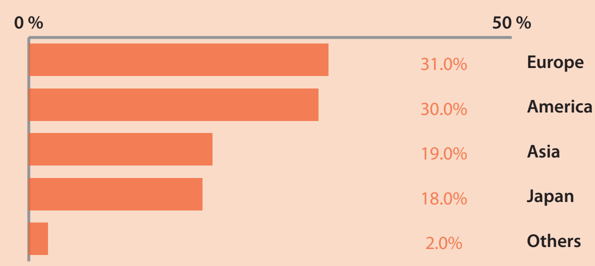


Figure 4:
Geographic distribution
Source: JESA Shanghai



MOTHER COMPANY – JESA CH

Company background and current situation

JESA was founded in 1969 to produce ball bearings in Freibourg, Switzerland. It is now a member of the POLYGENA Group. Two production sites were active until 2004 — one in Freibourg (with 130 employees and currently the only production site) and one in Slovakia which was closed in 2004 after the China set up was completed.

Sales representatives are stationed in Switzerland, France, United Kingdom and Germany. The company's yearly turnover is about CHF45m (USD36m). JESA is certified ISO 9001:2000 compliant.

JESA began its trading activity in 1969 by purchasing and selling standard ball bearings from Japan. In 1995, JESA and Bosch agreed to source bearings from China at competitive costs with the aim of continuously developing quality. Bosch has remained an important customer of JESA. Other customers have also been developed over the years which utilize ball bearings from JESA's Chinese sources.

Product lines

JESA's product range is divided into four main families:

- special bearing solutions
- plastic over molded ball bearings
- ball bearings unit
- standard bearings.

The range varies from low margins, high-volume standardized bearings to customized special bearings for specific applications. Standard bearings customers are large companies that use them, for example, for power tools and escalators. Custom bearings are developed jointly with clients for the automotive industry as well as for other industries.

Geographical markets

JESA is selling its products in most European countries: Switzerland, Germany, France, the Netherlands, Italy, Great Britain, Slovakia and other East European countries. The company's long-term goal is to develop sales through a direct presence in other key markets.

Competitors and competitive advantage

The extensive consolidation of the ball bearing market in recent years has reduced the number of market participants to less than 200 firms which are involved in the manufacturing of ball bearings. In the years ahead, the global ball bearing market is expected to continue consolidating into a quasi oligopoly structure – consisting of only a small number of major multinationals based almost exclusively in developed countries.

Most of the leading bearing-producing multinationals are well diversified as they offer a wide range of products in addition to bearings for the automobile, aerospace or related industries. However, their ball bearing production has constantly accounted for a substantial part of their total operations. The chart below shows that the top companies account for more than three-quarters of the world bearings market.

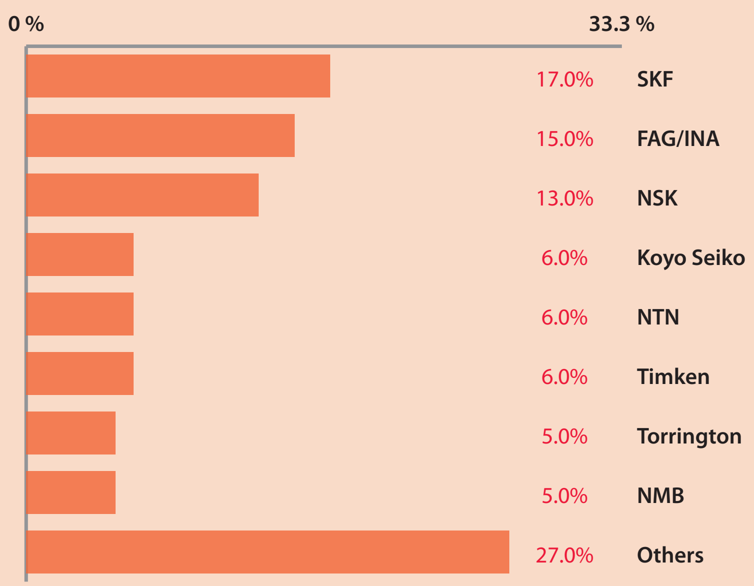


Figure 5:
The top companies of the world's bearings market.
Source: JESA Shanghai

JESA differentiates itself from competitors by focusing on the following dimensions:

- customers' needs
- innovation
- technology
- precision engineering
- service

JESA's advantage is its specialty production of precise miniaturized bearings and plastic over-molded bearings. JESA China's access to low-cost production also generate a competitive advantage.

CHINA INDUSTRY TRENDS and OUTLOOK

Exported bearing from China during the first half of 2005

Through the first half of 2005, China reported that the country's bearing exports reached 1.24 billion sets, up by 18% over the same period of last year. The total value of all finished bearing and bearing component exports is reported as USD694.3m for the 1st and 2nd quarter of 2005, up by more than 38% from 2004. Since steel costs have been going up and the overall sales price level going down, margins of bearing manufacturers have certainly not increased. These figures clearly show that China is producing more and more sophisticated bearings, commanding higher prices per set.

The bearing production industry in China

Bearings factories in China can be categorized in three groups.

a) **Small enterprises**

There is a big quantity of small factories (employing not more than 200 people) and possibly many dozens that produce all possible types of bearings in China. These companies' organization level is poor and the quality level can range from very low to acceptable. The bearing standard goes from rolled tracks with ball tracks ground and polished. They are mainly family-owned and either they produce for the local market or have some export activity through trading companies. Due to the very low cost level, they offer the lowest possible prices but stability of the process and quality of the products are not guaranteed.

b) **Medium to big companies**

This is a group of producers which have made significant progress in the last ten years. These companies have sold their products to organizations in China that produce for export or have already exported their bearings for some years. Due to regular contact with demanding customers, the manufacturing and quality level of these companies have made significant improvements. All of these companies are ISO-certified — some through Chinese certification bodies and others through the likes of TUV [i] and SGS [ii]. The manufacturing capability of these companies is improving steadily while manpower is being gradually replaced with automated machines. These producers often copy Western manufacturing processes sometimes in ways that make little sense. The production equipment is normally of Chinese origin, completed with a few imported machines.

Their quality standard is normally quite satisfactory, especially since manufacturing processes involve stringent quality control (QC) steps. The raw material is produced locally with the exception of critical elements such as seals or special greases. The export activity of these medium to big companies is conducted through agents but some of them have set up their own sales organization in Western countries.

c) **Subsidiaries of Western or Asean (i.e. Japan, Taiwan) bearing manufacturers**

All major multinational bearing manufacturers (SKF, FAG, INA, NSK, NMB, etc.) have already set up at least one production base in China for the following reasons:

- to manufacture for global customers producing in China which require international group standards locally (mostly for the automotive industry)
- to have a cost-effective production base for exporting to the world market
- to produce for the growing demand of the local market

The production processes of these manufacturers is the same as in Western production sites. Although the machinery is usually not of the latest generation, it is made up of fully functional modern equipment. The quality standards of these subsidiaries mirror their respective mother companies'. The raw material is commonly imported with some local content. The tendency is to develop the quality of local raw materials and soon after, switch gradually to 100% local content.

JESA in CHINA

Subsidiary background and current situation

JESA China ("JESA CN") is a sourcing, trading and quality control subsidiary of JESA CH. It currently employs ten personnels.

JESA started its activities in China because Japanese bearing manufacturers became less and less competitive over the years. In order to keep its trading activity, JESA CH established a partnership with Chinese manufacturers in 1995. Purchases were done through a Chinese trading company (CMEC) who was dealing with six bearings factories in Wuxi (simply named W1 to W6 factories).

The yearly turnover made with ball bearings purchased in China currently accounts for one-third of JESA CH's total turnover.

JESA CN's activities are divided into two profit centers:

- Sales to JESA CH
- Direct sales to other customers, both local and foreign

The products delivered to JESA CH are used both as:

- finished products for re-selling to clients
- semi-finished products that need to go through additional production processes in JESA CH prior to selling

Business development has been very strong for JESA CN with sales expected to reach USD9.86m by the end of 2005, mainly to JESA CH. As a result, full return on investment is expected to be achieved only two years following the subsidiary's set up.

Motivation and market entry strategy

Development in China as well as in communication technology makes it easier today for JESA's clients to purchase directly from low-cost suppliers. In addition, some of JESA's large customers are setting up their own manufacturing subsidiaries in China and will no longer find the need to import what they can source locally. Without an operation in China, JESA would definitely lose business from its clients that are moving to China. Should the subsidiaries of these clients successfully source from China, in time, their mother companies in Europe will certainly use the sourcing knowledge of their daughters in China and cease purchasing from JESA in Europe.

Through JESA's full knowledge of the sector in China and direct access to local producers, JESA's China subsidiary is able to obtain the best possible prices and ensure quality. There is also an opportunity for a local JESA entity to sell to international clients that JESA does not yet serve – for instance, the USA.

Due to the above reasons and the importance of its trading business (33% of total turnover), JESA decided to set up its own subsidiary in China. In so doing, it protects its trading activity by adding more value to its position in the supply chain (better prices and quality) and by serving clients (in China and abroad) who want to purchase directly from China.

JESA CN activities are summarized in Figure 6 below.

In order to fulfill these needs and maintain continuity, after obtaining advice from China-based business professionals, JESA decided to set up a joint venture (JV) with its trading partner in China. This allowed the acquisition of the JESA business know-how in China, including the relationships with the W1 to W6 factories.

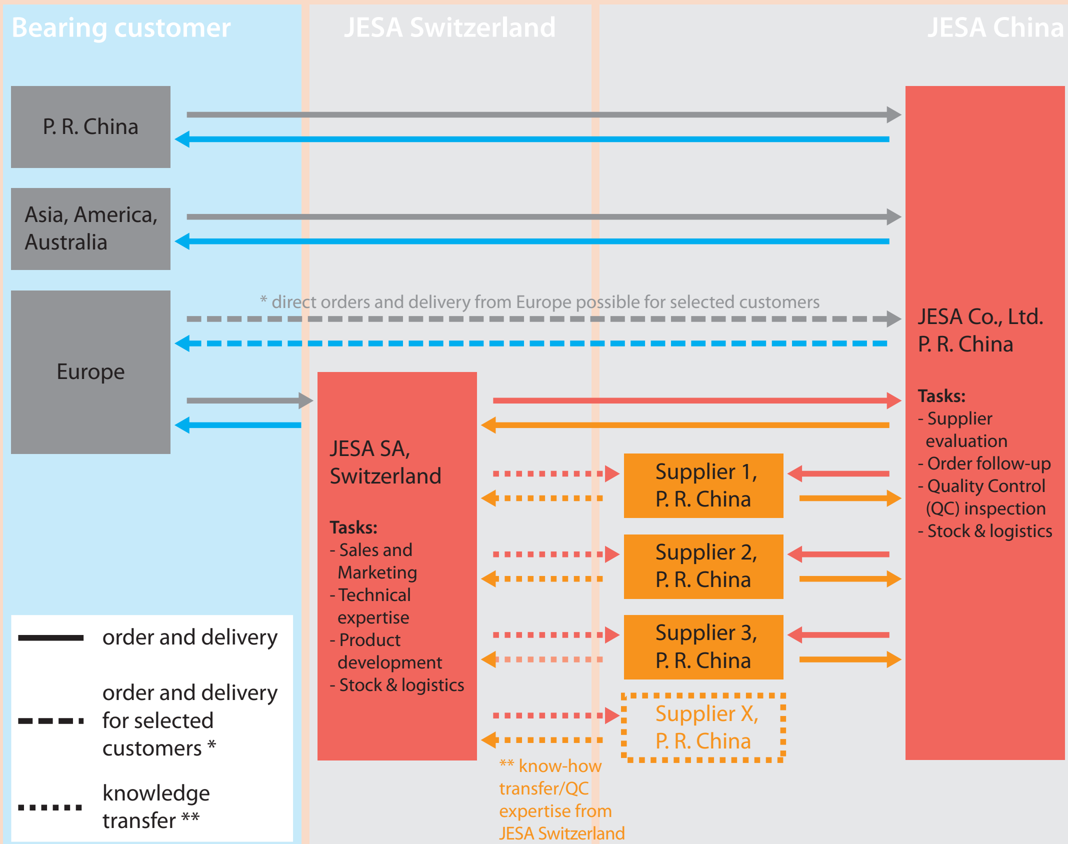


Figure 6: JESA CN activities / business model
Source: JESA Shanghai

The negotiations for setting up the operation in China began in 2002 and operations officially started in 2003. JESA CN was set up in the duty free zone of Waigaoqiao in Pudong (foreign-invested trading enterprises are permitted to register in the Shanghai area only in the duty free zone at this time. JESA CN is an equity joint venture owned 70% by JESA CH, with a business scope that allows trading and services on goods traded. General Management of JESA CH is ensured by the local partner.

To maintain continuity and to handle return of value added tax (VAT) on export, the previous Chinese trading company, CMEC, was also retained albeit only as an export agent that effect payment to suppliers, export goods and collect returned VAT from the Chinese government (in the range of 13% of amounts exported). These services are rendered against a commission proportional to the capital needed involvement. Such activity is indeed capital intensive as VAT returns are made only within 6 to 18 months after export. Since operations began in Wuxi and Ningbo, a representative office of JESA CN was established in Wuxi where all the operations are conducted.

JESA responsibilities and the shutting down of the Slovak operation

CASE STUDY

After the successful set up of JESA CN, the group management decided to close its Slovak manufacturing operation. JESA Slovakia was lacking flexibility and was unable to match the low cost levels of China. A majority of the Slovak production was subsequently outsourced to the Chinese suppliers of JESA CN.

The main responsibilities of JESA CN are:

- sourcing, selection of suppliers and supplier management
- handling of orders, technology improvement, quality control with suppliers and claims (bridging the language and culture gap)
- sales to direct clients (local and foreign)

At the beginning of the activity, the complete sales volume went through JESA CH — the geographic market being Western and Eastern Europe — where JESA CH provides technical and logistic support to end users. Today, when volume and products allow, administrative and logistic support for the customer is also transferred to JESA's Chinese operation.

Resolving conflict of interests between JV partners, business controlling and results

Considering that JESA CN is a joint venture, in which the minority partner functions as General Manager, the income scheme for the China operation has been set up in order to generate a common interest between Switzerland and China. Although JESA CN's interest would be to sell to JESA CH at highest possible price and JESA CH's is just the opposite, both entities are united by the general purpose of buying at lowest possible prices in China and selling at highest possible prices to final customers. As a result, the income sources for JESA CN are set as follows:

■ **Gross margin for sales to direct customers**	as high as possible
■ **Gross margin for sales to JESA CH**	a fixed % to cover JESA CN costs
■ **Participation of JESA CN in the gross margin of JESA CH trading**	a fixed low % to generate profit

Setting the gross margin of JESA CH at a level that will cover JESA CN's costs ensure JESA CH with the lowest prices, while the contribution to the gross margin offsets the disadvantage for JESA CN. In addition, the volumes that JESA CH brings to JESA CN make the relatively low contribution of JESA CH to the margin acceptable. Both JV partners have a mutual interest to sell from JESA CN to direct clients to as high prices as possible, in order to maximize profits. This is reliant on the skills of the local management and the market situation in China.

