Sizing up Chinese markets

How to go about doing business in — and with — China **Interviewed by Adam Burroughs**

China's economy is growing at a fast pace and its government has worked to attract foreign companies, which is opening opportunities for them to get involved in the country's market.

"There is a demand and need by so many Chinese companies that have capital and want to expand their business but don't have the technology a lot of U.S. companies have," says Julia Zhu, senior counsel in Dykema Gossett LLP's corporate finance group.

There are lots of matching opportunities for U.S. companies that have great technology but don't have a market or the capital to expand their business, which she says creates a good environment for U.S. companies.

Smart Business spoke with Zhu about how to enter the Chinese market.

Julia Zhu
Senior counsel
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What do business leaders need to know about doing business in and with China?

First, it's about the business structure you want to set up. Choosing a physical presence in the country or a procurement strategy depends on whether the company wants to produce goods or services in China for the domestic market. If the foreign company's focus is on exporting, it might consider using China as a manufacturing base for finished goods or do production outsourcing, which means a straightforward procurement strategy. This can be good for foreign businesses new to Chinese markets while keeping the option open to setting up local production later.

What are some options in regard to business strategy and structure?

If the foreign business wants to set up a physical presence in China, two of the most popular choices are wholly foreign-owned enterprises and joint ventures.

Having a wholly foreign-owned enterprise means you have the sole responsibility for profits and losses. It takes less time to establish because the foreign company doesn't need to find a local partner or enter into a joint venture contract. Also, this structure gives the foreign owner greater control over company operations, training and recruitment of employees, and better protection of intellectual properties.

With joint ventures, there are two types — an equity joint venture is typically used for long-term projects, and a cooperative joint venture is better suited for short-term projects.

Generally, joint ventures are preferred when a foreign company wants to enter industries for which the Chinese government has restrictions on investment. The government has a list of all the industries in which companies can invest only through joint venture structure.

A joint venture can also be preferred when a company needs a partner to share its capital burden. Chinese companies can have certain technological or distribution advantages, making a joint venture an attractive choice. Successful joint ventures are imbued with clear rules and clear strategy between partners.

There are some disadvantages, such as statutory features where Chinese law requires unanimous approval from a company's board of directors for major issues, including capital changes and mergers and acquisitions.

How should location factor into a company's strategy?

Location can be very critical to the success of foreign investors. They need to look at the nature of their business, as well as incentives offered by the local government, their logistical needs, import and export requirements, and government inspections and restrictions.

The theme now is to go west. The Chinese government has implemented tax policies as a strategy to encourage investors to go west. In some cases, qualified foreign investors can have tax holidays.

When people talk about investing in China, they often talk about first-tier cities, such as Beijing, Shanghai and Guangzhou. However, investors should consider second-tier cities such as Nanjing, Dalian, Wuhan and Chongqing that have cheaper labor costs, greater government support and less competition.

What protections exist for intellectual property?

Intellectual property (IP) is a big concern for foreign investors. The government has taken measures to improve the IP environment. Although China's IP environment is risky, many foreign businesses have found a way to work in it. The key is to take a proactive, strategic approach rather than a purely legal approach. Businesses should engage the legal system while reducing dependence on it. While traditional legal methods of protecting IP may not always be effective, copyrights, trademarks and patents should still be registered as an important starting point.

Some companies avoid manufacturing innovative, high-margin products in China and instead focus on mature commodity products with lower margins. Others might develop products in countries with better IP protection and bring them to China to guard certain proprietary details. You can also protect yourself with thorough investigation. Watch markets for products like yours, educate suppliers and employees regarding enforcement, and execute agreements to retain key employees.

How else does the Chinese legal system affect business?

Legal compliance in China is different than in the U.S., where one has the narrow task of following existing laws. In China, legal compliance should not be viewed as a standalone legal requirement removed from corporate activities and results, but as a key driver of project completion and investment returns. For business planning, it's helpful to divide those compliance issues into several categories, such as actions that cause a project not to be approved; internal operating issues, such as those pertaining to labor; external laws, such as bribery and breach of contract; and investment exit issues. By taking a broad view of compliance and conceptualizing compliance issues as a vital part of business performance, it is possible to formulate a compliance strategy that substantially increases the likelihood of success of foreign business. <<

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