JESA CN is making use of a third party controlling organization in Shanghai to manage JESA CN's accounting procedures. This is to ensure adherence to the corporate governance principles against corruption. Indeed, there is a risk that JESA CN purchasing employees might take actions to draw personal benefits from the purchasing transactions.

Customers / market segment

JESA CN's major market orientation is export (local sales are made to those customers of JESA CH that need bearings for their Chinese operations). However, JESA CN's direct sales in China and markets where JESA CH is not active has remained minimal with just one large volume, low margin, client at the time of printing. Possible JESA customers with bases in China are:

- Bosch Group (28 joint ventures)
- Bobst (production unit in Shanghai)
- Schindler (production unit in Suzhou)
- Saia-Burgess (production unit in Shenzhen)

At a later stage, JESA CN plans to gradually develop its direct selling activities to other countries.

Local competitors and competitive advantages

There are a lot of local trading companies selling Chinese bearings in Western markets. Additionally, bearing producers have started exporting directly as well. The main advantage of JESA CN, in comparison to its local competitors, is its access to the European market. JESA CN differentiates by selling to market niches where a higher level of reliability, service and precision are required. The mother company's geographical and cultural closeness and her engineering skills translate into the capability to engineer customized, precision bearings for clients while producing them in China.

Suppliers becoming competitors, JESA CN in the value chain

With their quality level improved through years of JESA purchases and support, JESA CN suppliers are also increasingly expanding their own direct sales in Europe. A lower level of contact and service with European clients is increasingly becoming sufficient; thereby JESA CN suppliers or other Chinese bearing suppliers are more able to sell directly in the standard range. The technical and communication ability of Chinese suppliers is bound to grow. The day may come when the best and bigger ones will set up their own customer relations management offices in Europe and compete on JESA's niche.

For the long term, JESA is considering options to secure its position in the value chain in more aggressive ways by:

- improving its service level in Switzerland and China to serve increasingly demanding clients with products that require more sophistication in terms of both handling communication and technical abilities
- taking over the manufacturing processes in China which would ensure JESA technical superiority over Chinese suppliers and increase JESA's competitiveness

Location and legal environment

The choice of the location of JESA's subsidiary was influenced by two factors — the need to set up a foreign-invested trading company (only possible in Shanghai Waigaoqiao Free Trade Zone in the Yangtze Delta) and its local proximity to suppliers. This last factor also determined the establishment of the subsidiary's representative office in Wuxi.

From January 2005, and in accordance with WTO agreements, the Chinese government authorizes foreign-invested enterprises to set up trading and distribution companies outside of the Free Trade Zones all over the country. However, implementation policies have not been published so far, therefore, registration of such companies is granted on an experimental and case by case basis. JESA CN has the option to move its trading company's legal seat to Wuxi and will exercise it if such application does not generate too many and complex administrative efforts.

FACTORS FOR SUCCESS, RISKS and OPPORTUNITIES

Opportunities

Through its long relations with suppliers and its local operation, JESA has the opportunity to purchase technically complex products in China that others would need to purchase in Eastern or Western Europe. Moreover, its existing relationship with the Chinese suppliers and the relatively large volumes purchased from them should also enable JESA to lock them in its supply chain. JESA CN also provides the Group the opportunity to stay at the edge of new developments in China and to constantly evaluate the production market for new suppliers, new products and better prices.

Risks

The major risks for JESA's trading business rest in the development of the competition and in the forward integration of the Chinese suppliers. They may unavoidably become JESA's direct competitors; some of them may do so after benefiting from JESA's technical support and after having been introduced into the European market by JESA. This risk is increased by European companies that may try to purchase directly from China and even set up their own sourcing offices locally.

Success factors

- **Early start (Japan 1969; China 1995)**

This pioneering attitude has allowed JESA to build a strong supplier base and a proportionally important size of purchases along with them, while consistently offering customers competitive products from China at attractive prices. Overall, this has provided JESA with both customer and supplier interest and loyalty. In addition, it has created a tested working relationship with a Chinese trader and their managers who are now able to manage JESA's own set up in China without prior training.

- **Local support for strategy and business controlling**

Without support from a local expert, the joint venture set up may not have been successful as JESA was unaware of the possibilities and risks of a JV in China and a fortiori of how to translate common interests into a working cooperation. Of importance is also JESA's long-term strategy in China, for which local support is necessary in order to not depend only on JESA's Chinese partner for information and opinions. Unethical behavior from purchasing personnel entails the important risks of loose quality control and finally, disagreeable shipments. These, in turn, may result in the loss of important customers as well as considerable economic losses in the future. Local business controlling reduces the risks of JESA CN staff's improper behavior. Besides and on the financial side, it guarantees that constant attention is put into details which make JESA CN competitive. Indeed, in order to avoid having JESA's global clients sourcing directly from suppliers while maintaining a margin, it is essential that JESA CN purchases at a most competitive quality/price ratio and provides excellent service.

- **Efficient bridge between European clients and Chinese suppliers**

JESA's presence in China for purchases and in Switzerland to develop technical solutions with clients provides an efficient bridge to the technical and cultural gaps between Europe and China. JESA has been able to derive good value out of this expertise. This bridge, however, entails technical support to suppliers and pushes JESA to develop strategies to integrate its suppliers to prevent them from turning into JESA's competitors.

Information on JESA courtesy of :
Michael Ma - General Manager, JESA CN
André Brülhart- Managing Director, JESA CH
Case Study written by: *Patrick Schaufelberger*
Approved for publication on: *September 2005*

Notes

i TUV - (TUV Rheinland Group) is a global leader in independent testing, certification and assessment services.

ii SGS - is one of the world's leading inspection, verification, testing and certification companies.

IX HR Selection & Management

The elements related to the selection and management of human resources are the set of success factors most consistently rated of decisive importance.

'Quality and qualification of the management team' is almost unanimously ranked as the most important factor of success. (See the initial Swiss China Survey chapter, for details on factors of success.)

To ensure high quality management, a foreign company needs to attract excellent managers who are also able to share the mother company's culture. Assessing and selecting the most suitable candidates is more an art than a business science: psychological evaluations are difficult to conduct, particularly within a foreign culture.

Additionally, for an excellent match a favorable 'chemistry' between the local managers and the mother company also needs to develop. This allows the local management team to be understood and properly supported.

To provide the most important elements to build and retain good Chinese management, this chapter proposes contributions on the legal labour situation, the management of human resources as well as the selection of employees.

Important results of the Swiss China Survey are also listed, particularly in terms of remuneration trends in regions and which functions are given to foreigners in Swiss subsidiaries.

Interestingly big cities are not necessarily seeing faster salary increases than second tier ones. Actually, the cost of the personnel most difficult to find (the middle management) is growing slowest in Shanghai and Beijing.

Yet and considering the importance of human resources for success, the elements provided cannot replace the need to work with professionals to start up an operation in China.

1 Learning from Swiss Subsidiaries

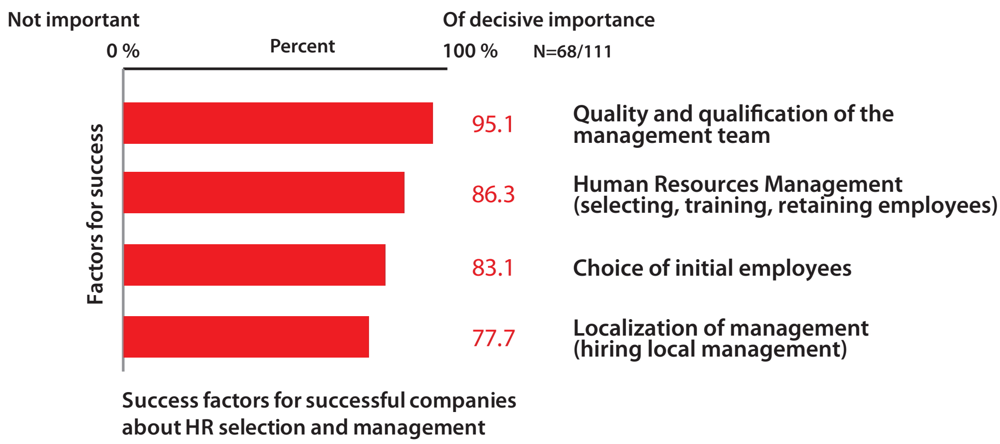
1.1 Human Resources Factors of Success

Successful respondents of the Swiss China Survey (N=68) have ranked the four human resources related factors of success as shown below. In all they compose the general category of 'Human Resources Selection and Management'.

As a category, 'HR Selection and Management', lists first or second with the product competitiveness related category (according to activity or region).

Survey chart IX - 1

HR selection and HR management category of success factors



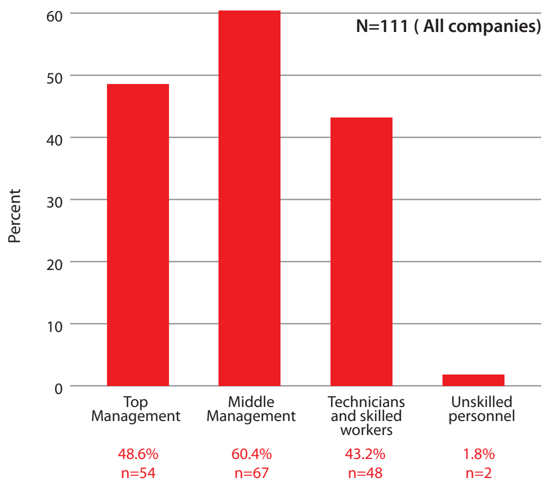
Source: Swiss China Survey, 2005

1.2 Difficulty to recruit personnel

The chart below indicates that **there are still plenty of available, unskilled personnel in China for Swiss companies, whereas middle management is in highest demand**. Middle management is certainly crucial since its performance determines the quality of operations and the ease with which a mother company can communicate with its China subsidiary. Indeed, the General Manager cannot know all elements of an operation and much less handle all questions and issues that may come from the mother company.

The scarcity of good middle management is a defining element when selecting the location for a subsidiary. Often, top managers may be willing to relocate for good compensation at the cost of a spouse leaving a job. Middle managers and their families have more limited means and mortgages to pay for, so that both spouses usually work. The relocation of such a family is made more difficult at costs that would remain reasonable in proportion to a middle manager's usual remuneration package.

Survey chart IX - 2



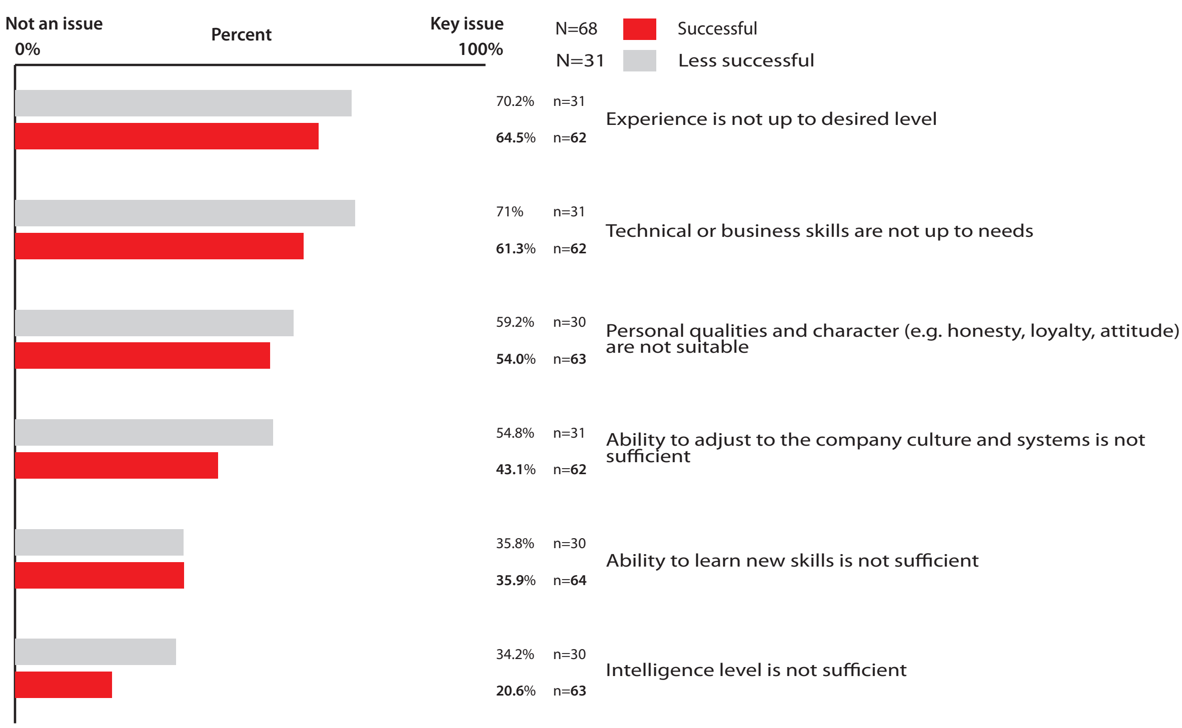
At which levels do you feel it is difficult to find suitable human resources for your company? (“yes” or “no” answer) (multiple selection possible)

Source: Swiss China Survey, 2005

Survey chart IX - 3

The chart below indicates perceived reasons for not obtaining the right human resources.

For the personnel you have difficulties to acquire, what are the key difficulties?



Source: Swiss China Survey, 2005

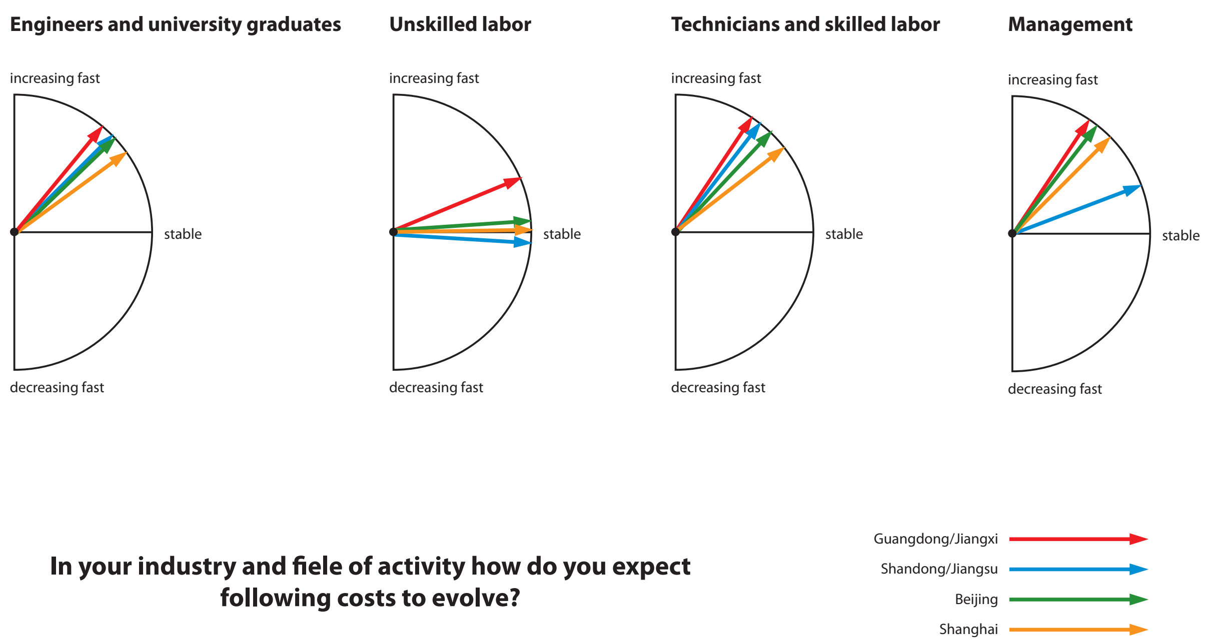
1.3 Human Resources costs trends

Contrarily to what is usually expected, **in terms of human resources, Shanghai and Beijing do not appear to be the place where costs are growing faster**. On the contrary, for the staff that are most difficult to find and of key importance to run a foreign operation - the middle management (technicians, university graduates) - Shanghai remuneration levels are increasing at the slowest rate of all. Moreover, for the other positions, Shanghai comes second lowest in cost increase after the Jiangsu/Shandong region.

Unskilled labor costs are also increasing at more or less the same rate in big cities (Shanghai and Beijing) as in second tier locations (Jiangsu/Shandong). This clearly indicates that the unskilled workforce is very mobile.

Overall, the South (Guangdong/Jiangxi) is clearly the least attractive in terms of HR costs trends; there all human resources costs are perceived to grow fastest by the survey respondents. (Also see Chapter I, General Environment and Trends, 'Geographical Regions' for more details on main regions and the evolution of other types of costs.)

Survey chart IX - 4
Human resources costs trends by regions
(All respondents by regions, 102 answers)



Source: Swiss China Survey, 2005

Following are tables to give an idea of China's personal income tax regime and welfare system. For the latter a comparison is made between 3 locations to give an idea of the regional differences to be expected in terms of social welfare systems.

Personal income tax calculation for local Chinese employees:

Applicable to Wages and Salaries Received from a Company in China (Based on Gross Income)

Taxable Monthly Income = **Gross Monthly Salary - Tax Free Amount**
Monthly income tax = (Taxable Monthly Income - Individual Social Welfare) x Tax Rate - Deduction

Notes:

1. The Gross Monthly Salary is the amount the employee earns before any deduction (e.g. welfare & tax)
2. In 2006 in Shanghai the **Tax Free Amount** is RMB 1'600 which is deducted from the **Gross Monthly Salary**
3. No tax applies for **Gross Monthly Salary** lower than RMB 1'600 (in Shanghai)
4. On Individual Social Welfare income tax is not applicable and deducted from the **Gross Monthly Salary** (see formula above)
5. For online calculation use this link "http://hrs.ciicsh.com/service/company/hr_tools.asp" (in Chinese only) and go to "税务计算"
6. Individual Social Welfare (=welfare paid by employee) and **Tax Free Amount** are determined according to local regulations and vary from city to city

Calculation base:

Level	**Taxable Monthly Income (RMB)**	**Tax Rate %**	**Deduction (RMB)**
1	less than or equal to 500	5	0
2	between 501 and 2000	10	25
3	between 2001 and 5'000	15	125
4	between 5'001 and 20'000	20	375
5	between 20'001 and 40'000	25	1,375
6	between 40'001 and 60'000	30	3,375
7	between 60'001 and 80'000	35	6,375
8	between 80'001 and 100'000	40	10,375
9	more than 100'000	45	15,375

Example:

1

If Mr. XXX, a local employee, receives Gross Monthly Salary from the company in Shanghai of RMB 6'000;
his taxable income is RMB 4'400 (6'000 - 1'600) and is on Level 3. His Individual Social Welfare in Shanghai is 18% of the **Gross Monthly Salary**, which is RMB 1'080. His income tax shall be calculated as:

Monthly income tax= (6'000-1'600-1'080) x 15% - 125 = **RMB 373 (or 6.2% of his Gross Monthly Income)**

Therefore his Net Monthly Income is 6'000-1'080-373 = RMB 4'547

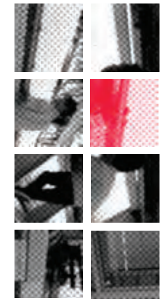
2

If Mr. ZZZ, a local employee, receives Gross Monthly Salary of RMB 10'000 from a company in Shanghai;
his taxable income is RMB 8'400 and is on Level 4. His Individual Social Welfare in Shanghai is RMB 1'098, which is the maximum according to the PRC local Labor Regulation. His income tax shall be calculated as:

Monthly Income Tax= (10'000-1'098-1'600) x 20% - 375 = **RMB1'085.4 (or 10.9% of his Gross Monthly Income)**

Therefore his Net Monthly Income is 10'000-1'098-1'085.4 = RMB7'816.6

Source: CH-ina (Shanghai) Co. Ltd



Comparison of Social Welfare Systems in Shanghai (SHA), Suzhou (SZ) and Dalian (DL)
This chart intends to give both an explanation of China's welfare system and of its variety (1 Euro ~ 10 RMB)

Social welfare cost

No.	Item	Maximum Base[1]					Total rate					Total fees				
		DL	SZ	SHA	SHA Suburb[3]	Employed in Shanghai Non-Shanghai residence permit[4]	DL	SZ	SHA	SHA Suburb	Employed in Shanghai Non-Shanghai residence permit	DL	SZ	SHA	SHA Suburb	Employed in Shanghai Non-Shanghai residence permit
1	Pension[2]	4677	4750	6099	1220		27.0%	28.0%	30.5%	17.0%		1262.79	1330.00	1860.20	207.40	
2	Unemployment insurance[2]	4677	4750	6099	1220		3.0%	3.0%	3.0%	2.0%		140.31	142.50	182.97	24.40	
3	Social medicare[2]	4677	4750	6099	1220		10.0%	12.0%	14.0%	5.0%		467.70	570.00	853.86	61.00	
4	Housing fund[2]	4677	4750	6099	1220	6099	20.0%	20.0%	14.0%	0.5%	14.0%	935.40	950.00	853.86	6.10	853.86
5	Childbirth insurance[2]	4677	4750	6099	1220		0.5%	1.0%	0.0%	0.5%		23.39	47.50	0.00	6.10	
6	Industrial injury insurance[2]	4677	4750	6099	1220		0.7%	0.0%	0.0%	14.0%		32.74	0.00	0.00	170.80	
	Lump Sum social insurance[4]					2033				60%*37%						172.50
	Total						***61.2%***	***64.0%***	***61.5%***	***39.0%***		***2829.59***	***3040.00***	***3750.89***	***475.80***	***1026.36***

Note:

1. The maximum gross salary taken as a base to calculate the social welfare varies from city to city and is adjusted every year; for 2005 this Maximum Base is RMB6099 in Shanghai, RMB4750 in Suzhou and RMB4677 in Dalian; for employees with gross salaries below the maximum base the actual gross salary is taken as a base

2. Pension, Unemployment Insurance and Social Medicare are mandatory in the three cities; Housing Fund is mandatory only in Shanghai and optional in the other two cities; Childbirth Insurance and Industrial Injury Insurance are mandatory in Suzhou and Dalian and optional in Shanghai.

3. In Shanghai, lower standard of social welfare is applied in the suburban areas: Minhang district, Nanhui district, Baoshan district, Qupu district, Jiading district, Songjiang district, Chongmin district, Fengxian district; the maximum base of RMB 1220 applies

4. Another labour regulation in Shanghai applies to the Non-Shanghai Residence Permit holder; those employees pay the Comprehensive Insurance instead of normal local social welfare except of the Housing Fund; The Comprehensive Insurance is calculated as follows: average monthly (maximum) gross salary of last year x 60% x 12.5% + RMB20 as administrative charges (the average monthly (maximum) gross salary is determined by the government)

Pension monthly enjoyed by employee after retirement (60 year-old for male, 55 year-old for female)

Shanghai	Suzhou	Dalian	Shanghai Suburb	Employed in Shanghai Non-Shanghai residence permit
Monthly Retirement Pension = (Totally Paid Pension x 8%) / 120 months This means the total individual part will be divided into 10 years delivered as a fix monthly payment until deceased 8% is the individual part of the pension fund; the company part is brought into the common social fund system	Monthly Retirement Pension = (total paid pension x 8%) / 120months + 20% of the average monthly salary of the year before retirement This means the total individual part will be divided into 10 years delivered as a fix monthly payment until deceased 8% is the individual part of the pension fund; the company part is brought into the common social fund system	Monthly Retirement Pension = (total paid pension x 8%) / 120months + 20% of the average monthly salary of the year before retirement This means the total individual part will be divided into 10 years delivered as a fix monthly payment until deceased 8% is the individual part of the pension fund; the company part is brought into the common social fund system	Fixed monthly Retirement Pension paid by the social pension system	see note 4 above

Unemployment insurance

Shanghai	Suzhou	Dalian	Shanghai Suburb	Employed in Shanghai Non-Shanghai residence permit
To unemployed people a fixed monthly allowance is paid. The amount is yearly adjusted according to the lowest salary of the previous year. For 2005 this amount is RMB 290/month	To unemployed people a fixed monthly allowance is paid. The amount is yearly adjusted according to the lowest salary of the previous year. For 2005 this amount is RMB 380/month	To unemployed people a fixed monthly allowance is paid. The amount is yearly adjusted according to the lowest salary of the previous year. For 2005 this amount is RMB 245/month	To unemployed people a fixed monthly allowance is paid. The amount is yearly adjusted according to the lowest salary of the previous year. For 2005 this amount is RMB 245/month	see note 4 above

Social medicare for diseases categorized as normal and serious

Shanghai	Suzhou	Dalian	Shanghai Suburb	Employed in Shanghai Non-Shanghai residence permit
The individual part (2%) of the Social Medicare Fund is used for normal diseases and paid into a personal account in April of each year; the company part (12%) is paid into the common social medicare fund system and will be used for serious diseases.	The individual part (2%) of the Social Medicare Fund is used for normal diseases and paid into a personal account in April of each year; the employer part (10%) is paid into the common social medicare fund system and will be used for serious diseases The employees receive each year additional funds to their personal account from the common fund system; for those below 45 years it's additional 1%; employees above 45 years additional 1.5%	The individual part (2%) of the Social Medicare Fund is used for normal diseases and paid into a personal account in April of each year; the employer part (10%) is paid into the common social medicare fund system and will be used for serious diseases The employees receive each year additional funds to their personal account from the common fund system; for those below 45 years it's additional 0.8%; employees above 45 years additional 1.3%	The social medicare fee is totally paid by the employer and is brought into the common social medicare fund system; the employees get each year 1% - 4% of 60% of last year's Shanghai average anually salary into their personal account depending on the years contributing to the social medicare fund; the employees are only entitled to this fund when contributing 20 years or more	see note 4 above Payment is made by the common social fund system in case of one of 17 serious illnesses only, as defined by the government: Retention to be paid by employee / illness =[average monthly (maximum) gross salary of last year]*12*10% Costs which exceed retention will be jointly covered by the common social fund system (80%) and the patient (20%)

Housing fund

Shanghai	Suzhou	Dalian	Shanghai Suburb	Employed in Shanghai Non-Shanghai residence permit
The entire housing fund (14%) is paid into a personal account; the employees can use this when purchasing property for their own living.	The entire housing fund (14%) is paid into a personal account; the employees can use this when purchasing property for their own living.	The entire housing fund (14%) is paid into a personal account; the employees can use this when purchasing property for their own living	The entire housing fund (0.5%) is paid into a personal account; the employees can use this when purchasing property for their own living	The entire housing fund (14%) is paid into a personal account; the employees can use this when purchasing property for their own living

Optional benefit (most foreign-owned company provide more benefit to employees as follows)

No.	Item				RMB/month	Coverage
1	Life insurance				40	RMB200'000 indemnity for accidental physical disability and accidental death; RMB100'000 indemnity for death due to disease
2	Medical insurance				66	100% outpatient reimbursement
3	Serious disease				30	More reimbursement to employee for medical fees for 17 kinds of disease uncovered by social medicare fund; max. RMB10'000 indemnity for 12 kinds of serious disease
4	Supplementary medicare				40	Year end subsidy of RMB500 for non-reimbursable medical expenses for those who fulfils at least 1 year employment term; plus 90% subsidy for those who resign job within 1 year
5	Hospitalization subsidy				20	RMB100 per day
6	Single-child insurance				36	50% medical reimbursement for single child of employee; nursery fee reimbursement
7	Medical support				30	Annual physical examination; daily medical consultation, ultra sound and cardiogram services (no extra charge)
8	Risk fund				10	Subsidies for baby delivery, operation, disaster and family member death
	Total				***272***	

Note: The chart above is currently in use in Shanghai. Different cities could offer similar optional benefit systems.

Source: CH-ina (Shanghai) Co. Ltd

Personal Income Tax For Foreign Employees:

Applicable to Wages and Salaries Received from a Company in China

Taxable Monthly Income = **Gross Monthly Salary - Tax Free Amount**

Monthly income tax = (Taxable Monthly Income) x Tax Rate - Deduction

Notes:

1. The **Gross Monthly Salary** is the amount the employee earns before any deduction (e.g. welfare & tax)
2. In 2006 the **Tax Free Amount** is RMB 4'000 which is deducted from the **Gross Monthly Salary**
3. No income tax applies for **Gross Monthly Salary** lower than RMB 4'000.
4. For online calculation use this link "http://hrs.ciicsh.com/service/company/hr_tools.asp" (in Chinese only) and go to "税务计算"
5. No indiidual Social Welfare is paid by foreingers in China

Calculation base:

Level	Taxable Monthly Income (RMB)	Tax Rate %	Deduction (RMB)
1	less than or equal to 500	5	0
2	between 501 and 2000	10	25
3	between 2001 and 5000	15	125
4	between 5001 and 20'000	20	375
5	between 20'001 and 40'000	25	1375
6	between 40'001 and 60'000	30	3375
7	between 60'001 and 80'000	35	6375
8	between 80'001 and 100'000	40	10375
9	more than 100'000	45	15375

Example:

If Mr. YYY, a foreign employee, receives Gross Monthly Salary from the company in China of RMB 30'000;
his taxable income is RMB 26'000 and is on Level 5. His income tax shall be calculated as:

Monthly Income Tax= (30'000-4'000) x 25% - 1'375 = **RMB 5'125** (or 17.1% of his Gross Monthly Salary)

Therefore his Net Monthly Income is 30'000-5'125 = RMB 24'875

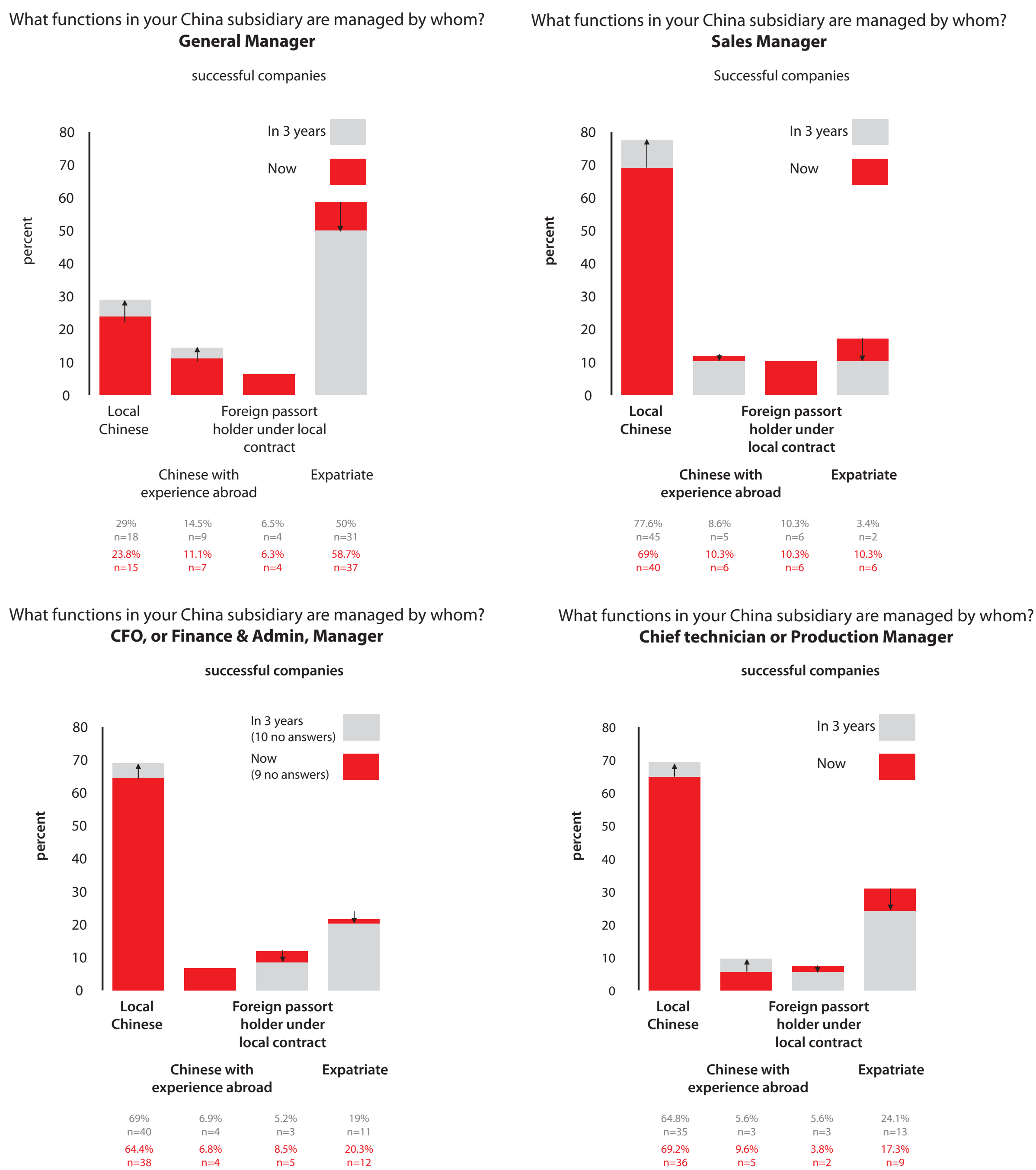
Source: CH-ina (Shanghai) Co. Ltd

1.4 Localization of management

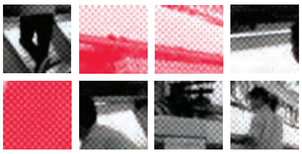
The drive to localize management is still present in Swiss subsidiaries. The top management positions that are already mostly held by Chinese are the Sales Managers, Production Managers/Chief Technicians and CFOs. It is the case for more than two third of the respondents to the survey.

Interestingly, the trend is for local Chinese without experience abroad to take these positions (particularly Sales Managers). On the other hand, almost two third of the General Managers positions are held by foreigners, though this proportion is expected to go down to 56% in the 3 years to come.

Survey chart IX - 5



Source: Swiss China Survey, 2005



Interestingly, even for GM positions, local Chinese are hired in higher proportion to those with an experience abroad. This may well have two reasons: Chinese returning from a few years abroad have missed the evolution of the local situation, known to develop very fast. At the same time, their remuneration expectations may not be competitive with purely local managers with the right profile.

By experience, the nationality of managers (or even staff), is of less and less importance in recruitment decisions: skills, experience, personality and attitude actually make the difference.
In this respect, with the growths in foreign investment and the job experience FIEs provide, local Chinese are more and more best equipped to provide optimal performance.

This is also evidenced by the closing of the salary gaps between foreigners and Chinese. For similar positions and functions, Chinese General Managers earning close to European salaries and young foreign university graduates accepting middle management jobs at local Chinese salaries.

2 Employment in China and the Labor Law

by Niklaus Gadient, Attorney-at-law and a Partner at Ernst & Young

The rather large and cheap supply of manpower that is currently available in China plays an important role in the decision making criteria for today's investors. In addition to this, **the legal position of local employees is covered by the Labor Law Act but trade unions do not play an active role**.

In practice, employees are well protected by the Labor Law Act especially against dismissal, which needs to be supported by evidence of improper behavior or inability to perform the task as well as the impossibility to re-assign the employee to another task.

Chinese labor law consists of a multiplicity of national and local laws. The Labor Law Act (Labor Law of the People's Republic of China) in force since January 1, 1995, represents the most significant legal source in this area. Local regulations supplement national law but modify it in some areas.

Employees in China hold rather a weak position vis-à-vis their employer. However, since a new administrative directive came into force as of December 1, 2004, **the protection of employees is now centrally regulated by the state**. The authorities can thereby better control the adherence to legal regulations for the protection of women and children, the monitoring of working hours and minimum wage and the payment of social security contributions as well as the completion of written employment contracts. Those found not to be in compliance can then be prosecuted.

2.1 Obligation to Retain Employees when Forming a Joint Venture

With regard to joint-venture negotiations, the question is often raised as to how many of the (usually too many) new employees should be employed by the joint venture? This is often a difficult topic of discussion. Even in China the dismissal of employees through redundancy is neither easy nor cheap. However, there is essentially no obligation to take on all employees and economic considerations can influence the decision. In practice, however, foreign investors are regularly pushed to employ most or even all employees of the new venture and local authorities actively encourage this position. The city authorities of Shanghai, for example, require confirmation from the Chinese enterprise that the foreign investor will take over a majority of the existing staff. Thus, as far as dismissals are allowed, redundancy payments must be made and the amount depends on both the length of service and seniority of the employee.

2.2 Employment of Local Employees

A Foreign Invested Enterprise (FIE) can recruit local employees in China through the use of special employment agencies. With the permission of the local administrative authorities an FIE can also enlist employees from other regions. In practice, there are only restrictions on the direct recruiting of employees by the FIE. It may be stipulated, for example, that a recruitment advert needs the prior approval of the local labor authorities.

Staff of Representative Offices needs to be hired through a government agency. Enterprises with foreign Investment (i.e. WOFE JV) can hire directly or through an agency and often appoint a government agency to handle all welfare and tax issues.

2.3 Availability, Mobility and Remuneration of Employees

Salaries can be negotiated but there are local minimum wage requirements. Minimum wages vary greatly and can be far lower in the interior of the country than in Shanghai, Beijing or Guangzhou.

Despite China's vast population, the number of employees available and sufficiently qualified for foreign enterprises in the market place is by no means inexhaustible. There have also been reports of a lack of available low cost migrant workers in the rapidly developing geographical areas in the southeast of China, but also in highly specialized technical, research and developmental fields in all developed areas of China.

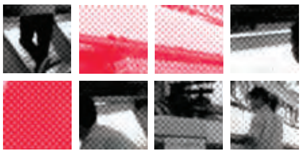
However, the working population is in general very mobile, although middle managers and technicians with supervision functions are notably less so. Indeed, high-level managers and normal workers are willing to move for better opportunities; top managers move their family along, while workers are usually young and single or willing to live separately from their spouses. Middle managers are often married, bought a house and need both spouses' salaries to cover mortgage and living expenses. As a result, middle managers and skilled technicians are more difficult to find than other employees, and their salaries increasing faster.

The mobility of other employees ensures that salary differences in different regions usually reflect the difference in the cost of living. Provided an employer is ready to offer dormitories to workers and adequate housing to managers, the remuneration of such employees (excluding the extra living allowances), at equal qualifications and attitude, is not higher in large or developed cities than in smaller centers.

Smaller centers actually see a brain drain towards the larger ones. Total costs (including living allowances) of management and technicians are thus higher than in top tier cities (at equal attitude and qualification). Yet, workers' total costs may be lower by up to 30%. It is important to note, however, that the salary mass of a foreign enterprise in China is usually made for a large part by supervisors and the management, so that savings on workers' costs may not balance extra costs of management, unless the activity is labor intensive and requires a large proportion of workers in the total headcount.

According to the "same salary for the same work" principle, Chinese managers are allowed to claim the same payment as their foreign counterparts in the same company. The non-wage labor costs (pension, health insurance, insurance against accidents, etc.) can be high, in some cases amounting to up to 50% and more of the total salary. However, there is a cap to the total amount of welfare to be paid. As an example, an employee in a FIE in Shanghai pays 18% of the contributions and the remainder is paid by the employer. In this case, the employer's maximum contribution is currently limited to RMB 4,869 per month (2005).

For many foreign companies, retaining capable employees is an even greater challenge than recruiting new ones. At



the moment, in places like Shanghai, career oriented employees hesitate to leave a company before 3 years of service for fear of losing opportunities in the future by being perceived to be unstable. The fact, however, is that employees are more volatile than, for example, in Switzerland

2.4 Approval of Employment Contracts by the Authorities

Employment contracts with Chinese employees must be concluded in written form and presented to the local labor authorities for certification within a month after their signing. **It is common practice to coordinate a standard employment contract with the competent authorities**. Non-competition clauses or similar regulations for the protection of the employer are permitted but employees are subject to restrictions which can be compared with those in western legal systems.

2.5 Social Security

Chinese social security law – as with many other legal areas – is determined by a multitude of different regulations. **A uniform, nationwide social security law has not yet been established**. In rural areas, the social security coverage of employees is still not well developed and generally non-existent. In urban centers, a differentiation is made between employees of state-owned enterprises and employees of private entities. The employees of state-owned enterprises benefit from a model similar to that of the western pension scheme, whereby contributions are disbursed directly to the beneficiaries. The government supports this system with substantial subsidies. However, as this leads to a considerable strain on finances, the government is striving for an adaptation of the social security system comparable with those of private entities.

The old age pension scheme for employees of private entities is built on a three pillar system. The first pillar consists of a legally prescribed old-age pension plan; one part of the contribution is paid directly to pensioners, while the remainder is paid into the individual account of the respective employee. Contributions are paid by both the employer and the employee; the portion of the employer should not amount to more than 20% of the salary and that of the employee to no more than 11%. This first pillar is supplemented by a fund system subsidized by the state, which should bridge any gaps. The second pillar consists of voluntary pension funds of the respective private companies. The third pillar consists of the voluntary individual saving plan of the employee. Due to social security agreements between China and the home country of a foreign employee, special regulations may apply.

2.6 Termination of an Employment Contract

Probation periods of up to six months can be agreed upon. During such a probation period, the employment contract can be terminated at any time. In cases of a serious breach of contractual obligations, the contract may be terminated without prior notice. In all other respects **the employer must observe a legal notice term of at least 30 days**. Furthermore, **Chinese labor law requires justification for the dismissal – including for example an unsatisfactory job performance**. However, dismissal for this reason is only acceptable in cases where additional training or the redeployment of the employee has not yielded satisfactory results. Due to the strict legal requirements, a clear job description and a detailed system of employee appraisal should be defined in the employment contract and company human resources regulations. The termination of the contract due to an insufficient job performance is thereby facilitated. Another recognized reason for giving notice is a permanent illness of the employee which does not originate from the occupation of the employee. Dismissals for operating reasons are only permissible in exceptional cases and the dismissed employee has the right to demand that he/she be considered as a preferred candidate for new employment positions within the following six months. In all other cases, the dismissal requires a compensation payment. Without the support of trade unions and local labor authorities the dismissal of an employee can only be enforced with difficulty.

2.7 Collective Labor Law and Trade Unions

Employee representatives are responsible to look after employees interests through trade unions. However, **the influence of trade unions is rather insignificant and cannot be compared with European employees organizations**. Traditionally an enterprise trade union in China has the function of facilitating the company's management and is directed by the company leadership. It is actually often an advantage to support the set-up of a trade union in a FIE; it allows a channel to employees and easier legal enforcement of human resources management. Yet, the role of trade unions might become more independent of management with further economic development.

The law provides for the conclusion of collective contracts, but collective agreements are not very frequent. According to Chinese law, representatives of the trade union have to be invited to the meetings of a company if the subject-matter of the meeting affects the interests of the employees.

2.8 Delegation of Expatriates

It is nearly impossible to control a subsidiary in the Chinese market from Europe. In order to achieve sustained successful economic investments in China, it might be necessary or even crucial to temporarily dispatch foreign employees to the location of the subsidiary to help with the setting up and development of the Chinese enterprise. In the run-up stage extensive planning for all the legal and personal matters concerning the assignment abroad should take place. As the various aspects of an assignment in China are highly complex, **it is advisable to engage an experienced advisor in both the home country as well as in China**. The following paragraphs depict some of the regulations to be observed with regard to a China assignment of an expatriate.

2.9 Labor Law Requirements

If the stay in a foreign country exceeds one month, most European employers are obliged by law to provide the employee, before departure, with a document that must contain the following data: the duration of the activity abroad; the currency in which the salary shall be paid; additional payments in connection with the assignment abroad and additional non-cash benefits, as well as conditions agreed upon for the return of the employee.

2.10 Form of the Employment Contract

The composition of the employment contract of expatriates normally adheres to the duration of their stay. If the assignment abroad is short, the European employment contract is often supplemented with a delegation agreement. If the assignment is longer term, the European employment relationship is normally suspended and a temporary employment contract with the Chinese company is formally concluded. Finally, in the case of an undetermined assignment abroad, the European agreement is cancelled and an employment contract with the Chinese company is concluded as a consequence of the "transfer". In this last case, the employee does not normally get a guaranteed right of return.
A local contract in China is usually necessary because of regulations concerning the visa requirements.

In practice, mixed forms or – even unclear or noncommittal regulations – can often be found, especially due to the high complexity of the legal relationship. Therefore **negotiations of an expatriate agreement should give reason to create a contractual basis that is concise and reflects the current situation**. Important points of the agreement are the exact description of the position, the field of responsibility and, where applicable, the reporting line; regulations regarding salary and possible extra-pay for the assignment abroad, regulations regarding currency alignment as well as a regulation of the tax liability in China and/or the home country. Furthermore, special clauses have to be defined concerning the outward and return flight, children's education as well as any regular flights home, the rights and duties in case of a transfer and the eventual return as well as the notice term and other questions that have to be arranged should the employment relationship need to be terminated.

2.11 Applicable Law

The principle of contract autonomy also applies in labor law, i.e. the employment relationship can be subjected to the law mutually chosen by the parties involved. However, such a choice of law is superseded by the compulsory regulations of the objective contract statute that pertains to the local labor law.

If no special law was agreed upon, the employment relationship is subject to the law of the country in which the services are generally provided, even if the employee is temporarily delegated to another country (i.e. China). It is arguable as to how long a temporary assignment can last. If the stay in China is not continuous and does not exceed three years, the temporary character could actually be regarded as preserved. As a consequence, from a legal point of view, the relevant European labor law is applicable to the employment relationship with the home company.

Since Chinese labor law does not rely on the contractual relationship, but on the fact that the employee is working for a Chinese company in China, a foreign employee would therefore be considered to be subject to Chinese labor law. However, it is not clear whether and to what extent employment contracts with foreign employees are actually subject to the regulations of Chinese labor law. The relevant regulations generally refer to the employment contract as approved by management and therefore unfortunately do not further clarify the situation.

Due to the insecure legal position, a careful check should be carried out – in the interests of both parties – to see whether the law of the home country should explicitly apply when setting up employment contracts with expatriates being sent to China. Provided there is given reason and within the limits of certain restrictions, such ***a choice of law concerning the relevant expatriate is permissible, also from a Chinese point of view***. In this regard, a place of jurisdiction or arbitration outside the People's Republic of China should be mutually agreed upon in writing.

2.12 Work Permit and Residence Permits in China

An essential condition for the formal employment of a foreigner in China is that the respective position cannot be filled by a Chinese person. Obtaining a work permit can cause considerable difficulties because the FIE has to convince the local labor authorities that qualified local personnel could not be found. In practice, the authorities often grant permits for management and technical positions considering the size of the company and of the made investment.

A breach of the Chinese regulations concerning work and residence permits can lead to unpleasant consequences for the company as well as for the employee (even imprisonment is possible).

2.13 Tax Law Requirements and Tax Liability of Expatriates

Expatriates working in China are subject to Chinese tax law. This principle is not changed by the frequently used practice of splitting an employee's salary so that it is partly paid in the home country and partly in the host country (China). The portion paid into an account in the home country is taxable in China if it is received for work performed in China. Income derived for other activities than those performed in China (rent received for real estate owned abroad, for instance) is however not taxable in China, should the employee stay consecutively less than 5 years in China.

The tax liability of an employee is determined according to the length of their stay in China. **If their stay is shorter than 183 days, the salary of the expatriate is not subject to taxation in China, provided they are paid by the home company**. Otherwise, taxes have to be paid in China. Basically, for a stay of 183 days up to one year, the salary for services rendered in China is taxable in China. If the employee works outside the People's Republic of China, the portions of salary concerning employment outside of China are not taxable in China. If a foreign employee is delegated to China for a period of one to five years, the total salary of the expatriate is taxable in China as a matter of principle. However, it is possible that an administrative decision may limit the duty to pay tax on income that is earned in China or abroad and then transferred to China. If the employee stays longer than five consecutive years, the total income is taxable in China. To avoid such a situation, foreign companies regularly interrupt the stay of their long staying expatriates in China for at least one month, every five years. This practice is currently generally accepted by Chinese tax authorities.

2.14 Costs Regarding Staff Delegations

With regard to the cost of transferring staff abroad, the European tax authorities are generally of the opinion that the company which profits from the services provided by the expatriate has to cover the costs and can then offset these costs for tax purposes. In principle, it is assumed that this is the host company and only in exceptional cases is it the home company. Of pivotal importance here are the vested interests of the home company as well as those the host Chinese company in connection with the delegation. In this regard, it is crucial that **an objective comparison be made so that the accrued costs can be split accordingly**.

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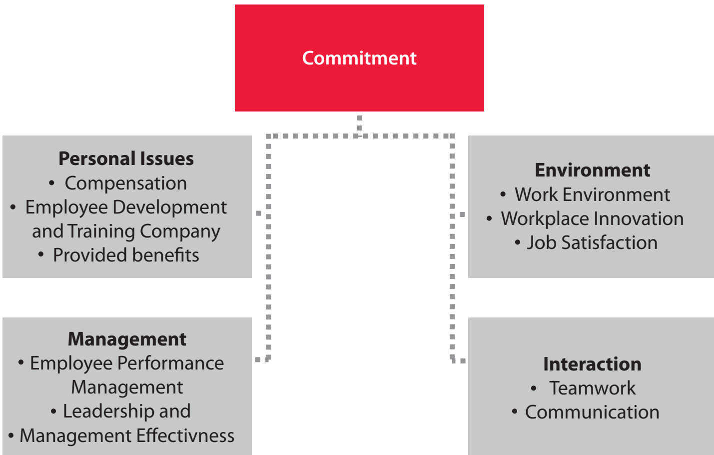
3 Human Resources Management

by Tim Wieringa, project manager and head of HR department, CH-ina

3.1 What Chinese personnel look for in a job

Fig IX - 1

Drivers of commitment



Source: A. Gertsch (2004). Retention management of Chinese employees - Diploma Thesis. Zurich University of Applied Sciences. Winterthur.

Extensive studies have been made to find out what keeps personnel committed to their jobs. Below is a summary of the various elements according to recent research in China. It is not fundamentally different from what is uncovered in European circumstances. The relative importance of the various elements may change, though.

Below are excerpts of the results of a survey carried out in Fall 2004 among 144 workers, supervisors and managers of Swiss companies in the machinery and electronics field in the Shanghai area[1].

The main reasons to stay in the current company (or to leave the previous employer) are directly linked to: (see Figures 2 and 3)

- the opportunity for personal and career development in general.
- the working atmosphere in general (teamwork, corporate culture, management style)

  Remuneration (compensation and benefits) has its importance, yet and **contrarily to what one usually thinks of Chinese staff (at least those employed with Swiss companies), it is one of the least important reason to stay.** Additionally, when an employee's personal development aspirations cannot be fulfilled, the next job must offer better compensation so that the employees makes the step to leave 2.

Fig IX - 2

Reasons employees leave an organization

(Percentage will not total 100 as multiple select was possible)

	Frequency (n=126)	Percentage
Career perspectives were limited	66	52
Competitor offered higher compensation and benefits	58	46
Development and training was not according to my needs	53	42
Corporate culture	39	31
Discontent with management style	33	26
Inharmonious teamwork (mobbing)	32	25
Was not able to use my skills and knowledge	31	25
Work environment (protection, technology) was dissatisfactory	27	21
Occupation and content of work was dissatisfactory	24	19
Job security	23	18
Location of the company	16	13
General discontent	15	12
Work-life balance was too limited	14	11

Source: A. Gertsch (2004). Retention management of Chinese employees - Diploma Thesis. Zurich University of Applied Sciences. Winterthur.

Fig IX - 3

Reasons employees continue to stay with an organization

(Percentage will not total 100 as multiple select was possible)

	Frequency (n=144)	Percentage
Development and training	76	53
Able to use skills and knowledge	74	51
Good teamwork and work relations	69	48
Career perspective	68	47
Job security	61	42
Work environment	60	42
Occupation and content of work	57	40
Management and leadership style	56	39
Compensation and benefits	52	36
Corporate culture	46	32
Location of the company	30	21
Work-life balance	25	17

Source: A. Gertsch (2004). Retention management of Chinese employees - Diploma Thesis. Zurich University of Applied Sciences. Winterthur.

Yet, it is important to keep in mind that, for most Chinese, personal development has two purposes, while the second one - the opportunity to earn more - may often be seen as the actual purpose:

- self-fulfillment and the feeling of achievement,
- but also the opportunity to get better remuneration and a better position in society through a better career (also see Chapter I, General Environment & Trends, Chinese history, business culture and psychology).

Interestingly as well, results on preference of type of compensation show that Chinese employees of Swiss companies are rather risk-adverse: after the base salary, they value highly (to about the same level):

- pension fund contribution
- health and accident insurance
- housing fund contribution in favor of employee.

Besides, they rank 'annual leave' at the same level of importance of the welfare, while 'working long hours' is considered normal.

This indicates the preference of Chinese for a bulk of quality time off and better pay, rather than regular leisurely work.

This "work hard, play hard" mentality helps illustrates the constant striving for a 'better life' of Chinese middle-class employees. For them a better life means:

- the feeling of personal achievements
- more material means through a better career
- more fun through a better working atmosphere and more holidays

Such a positive attitude towards work actually turns Chinese employees into extraordinary assets for a company that knows how to manage its human resources adequately. **Employee's thirst to learn and improve themselves is a constant opportunity to motivate staff and to drive the company towards excellence**.

In order to fulfill their aspirations, employees look for companies that:

- are successful and are growing fast
- have a good reputation and image (Swiss companies as a whole benefit from an excellent, maybe the best image)
- offer the opportunity to learn, through training but most importantly through good management
- offer the possibility to grow within the company, i.e. to get more responsibilities and better positions with time

This often speaks in favor of smaller but good companies that are starting in China: learning, growth and career opportunities are actually better in such cases than in large multinationals.

3.2 Retaining and Motivating Managers

While the above is general and broad, a few important conclusions and recommendations can be made - based on general research and experience - to manage and retain managers, whose performance is so important for the success of Swiss companies in China:

3.2.1 Management by objectives (MBO) and performance related incentive

In order to be able to develop themselves, most Chinese managers expect to receive targets and resources and then be trusted and left alone to achieve the results. While the need for reporting and following instructions is fully understood, micro-management is perceived as a hindrance to personal development. (In addition it may well be ill-inspired as foreign managers usually do not understand the full picture of a Chinese issue and tend to make suboptimal decisions.)

While willing to take responsibility to achieve results, Chinese managers also expect to have a remuneration that increases importantly if their contribution to the company is significant. As a result they are usually willing to have an important variable part of their remuneration (one-third up to one-half for sales managers). Success stories of turnaround of Chinese State-owned companies (such as Haier in 1990) can often be related to highly variable pay according to achievements (down to the cleaner of the canteen). As a result, piece wages and large performance related bonuses are commonplace in China.

While hoping for little micro-management, Chinese actually value coaching considerably, as long as it comes from someone who is actually more knowledgeable in areas important to the business and can teach them valuable skills. (Teachers traditionally have a considerable importance in China. (Also see Chapter I, General Environment & Trends, Chinese history, business culture and psychology)

3.2.2 Coaching and making decisions in an unknown environment

The value of coaching by a foreign manager is in the aspects that a Chinese does not know well and a foreign manager has valuable experience. However, practically all areas of management (excluding purely technical ones) are affected by the particular circumstances of the Chinese business environment.
Therefore a coach's initial task in China is to keep a completely open attitude, understand the influence of the Chinese environment on her or his knowledge and adjust.
The first step of a foreign manager coaching a local one should almost always be listening and taking advice before giving any and making decisions. This may bring difficulties with Chinese employees who expect their managers to know what to do. On the other hand, at managerial level, Chinese are usually happy to have the chance to explain their problems and look for solutions jointly.

Participative management in China, more than being a fashionable style, is the best decision making tool for a Swiss manager.

Foreign managers can often bring better experience to their Chinese counterparts in human resources management, technical and technology management and maintenance, planning, as well as out-of-the-box and strategic thinking. They can also demonstrate exceptional personal qualities that will be recognized and valued as an example: fairness, loyalty to others and the company, honesty are some of the important examples.

3.2.3 Keeping a close and personal relationship

To increase one's understanding of the business environment, Chinese subordinates can be the best support. However, by deference and respect, they will usually avoid contradicting superiors or giving their opinion unless they feel they have established a personal relationship with their superior. Maintaining a close relationship with subordinates is therefore essential for a foreign manager to make right decisions and to provide good management to her or his subordinates. Besides, traditionally, Chinese develop a loyalty towards people rather than organizations. (This can be traced to the lack of rule of law and the necessity to rely on friends and acquaintances rather than on institutions.) A personal relationship naturally allows developing a feeling of mutual loyalty that also becomes an important element of managers' retention. (Also see Chapter I, General Environment, Chinese history, business culture and psychology)

3.2.4 Formal training and career plans

Offering the possibility to climb the social and monetary ladder remains very important for any employee and particularly for managers. As a result, offering flexibility and financing for formal training or education (such as EMBAs) within a career plan is essential for manager retention.

Should education be paid by the company, it is generally admitted that the employee benefiting from it commits to refunding it (or part of it), should he leave earlier than a period fixed in advance. As a result, training also works as a direct incentive to stay in the company.

3.2.5 Team building exercises and outings

Such activities combine the elements of fun, creating stronger relationships and a better working atmosphere. They are actually a valuable HR management and development tool. In addition, they often allow managers to see their employees in a different light and contribute to spot new talent internally.

Contributed by CH-ina (Shanghai) Co. Ltd
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4 Human Resources Selection

by Nicolas Musy, Vice Chairman SwissCham China, Managing Partner CH-ina

The process of selecting the most suitable staff for a company actually involves many interactions. The company and its management needs to be attractive to the right potential candidates, while the company needs to be able to define the values it looks for in staff, objectively assess candidates and, very often, be flexible enough to modify requirements depending on available employees.

When selecting employees for subsidiaries in China we suggest the following five steps:

4.1 Identifying the selection criteria

Before the start of the search, the requirements for the position need to be identified. The overall company concept and strategy as well as the other key functions need to be considered to make a decision on a job description for the position. Besides, **having a clear idea of the concept and targets of the position gives a professional impression to candidates and is part of the selling of a job**; it is important, should one want to attract best qualified people.

4.1.1 Job descriptions

They will usually be similar to those a western company would establish, however a few particularities need to be considered:

- China is an administration-intensive environment, so that many more administrative functions are needed, sometimes required by law. (The cashier and the accountant may not be the same person. An accountant need to be hired by a foreign company, for instance)
- **Partly as a result, personnel in China are much less "multifunctional" than in Switzerland and not really used to have a set of functions. Drivers, for instance, usually only drive.**
- Many support functions are usually needed for an operation in China, while they would never be hired in Switzerland, e.g. drivers, but also guards, cleaners, possibly cooks and staff to take care of dormitories
- The environment is changing fast, requiring particular qualities from employees to be efficient and to grow with the company.

4.1.2 Selection criteria

Though different corporate cultures may have different views, criteria can broadly be categorized as follows:

4.1.2.1 Personality (character, attitude, manners)

It is a key element for a long term cooperation: does it fit corporate values? In order to have good foundations to build on, we recommend looking for Chinese managers who are:

- Polite, respectful

- Honest, loyal, straightforward, assertive
- Responsible and result-oriented, able to work independently, proactive, communication- and solution-oriented,
- Able to work in a team or team-oriented

4.1.2.2 Intelligence

It is the essential ingredient for a dynamic operation, able to meet challenges and adapt. Staff should be

- Learning fast,
- Able to think carefully and out of the box
- Creative and resourceful

4.1.2.3 Education background

It gives an idea of the acquired knowledge of the candidate, his values and interests.

- Academic degrees
- Family education
- Self education (hobbies)

4.1.2.4 Skills and experience

Know-how is also needed to get things done…

- Technical and managerial skills; experience (according to the position)
- People's skills: ability to understand others, communicate with them, explain and convince
- English or other foreign languages and exposure to western working ways

4.1.2.5 Ambition and potential for advancement

Depending on the company's plans, it is preferable to have employees with faster or slower potential for development. Indeed, should a new employee expect taking more responsibilities relatively fast, the employer need be prepared in order not to lose the new staff.

4.1.3 Priorities of criteria

While in Switzerland skills and experience are given high value, in China candidates with the right know-how and exposure may not be easily available due to the current economic development of China. We recommend ensuring personality, intelligence and a suitable education background in priority. Indeed, **better a good personality with a fast-learning ability to acquire the needed skills than someone with the right skills who maybe dishonest or lack the ability to learn.** The fast-learning candidate will need a few more months to come up to speed, but will be able to evolve with the company, whereas the other one will be able to work immediately but may be unable to fulfill the company's needs one year later.

4.1.4 Establishing formal aspects

A successful process will end with a signed contract. However, once a process is started the employer needs to be able to provide details of the employment conditions to candidates. Being able to do so will show professionalism. Well-written non-competition and non-disclosure clauses need be included in contracts to avoid the loss of trade secrets or know-how. Additionally, well prepared contracts (and job descriptions) allow the easier termination of employment, since reasons must be given to let staff go. (Also see the Labor Law article in this Chapter.)

Well-written non-competition and non-disclosure clauses need be included in contracts to avoid the loss of trade secrets or know-how. **Well prepared contracts and job descriptions also allow the easier termination of employment, since reasons must be given to let staff go**.

4.2 Search

The collection of resumes is the next step, it can be performed in three ways:

- Classic advertisement in online and paper media
  It has relatively low costs, brings back a lot of applications and is therefore useful to have an idea of the market. However, one hundred resumes per position maybe received in a place such as Shanghai, making the evaluation and answering time considerable.
- Involving an executive search firm
  It is more costly but brings reliable results in a short time. The fee structure for these services is similar to Switzerland.
- Relying on the personal network
  May be very effective, yet it does not allow an overview and does not ensure that the most suitable candidates have been identified.

4.3 Selection

After collecting the resumes, the potential candidates should be selected. Depending on the chosen search method, normally many resumes are in the selection pool and choosing the right one is often not easy.

In general, the application material received is poorly done and not "employer-friendly" — unless applicants are top managers having worked for foreign companies. It is difficult to understand the level of English or the actual experience of candidates based on resumes but **eliminating all the poor resumes will almost certainly overlook good candidates at reasonable costs**. As a result a lot of interviews are needed. Pre-interviews by phone may allow and evaluation of the English level and provide the information that is missing on the resume. Still, conducting first interviews is finally the only way to assess the candidates. This part is certainly the longest and has to be intensive. On the other hand, it is important to go through the selection and assessment process in a short time: candidates normally expect a reply within a week and an interview within 2 weeks. Should time drag on, they assume that the employer is not interested and take other opportunities as they come.

Starting from the reception of the resumes the decision to hire a candidate should be made within a maximum of four weeks.

4.4 Assessment

Evaluating personality, skills and intelligence in a different culture is difficult and usually needs specialists. Yet, it is possible to reduce risks by:

- Having different persons participating in the interview and comparing impressions until consensus is achieved (at least one Chinese need to be present to read cultural elements)
- Preparing tests to judge personality and skills (particularly technical ones) to be given in case of disagreement among the various persons participating in the interview

Considering the importance of properly assessing future managers, using Chinese assessment professionals, is highly recommended.

The evaluation is normally done with two or three more interviews involving different managers of the company. It is important to realize that the assessment is also the chance for the candidate to evaluate the company. **It is essential to view the assessment as a two-way evaluation in which the employer has the opportunity to "sell" the company and the position**. Good marketing materials on career opportunities should be provided to potential hires. (Also see Human Resources Management section in this Chapter for details on what kind of jobs and companies Chinese employees are looking for.)

4.5 Hiring

After the decision process is completed, an employment agreement should be signed by both parties. **Well-made employment agreements are much more complicated than in Switzerland and should not be established without a specialist**. If the draft is already prepared in the beginning of the selection process the finalization of the employment can be done much faster, since internal discussions can then be minimized. Actually, based on experience, most of the jump-offs happen during this step.

Details of the employment contract should include objectives and a performance evaluation system, in order to prepare the management of the new employee.

As in Switzerland, new employees have a probation period. It provides the chance to further evaluate the hired employee. **It is usually better to wait until probation is over and both parties reconfirm their agreement before sending an employee for training abroad**.

Keeping the new hire depends then on his or her adequate management. (See Human Resources Management section in this Chapter.)

4.6 Compensation and Benefits

Below are examples of remuneration ranges for different functions in RMB (8RMB = 1USD). Managers have English communication abilities.
Salary levels vary a lot depending on the employee's level in terms of:

- Ability to communicate and understand, interpersonal skills, level of English
- Skills needed for the job and past achievements
- Intelligence, ability to think pro-actively and 'out of the box'
- Ability to learn and potential to take more responsibilities

Except for unskilled workers, most other staff expects welfare to be paid according to local regulations. Welfare levels vary considerably in China. Even between two districts of Shanghai, there are differences of up to 50% between welfare levels. (Staff may however require to be paid according to higher welfare levels paid in the city since their pension eventually depends on the amounts they contribute.)

The salaries below apply to East China area. Yet, **due to the mobility of the workforce, at equal qualifications in all aspects, salary levels are not necessarily very different in different places**. (Also see Chapter II, Preparing for China, location selection, for an analysis of cost of labor according to cheaper and more expensive areas.)

- Unskilled workers: 600 – 900 (no welfare)
- Skilled workers: 800 – 1'500
- Technicians: 1'500 – 2'500
- Administration, entry level, English: 1'500 – 2'500
- Engineering mgr: 8'000 – 25'000
- Sales manager: 15'000 – 40'000

- Sourcing manager: 6’000 – 20’000
- Finance manager: 6’000 – 20’000
- Top management (CEO): 20’000 – 60’000

See welfare system comparison in this Chapter for an idea of welfare costs. The employer’s part need to be paid by the company in addition to the above salary. Low costs meals and dormitories may additionally be offered, particularly to migrants workers coming from poorer areas of the country.

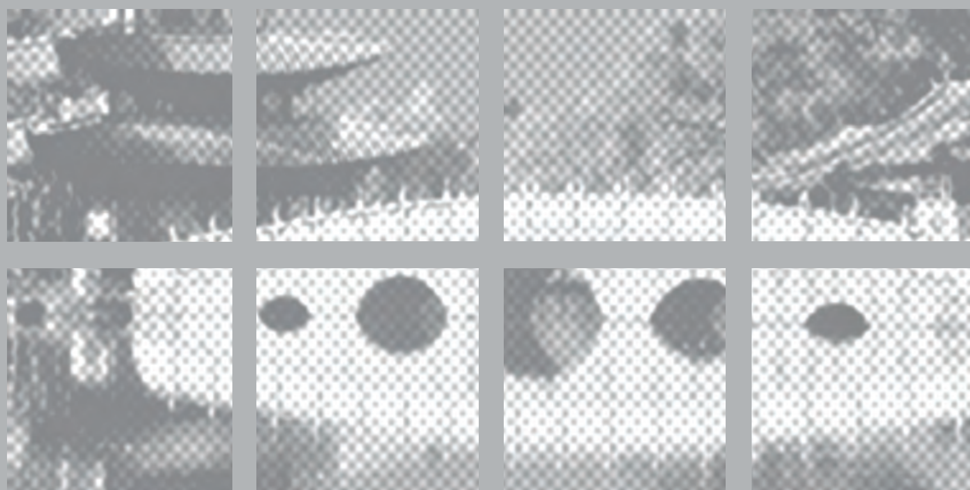
Bonus is generally expected in addition to salary, in the form of 1 or 2 months salary depending on the performance of the company. For managers and according to performance evaluation systems, 4 months of salary may be added.

Commissions based on sales, gross margin, savings on purchases may be paid in lieu of bonus, depending on the positions and the company policy.

Allowances in the form of mobile phone costs, transportation to work, training fees, housing (in case the employee changes city to work) or use of a car for a general manager or a sales manager may also be provided as extra benefits.

Contributed by CH-ina (Shanghai) Co. Ltd
CH-ina provides the integrated set of services needed for the establishment and operation of Swiss businesses in China.
Contact: CH-ina (Shanghai) Co. Ltd., 21-C, 1078 Jiang Ning Road 200060 Shanghai, PRC
Phone +86 21 6266 0844, Fax +86 21 6276 0856, e-mail: info@ch-ina.com, website: www.ch-ina.com

X Support for China



"We shall be unable to turn local advantages to account unless we make use of local guides."

Sun Tzu, The Art of War

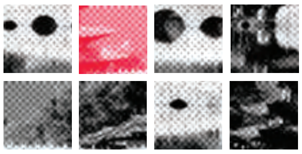
In China and in Switzerland, a rich diversity of private and governmental organizations, institutions, foundations, project managers and experts offer support in all aspects of the establishment and maintaining of business activities with China.

In addition to results of the Swiss China Survey on support aspects, this chapter provides an overview of these players and organizations. It highlights their fields of competence in one chart for a rapid evaluation of which institution or instrument may be considered for what need.

Organizations are described individually with the services they offer and their contact information. (These descriptions were submitted by the organizations themselves.)

By understanding, evaluating and making use of the competencies of specialized partners for specific needs and situations, managers will save valuable time and avoid costly mistakes, unavoidable in a environment as difficult as China.

(Also see Chapter III, Preparing for China, to understand difficulties met by respondents to the Survey and how to avoid them.)



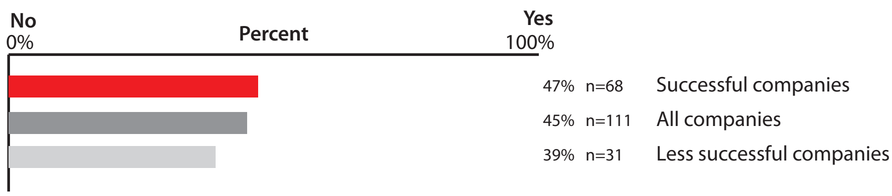
Support for Success

Acquiring support in China is no luxury to achieve success. Indeed the difficulties presented by China's environment for those having no experience with it are considerable as is shown by the very high rating that 'Comprehensive understanding of local business ways' gets as a success factor (94%, in second position, see the Initial Chapter: Swiss China Survey, 'Success in China').

Slightly more of the successful companies bought entry services than the less successful ones, though only 45 % of Swiss companies purchased support services for their China entry.

Survey chart X - 1

Buying services from institutions or other consultants



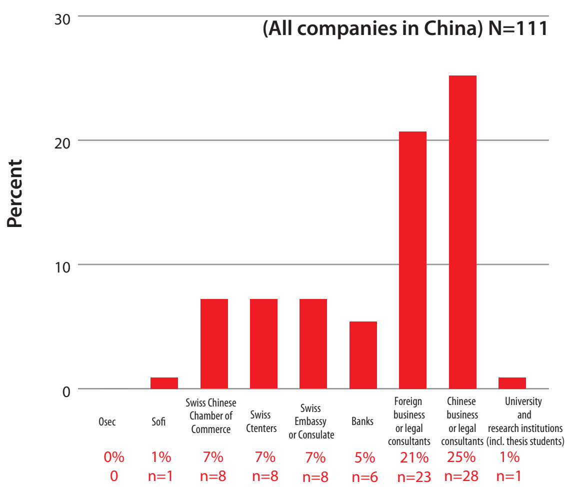
To start your business, did you buy services from institutions or other consultants?

Source: Swiss China Survey, 2005

Overall, respondents used mostly foreign consultants and institutions, but Chinese organization as well.

Survey chart X - 2

Institution used for support



To start your business in China, did you buy services from institutions or other consultants?

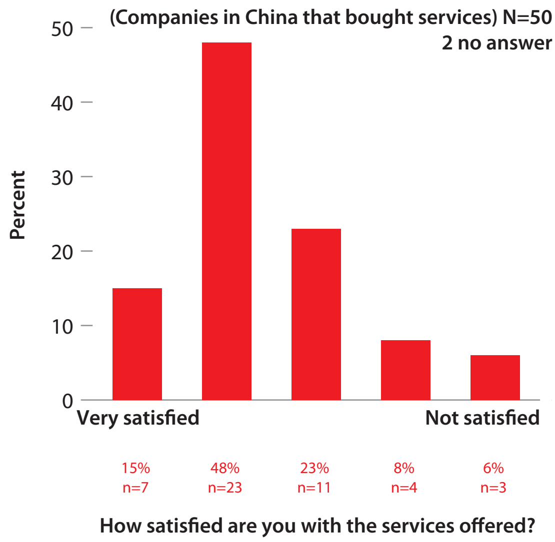
(Multiple selection possible)

Source: Swiss China Survey, 2005

In general those who purchased serviced where more or less satisfied:

Survey chart X - 3

Level of satisfaction with services offered

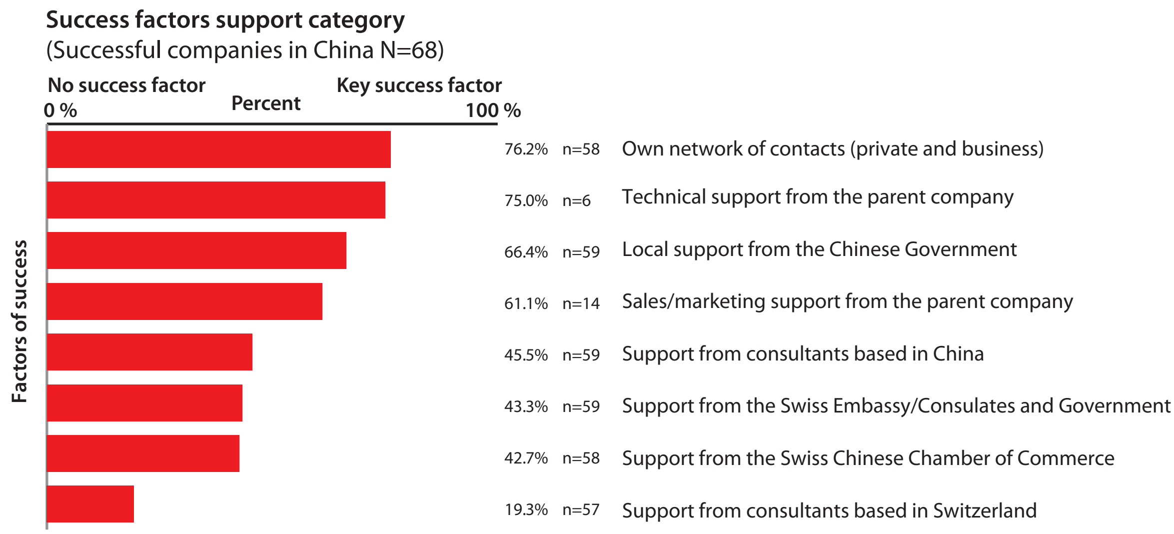


Source: Swiss China Survey, 2005

In terms of support factors of success, internal support elements (technical, marketing and network) come in the first position, with the Chinese government.

Survey chart X - 4

Support related success factors



Source: Swiss China Survey, 2005

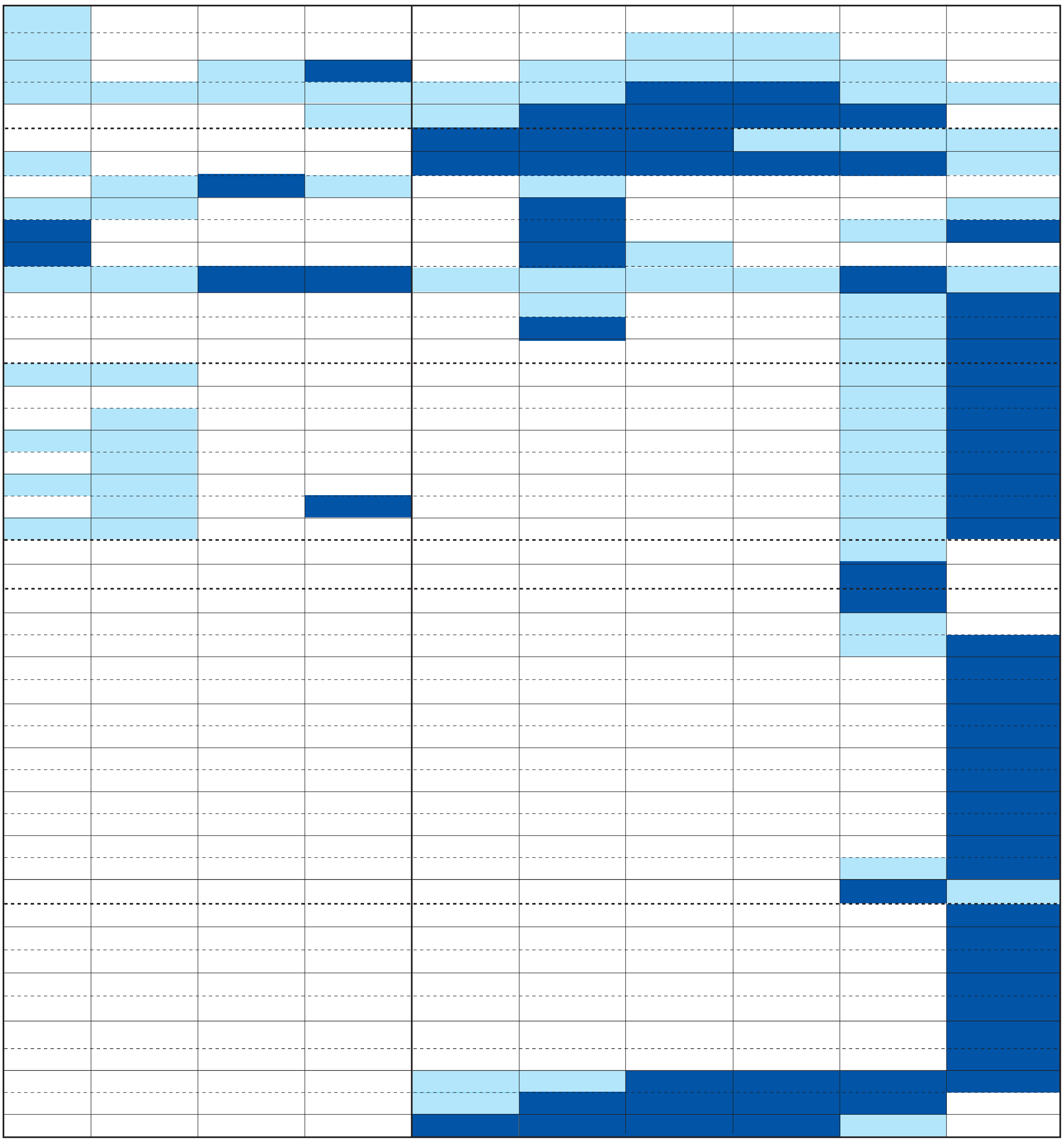
Overall, these results indicate room for organizations of support to develop their activities for the benefit of new China entrants.

based in Switzerland							
Seco	**Osec BusinessNet-work Switzerland**	**SOFI**	**erg**	**SCCC**	**SHKBA**	**SIHK**	*Relevant services for Swiss Businesses*
Swiss State Secretariat for Economic Affairs	Worldwide Business Network to promote Swiss and Liechtenstein foreign trade	Swiss Organization for Facilitating Investments	Official Export Credit Agency of Switzerland	Swiss- Chinese Chamber of Commerce	Swiss-Hong Kong Business Association	Chamber of commerce and industry of Switzerland	Short Description
Berne	Zurich, Lausanne, Lugano Swiss Business Hubs in Beijing and Shanghai	Zurich	Zurich	Zurich, Geneva, Lugano	Zurich	Regional chambers throughout Switzerland	Location
China Business Guide, Behind the China Kaleidoscope	Industry Reports, Behind the China Kaleidoscope			Bulletin, Swiss China Directory, Behind the China Kaleidoscope	Newsletters	Newsletters and magazines	Specific China-related Publications
www.seco.admin.ch www.chinaplatform.ch	www.osec.ch	www.sofi.ch	www.swiss-erg.com	www.sccc.ch	www.tdctrade.com	www.cci.ch	Website

Seco	Osec	SOFI	erg	SCCC	SHKBA	SIHK	Service	Phase
	Core Competence			Core Competence	Core Competence	Competence	Networking amongst Swiss and other businesses in Switzerland	General Information Gathering
	Competence			Core Competence	Core Competence		Representation of China-related interests of Swiss companies in Switzerland	General Information Gathering
Competence	Core Competence			Competence	Competence	Competence	China Information Platforms	General Information Gathering
	Competence	Competence		Core Competence	Core Competence	Competence	China related Seminars/Conferences	General Information Gathering
	Core Competence			Core Competence	Core Competence	Competence	China Orientation & Triage	General Information Gathering
	Competence	Competence		Competence	Competence		Relations/contact to Chinese Government	Entry Preparation
	Competence	Competence		Competence	Competence		Relations/contact to Chinese Administration	Entry Preparation
				Competence	Competence		Cultural & Business awareness training	Entry Preparation
	Core Competence			Competence	Competence	Competence	Support to Exports from Switzerland to China	Entry Preparation
	Core Competence			Competence	Competence		Coordinate Swiss participation in Trade Fairs & Exhibitions	Entry Preparation
	Core Competence	Competence				Competence	Specific Information gathering/Entry Market research	Entry Preparation
	Competence	Core Competence		Competence	Competence	Competence	Organization of Executive Trips (with on-site visits of potential suppliers, customers, competitors or partners)	Entry Preparation
	Competence						Supplier Search & Evaluation	Entry Preparation
	Core Competence						Distributor/Agent Search & Evaluation	Entry Preparation
	Competence	Core Competence					Regulatory frame & official authorizations evaluation	Entry Preparation
		Core Competence					China Strategic Concept	Strategy & Concept
				Competence	Competence		Location Selection	Strategy & Concept
							Entry Legal & Tax Optimization Concept	Strategy & Concept
							Technology transfer, training & IP protection concept	Strategy & Concept
							HR Concept: Company Culture, Structure	Strategy & Concept
		Core Competence					Business Plan incl. financials	Strategy & Concept
							IT Concept	Strategy & Concept
			Core Competence				Action and Implementation Plan	Strategy & Concept
							Export risk guarantee/insurance	Fund-ing
		Core Competence					Investment financing	Fund-ing
							Instant and virtual offices	Set - Up Implementation
				Competence	Competence		Instant workshops	Set - Up Implementation
							Legal Registration	Set - Up Implementation
							Application for encouraged status for duty/VAT free import of equipment	Set - Up Implementation
							Management and Human Relations Set-up	Set - Up Implementation
							Financial & Controlling	Set - Up Implementation
							Processes & Administrative Set-up	Set - Up Implementation
							China Manufacturing Physical Set-up & Commissioning	Set - Up Implementation
							Factory/Office Design and Installation/Construction	Set - Up Implementation
							IT Set-up	Set - Up Implementation
							Purchasing of local equipment/services	Set - Up Implementation
							Import of foreign equipment	Set - Up Implementation
							Homologations	Set - Up Implementation
							Opening Ceremony	Set - Up Implementation
							Part-time General Management & Coaching	Operation
							Accounting Services	Operation
							Auditing Services	Operation
							Controlling	Operation
							Legal compliance and Financial Optimization (e.g. tax, financial structure)	Operation
							IT Support Services (Network/Website Maintainance, ERP & CRM Implementation & Customization)	Operation
				Competence	Competence		Legal support services	Operation
							Support for problem solving on official adminstrative level	Operation
	Competence			Competence	Competence		Networking amongst Swiss and other businesses in China	Operation
				Competence	Competence		Representation of Swiss company interests in China	Operation

Competence   Core Competence

based in Switzerland				based in China					
Swissmem	**Consultants, Lawyers or other service providers in Switzerland**	**Academic institutes**	**SinOptic**	**Swiss Embassy, Consulates**	**Business Hub**	**SwissCham China**	**Business Council Hong Kong**	**Swiss Center Shanghai**	**Consultants, Lawyers or other service providers in China**
Association for machinery, electronics and metal industries	Private business consultants *)	Universities and related organizations	Online Sino-Swiss Information platform	Diplomatic representations plus consular services of Switzerland	Joint project of Osec and Swiss Federal Department of Foreign Affairs/Swiss Embassy	Swiss Chamber of Commerce	Swiss Chamber of commerce	The Swiss China Gateway	Private business consultants*)
Zurich, Winterthur	Throughout Switzerland	Throughout Switzerland	Lausanne	Beijing, Shanghai, Hong Kong	Beijing, Shanghai	Beijing, Shanghai	Hong Kong	Shanghai, Fribourg	Throughout China
		Academic publications	Newsletters and internet platform	ShanghaiFlash	Swiss China Directory, ShanghaiFlash, China Business Guide	Swiss China Directory, The Bridge, Behind the China Kaleidoscope	Swiss China Directory	Swiss China Directory, Behind the China Kaleidoscope	
www.swissmem.ch			www.sinoptic.ch	www.eda.admin.ch/beijing	www.eda.admin.ch/china_beishan/e/home/bustra/sbhchina.html and http://www.osec.ch/sbhchina	www.swisscham.org	www.swiss-biz.org	www.swisscenters.org	



Competence   Core Competence

*) For leads and addresses of consultants, lawyers or other service providers please contact the organizations listed overleaf.

Embassy of Switzerland, Consulate General Shanghai, Consulate General Hong Kong

Purpose/Mission of Organization
The Embassy of Switzerland in China is the official representation of the Swiss Confederation in China along with the Consulate general in Shanghai and in Hong Kong.

Nature of Organization
( ) Private ( ) Public (X) Gouvernemental (X) Non-profit ( ) Commercial
Membership: ( ) required (X) not required
Legal form: diplomatic

Services in the field of China Entry & Operations

• Provides Consular Service such as registration of Swiss nationals residing abroad, military service checks, welfare services for Swiss nationals residing abroad, issuing and extending passports and ID cards and personal, family and inheritance matters	Free, except for special administration fees (e. g. prolongation or issuance of passports)
• Maintains contacts with subsidiaries of Swiss companies	free
• Provides "basic services" in export promotion according to treaty between the Federal department of Foreign Affairs, the seco and Osec	1st hour free
• Provides assistance in legal questions including Intellectual Property Rights (IPR)	free*
• Assists in cases of delay of payment respectively not fulfilled payment obligations by Chinese constituents	free*

*) In accordance with the tariff scale of the Federal Council, a fee may be applied in certain cases.

Contact Information
Embassy of Switzerland
Sanlitun, Dongwujie 3
100600 Beijing

Opening hours of the Visa section:
Mo.- Fr. 9 - 11 am

phone requests from
Mo. - Fr. 2 - 4 pm under 010 6532 0943, fax: 010 6532 6210

Opening hours Embassy/Consulate:
Mo - Fr. 9 - 12 am
phone: 010 6532 2736 (no visa questions will be answered)
fax: 010 6532 4353
Email: Vertretung@bei.rep.admin.ch

Date of latest update: Nov 6, 2005

Consulate General Shanghai
22F, Building A
Far East International Plaza
no. 319, Xianxia Road
Shanghai 200051

Phone inquiries for visa matters from
Mo - Th 2 - 4.30 pm under 021 5257 4111

Opening hours from Mo - Fr from 9 - 12 pm
phone: 021 6270 0519 (no visa questions)
fax: 021 6270 0522 (also for visa matters)
Email: Vertretung@sha.rep.admin.ch

Consulate General Hong Kong
Suite 6206-07
Central Plaza
18 Harbour Road
Hong Kong

Opening hours from Mo. - Fr 9 - 12 am
phone: (+852) 2522 7147
fax: (+852) 2845 2619
Email: Vertretung@hon.rep.admin.ch

Swiss Center Shanghai

Purpose/Mission of Organization
The Swiss Center Shanghai offers a unique platform to facilitate Swiss SMEs' entry into the Chinese and Asian market and support their operations until it is successful. Small offices and instant workshops combined with a network of China-based experts offer the safety of a step by step approach and the assurance of an integrated, one-stop market entry implementation.

Nature of Organization
(X) Private ( ) Public
(X) Non-profit ( ) Commercial
Membership:
(X) required for use of space

Basic Information
Number of employees: 4
Founded in (year): 2003
Ownership & linked organizations: Fondation Swiss hCenters & Xinzhuang Industry Park
Legal form: Contractual Joint Venture

Services in the field of China Entry & Operations

• Instant Office Space	payable
• Instant workshops (small workshops for rent to SMEs)	payable
• Company legal registration	payable
• Organization of business related circles delegation from Switzerland to China and vice-versa. Organization of company specific executive visits	payable
• Translation, secretarial services and interpretation/business assistance for travelling overseas business people.	payable
• Networking service, communication within the Swiss community	payable
• Swiss China Survey project leader	payable

Contact Information
Contact Person:
Michelle Zhang
Title / Function:
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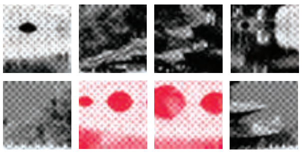
Tel: + 86 21 54428880
Fax: + 86 2154428881
Email: info@swissceners.org
Website: www.swisscenters.org

Date of latest update: Sep 05, 2005



Swiss Business Council in Hong Kong

Purpose/Mission of Organization
The Swiss Business Council in Hong Kong provides business platform and networking for members in HKSAR. It has consensus voice of Swiss Business Community's view towards HKSAR and Swiss Government. It facilitates members to have access to Greater China and Asia Pacific Region.

Nature of Organization
(x) Private ( ) Public
(x) Non-profit ( ) Commercial
Membership: (x) required ( ) not required

Basic Information
Number of employees: 1
Founded in (year): 1982
Legal form: association

Services in the field of China Entry & Operations

• Providing business platform and networking	For free
• Communicate with government institutions and Swiss community	For free

Contact Information
Contact Person: Ms Irene Lo
Title / Function: Secretary General
Address: GPO Box 9501, Hong Kong
Tel: (852) 2524 0590
Fax: (852) 2522 6956
Email: admin@swiss-biz.org
Website: http://www.swiss-biz.org

Date of latest update: 23.09.05

Swiss Business Hub China, Beijing; and Swiss Business Hub China, Shanghai

swiss business hub china
瑞士商务促进中心 中国
member of business network switzerland

Purpose/Mission of Organization
The Swiss Business Hub China offers to small and medium-sized Swiss and Liechtenstein enterprises specific services for strengthening and developing their business relations with China. It also functions as a networking platform and helps fostering business relations between Swiss/Liechtenstein and Chinese companies.

Nature of Organization
( ) Private (X) Public
(X) Non-profit ( ) Commercial
Membership: ( ) required (X) not required

Basic Information
Number of employees: 5 (incl. part-time)
Founded in (year): 2002
Ownership, parent organizations, linked organizations: Ownership: Swiss Embassy Beijing; linked to Osec Business Network Switzerland (operational matters)
Legal form: diplomatic

Services in the field of China Entry & Operations

• General information about the Chinese market	free
• Information about the Swiss economy for Chinese companies and media.	free
• Individual consulting and coaching of SMEs	Payable (1st hour free)
• Reports on presentations and trade fairs in various Chinese cities	Free (via Osec)
• Market and product analysis	Payable (1st hour free)
• Search of distributors, representatives and import partners	Payable (1st hour free)
• Organization of events and fact finding missions for Swiss companies	Payable (1st hour free)
• Official contacts with high ranking members of Chinese government and/or business sector (i.e. problem solving, discussion of issues with impact for Swiss industry, etc.)	Matters of general interest for Swiss industry: Free Matters of interest for individual company: payable (1st hour free)

Contact Information
Contact Person: Beat Bürgi
Title / Function: Counsellor, Managing Director Swiss Business Hub China
Address: c/o Embassy of Switzerland, Beijing
Tel: 0086 10 6532 2736 ext. 218
Fax: 0086 10 6532 43 53
Email: beat.buergi@eda.admin.ch
Website: www.osec.ch/sbhchina

Date of latest update: Oct. 4th, 2005

SinOptic – Services and Studies on the Chinese World

Purpose/Mission of Organization
To help supporting the relations between Switzerland and the Chinese World

Nature of Organization
(X) Private ( ) Public
( ) Non-profit ( ) Commercial
Membership: ( ) required ( ) not required

Basic Information
Number of employees: 1
Founded in (year): 1998
Legal form: individual company

Services in the field of China Entry & Operations

• SinOptic provides basic services	
• Online Sino-Swiss Information platform	Free
• Translation (mainly French-Chinese and Chinese-French)	payable
• Establishing and managing websites	payable
• Desktop publishing in Chinese language	payable
• Organizing delegations and companies visits to China	payable
• First help and orientation for SME's	payable
• Training on Chinese culture and civilization	payable
• Information for media	both
• Leaflet for specific organization (example: Hotel & Tourism)	payable

Contact Information
Contact Person: BÉROUD Gérald
Address: Avenue Juste-Olivier 2, 1006 Lausanne
Tel: +41 21 331 15 80
Fax: +41 21 331 15 61
Email: info@sinoptic.ch
Website: www.sinoptic.ch

Date of latest update: 3 Oct 2005

Swissmem (ASM and VSM)
The Swiss Mechanical and Electrical Engineering Industries

Purpose/Mission of Organization
Swissmem is the association of Switzerland's mechanical and electrical engineering («MEM») industries. Swissmem represents the business, social and training policy interests of some 950 member companies in dealings with political bodies, national and international organizations, employee representatives and the public. Swissmem offers to member firms a range of practical services, such as consulting on export issues, assistance with labour law problems, sector-specific educational and training programmes and marketing and export promotion activities.

Nature of Organization
( ) Private ( ) Public
(X) Non-profit ( ) Commercial
Membership: ( ) required ( ) not required

Basic Information
Number of employees: 80
Founded in (year): ASM (1905) and VSM (1883)
Legal form: Association

Services in the field of China Entry & Operations

• Trade statistics	Free for members
• Trade show organization	Payable
• Swiss Manufacturing Center (Business Park with Human Ressources and services for assembly, adaptation, spare parts logistics, sourcing)	Payable
• Economic information on specific markets	Free for members
• Legal and standards information, government relations	Free for members

Contact Information
Contact Person: Mr. Kurt A. Meier
Title / Function: Head of Division "Industry Sectors and International Affairs"
Address: Swissmem, P.O. Box, CH-8032 Zurich
Tel: ++41 (044) 384 41 11
Fax: ++41 (044) 384 42 42
Email: k.meier@swissmem.ch
Website: http://www.swissmem.ch

Date of latest update: 8. September 2005

SIHK Chambers of Commerce and Industry Switzerland

Purpose/Mission of Organization
The SIHK comprises of regional private chambers of commerce and industry for all kind of branches throughout Switzerland. Primary the small and medium sized enterprises are members to such chambers, but also major enterprises benefit from the services they provide.

Nature of Organization
(x) Private
(x) Commercial
Membership: (x) not required

Services in the field of China Entry & Operations

• The regional chambers offer different services to support Swiss companies expanding their business to China. Below are mentioned examples of such services. Please contact your regional chamber for details on the services they offer.	
• Access to database "Swissfirms" containing 12'000 registered companies and their services	free for members
• Seminars on topics in Business and Exports	payable (reduced rates for members)
• Consulting in Exports	free / payable
• Issuing of export papers and forms	payable (reduced rates for members)
• Forums on business topics	free for members
• Member of Business Network Switzerland: contacts to Osec, seco, Swiss Business Hub's, Chambers of Commerce in Switzerland and foreign countries, Swiss Center Shanghai	free

Contact Information
The SIHK is currently led by the IHK St. Gallen-Appenzell:

Contact Person: Margrith Neuenschwander
Title / Function: Head of Export Department,
Member of the Board IHK St. Gallen-Appenzell
Address: Chamber of Commerce and Industry St.Gallen-Appenzell, Gallusstrasse 16, 9000 St.Gallen
Tel: +41 71 224 10 30
Fax: +41 71 224 10 61
Email: margrith.neuenschwander@ihk.ch
Website: www.cci.ch

Date of latest update: 26.09.2005

SwissCham China
(Swiss Chinese Chamber of Commerce in China)

swisscham.org

Purpose/Mission of Organization
The Swiss Chinese Chamber of Commerce in China (SwissCham China) is a legal organization to represent and promote the Swiss-related business community in China and to foster synergies among its members in all aspects of common interest

Nature of Organization
(x) Private ( ) Public
(x) Non-profit ( ) Commercial
Membership: (x) required ( ) not required

Basic Information
Founded in (year): 1995
Ownership, parent organizations, linked organizations: SCCC
Legal form: Association

Services in the field of China Entry & Operations

• Events and Networking	Payable (member discount)
• Lobbying towards Chinese Government and Administration for specific cases	Payable (member discount)
• China Orientation & Triage	free
• Representation of Swiss companies' interests in China	free (for members)
• Specific information gathering for China entrants	Payable (member discount)
• Seminars and specific training on operations in China	Payable (member discount)
• Magazine "The Bridge"	free
• Directory of Swiss companies in China	free
• Swiss China Survey	Payable

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Date of latest update: 8 November 2005

Swiss-Hong Kong Business Association

Purpose/Mission of Organization

- To promote and facilitate trade and business opportunities between Switzerland and Hong Kong.
- To promote co-operation between Switzerland and Hong Kong for business and associated issues.
- To provide a conduit for the representation of Hong Kong interests in Switzerland.

Nature of Organization

(X) Private ( ) Public
(X) Non-profit ( ) Commercial
Membership: (X) required
(X) not required (service fee)

Basic Information

Number of employees: 1
Founded in (year): 2004
Ownership, parent organizations, linked organizations: Swiss-Chinese Chamber of Commerce, Hong Kong Trade Development Council (HKTDC), Member of Hong Kong Federation (of Associations worldwide)
Legal form: Association

Services in the field of China Entry & Operations

- Opportunities to interact and network with experts in doing business with Hong Kong and China.
- Regular information and events.
- Access to a database with business contacts.
- Support in market research and more.

Contact Information

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Date of latest update: End of September 2005

Swiss-Chinese Chamber of Commerce

Purpose/Mission of Organization
To promote trade and business relations between Switzerland and China and to support Swiss companies and individuals doing business with and investing in China. To maintain contacts with government authorities, economic institutions and trade associations of both countries to represent the economic interests of Swiss companies and to contribute to the development of the Sino-Swiss economic relations.

Nature of Organization
(X) Private ( ) Public
(X) Non-profit ( ) Commercial
Membership: (X) required
(X) not required (service fee)

Basic Information
Number of employees: 2.2 + voluntaries
Founded in (year): 1980
Chapters in Geneva, Lugano, Legal Chapter in Zurich, Partner organizations: SwissCham China, Swiss-Hong Kong Business Association, Member of ECBA (Euro China Business Association) and of SwissCham (Association of Swiss Foreign Trade Associations)
Legal form: Association (registered)

Services in the field of China Entry & Operations

Business Contacts - Assistance in establishing business contacts in China or Switzerland and in locating suitable agents, representatives, importers or exporters, manufacturers and suppliers. Free of charge to members.

Business Advice - Opportunities to meet with professional staff to discuss general or specific issues on the China market. Individual consultations are free of charge to members.

Information Services - Diversified information and documentation service, including database access. The Legal Chapter provides regular information on important Chinese legislation and regulations. First response to inquiries on legal issues is offered free of charge to members.

Public Affairs - Events and seminars throughout the year, featuring prominent personalities from business and public life from both countries (discount for members).

Publications - Quarterly Bulletin (included in membership fee), which summarizes important business information and facts. Members can use free of charge space for publishing their company news related to China and take advantage of advertising space at reasonable cost. Swiss China Survey among managers of Swiss companies in charge of China business activities in Switzerland and China.

Delegations – Assistance to Chinese delegations in their visits to Switzerland and support to Swiss business people going to China. Members are given priority in meeting delegations.

Government Relations - Maintaining regular contact with Swiss and Chinese Government agencies. Members may benefit from this network by facilitated contacts to these organisations through the Chamber.

Language Services – Link to intensive Chinese language courses, continuation courses or contacts for private language lessons. Links to qualified and specialized interpreters and translators. Reduced rates for members.

Human Resources - Support for companies and individuals in finding the right person or position in Switzerland and/or China (and other Asian regions). Link to specialists for search and integration of expatriates or local managers and specialists etc.

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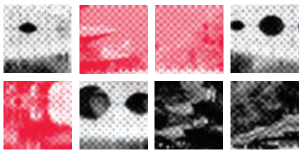
Date of latest update: End of September 2005



Export Risk Guarantee – e r g

Purpose/Mission of Organization
e r g is the official Export Credit Agency of Switzerland. It facilitates conclusion of exporters' foreign contracts by providing insurance cover against certain export risks (mainly payment risks).

Nature of Organization
( ) Private (x) Public
( ) Non-profit ( ) Commercial
Membership: ( ) required (x) not required

Basic Information
Number of employees: 15
Founded in (year): 1934
Ownership, parent organizations, linked organizations: Swiss Government
Legal form: Government agency

Services in the field of China Entry & Operations

• Export Credit Insurance ERG offers insurance products for short-term as well as medium-/long-term business against political, transfer and commercial risks.	Premium payable
• Project Finance A special scheme for covering project finance transactions is in place.	Premium payable
• Bonds and Bank guarantees. ERG provides cover against unfair calling stemming from political reasons.	Premium payable
• Investment Risk Insurance ERG administrates the investment risk insurance scheme of the Swiss government.	Premium payable
• Offers Offers for an insurance cover on a preliminary basis are valid for 6 months.	free
• Types of goods ERG can cover all types of exports such as consumer goods, investment goods or services. They must be of Swiss origin or meet a certain value-added portion made in Switzerland.	

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Date of latest update: 8 September 2005

Swiss Organisation for Facilitating Investments - SOFI

SOFI
SWISS ORGANISATION FOR FACILITATING INVESTMENTS

Purpose/Mission of Organization
To promote investment projects of Swiss companies in countries with developing and transition economies, and to enable the transfer of capital, technological know-how and managerial expertise through this process.

In China, SOFI concentrates on promoting and supporting investments of Swiss companies in emerging regions, where SOFI builds on partnerships with selected industry zones and local investment promotion agencies. Regions/Cities with particular activity are Sichuan, Chongqin, Jiangxi Province, Wuhan.

Nature of Organization
(x) Private, with public mandate
(x) Non-profit ( ) Commercial
Membership: ( ) required (x) not required

Basic Information
Number of employees: 25
Founded in (year): 1997
Ownership, parent organizations, linked organizations: KPMG/seco
Legal form: AG

Services in the field of China Entry & Operations

• Consulting services on investment strategy, project structuring, financing and implementation.	Partially payable
• Financing through the seco Start-up Fund (SSF), and access to other financing sources	Financing through start up fund is a repayable loan with interest
• Access to information about investment conditions and opportunities in economies under development or in transition	For free
• Support in search and selection of partners from industry and finance	partially payable

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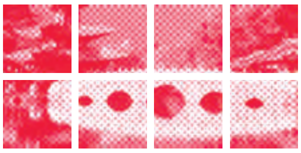
Date of latest update: 3.10.2005



Osec Business Network Switzerland

Purpose/Mission of Organization
Osec Business Network Switzerland (Osec) is the official federally-mandated promoter of Swiss foreign trade. As a network partner of Osec, the “Swiss Business Hub China” offers specific services to small and medium-sized enterprises (SMEs) from Switzerland and Liechtenstein to help them to launch and develop their business relations in China.

Nature of Organization
(x) Private ( ) Public
(x) Non-profit ( ) Commercial
Membership: ( ) required (x) not required

Basic Information
Number of employees: 72
Founded in (year): 1927
Ownership, parent organizations, linked organizations: OSEC is mandated by Seco, the Swiss Business Hubs are managed by OSEC
Legal form: Association

Services in the field of China Entry & Operations

• Providing up-to-date market-relevant information and product data (in cooperation with the Swiss Business Hub China)	Payable (member discount)
• Assisting companies who are seeking distributors, representatives and import partners (in cooperation with the Swiss Business Hub China)	Payable (member discount)
• Individual consulting for small and medium-sized enterprises	Payable (member discount)
• Assistance to SME’s participating in trade fairs in Chinese cities and reporting on these events (in cooperation with the Swiss Business Hub China)	Payable (member discount)
• Information about the Chinese economy and market via the central information platform at Osec Business Network Switzerland www.osec.ch	free
• Organizing promotional events for Swiss industry and providing media access	free (case by case)
• Providing information on the Swiss economy to Chinese companies and media (in cooperation with the Swiss Business Hub China)	free
• Swiss China Survey project leader	Payable

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Date of latest update: 11.10.2005

State Secretariat for Economic Affairs (Seco)

Purpose/Mission of Organization
The seco is the Confederation's competence centre for all core issues relating to economic policy. Its promotion activities directorate's task is to promote Switzerland's attractiveness as a business location. This includes the promotion and coordination of export , e.g. through the webbased China Coordination Platform as well as the mandated Osec Business Network Switzerland, which supports Swiss companies in expanding their business abroad (see Osec Business Network Switzerland).

Nature of Organization
Nature of Organization
( ) Private   (x) Public
(x) Non-profit   ( ) Commercial
Membership: ( ) required (x) not required

Basic Information
Number of employees: 553
Ownership, parent organizations, linked organizations: Osec Business Network Switzerland is mandated by Seco
Legal form: Government

Services in the field of China Entry & Operations

- The China Coordination Platform web-site informs and thereby supports all the federal organizations, business and economic agencies which are, in whatever way, involved in China — For free
    - The China Coordination Platform shall create synergies between different organizations of support
    - On the website, partners can introduce themselves and their activities in China
    - The Event Calendar on the China Coordination Platform contains information on China-related projects, events, workshops, exhibitions, etc.
    - The E-Mail-Tool of the China Coordination Platform allows users to post project ideas as well as searches and proposals for potential collaborative partners etc for the attention of other subscribers
- Swiss China Survey project leader

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Index