Entering China: An Unconventional Approach

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If you're thinking about doing business in China, you've no doubt heard the conventional wisdom that the best -- indeed, the *only* -- way to enter China is through an equity joint venture (EJV) with a well-connected Chinese partner.

Hear again. China is changing, and with it, so are the opportunities and challenges facing foreign companies that want to operate within its borders. While EJVs are still necessary in some regulated sectors, and foreign investment is prohibited in still others, there is a growing trend toward a new and possibly much more effective way of doing business in China -- as a WFOE, that is, a wholly foreign-owned enterprise. For all intents and purposes, EJVs and WFOEs are substantially the same in terms of taxation and corporate liability. They also operate under similar foreign exchange rules and comparable import and export regulations for licensing, quotas, and duties. In fact, their only real differences are that WFOEs take less time to establish than EJVs, are not technically required to have a board of directors, and are currently prohibited in some sectors in which EJVs are approved.

Government statistics on the numbers of WFOEs currently in operation in China are dated and perhaps misleading as they do not discriminate between businesses and holding companies. But based on my experience, I would characterize the movement toward WFOEs as dramatic. In fact, I anticipate that half of all foreign investments in China will be WFOEs by the year 2000. Consider: At the Suzhou Singapore Investment Park an industrial development area called a "showcase of the future" by the Chinese government, 94% of the 120 business projects approved so far are WFOEs, each with an average investment of $30 million.

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Why are WFOEs taking hold in the current environment? The answer is *not* a change in China's legal or regulatory codes. Instead, pioneering companies, frustrated by the limitations and under performance of EJVs, have begun experimenting with setting up WFOEs. Many of them have found minimal resistance from the authorities. Chinese officials are proving far more concerned with *what* outside investors bring to the country -- in terms of jobs, technology, and foreign exchange -- than *how* the deal is structured. At the same time, foreign investors are finding that WFOEs, because of the flexibility and managerial control they deliver, are an excellent fit with China's competitive situation today. The bottom line: WFOEs may well be the win-win China strategy that business people around the world have been waiting for.

Consider the example of Johnson and Johnson. The company is famous in China for its successful pharmaceutical EJV, one of the few examples of a highly functioning partnership. But in 1992, seeking more control over the sourcing and marketing functions, the company decided to launch its new baby, oral care, and feminine hygiene products venture as a WFOE. As hoped, the WFOE delivered the managerial control the company desired, and the results have been impressive. Since production began in 1994, the new WFOE's revenues have increased 40 to 50% a year. Indeed, the project is so successful that the company decided to make its latest investment -- the manufacture of heart devices -- a WFOE as well. And the company has indicated that in the future, all new investments in China will be WFOEs instead of EJVs, unless a Chinese partner offers a very significant contribution.

Contrast the Johnson and Johnson case with the experience of an American household products company which entered China in 1990 in an EJV with Shanghai Jahwa Corp., China's largest cosmetics manufacturer. The American company intended to capitalize on Jahwa's brand equity and distribution to push its own product line. Moreover, it hoped its Chinese partner would provide guanxi, the social and political connections required to make business run smoothly in China. Jahwa, meanwhile, had hoped the American company would upgrade its technology and increase its competitive capabilities both locally and abroad. These two companies shared the same bed, as it is said, but had different dreams. Their disputes over direction and resources paralyzed operations for three years. In 1993, Jahwa withdrew its top brands from the EJV and sold its share, leaving the American partner scrambling for another local partner to salvage its investment and save face.

Indeed, the number of unhappy EJV stories such as this one are accumulating, and for similar reasons. To make matters worse, when EJV partners come to realize that their union is not working, Chinese culture makes EJVs hard to dissolve because relationships based on trust and confidence constitute the basic fabric of Chinese society. Same bed, different dreams -- and divorce difficult! No wonder some companies have begun exploring the WFOE option.

China in Flux

China is a mystery to many foreign investors, and for good reason. The country is vast and varied, its culture and traditions deeply different than those of the West, its social, governmental, and economic systems unimaginably complex. These exigencies alone would make a joint venture difficult. After all, joint ventures are notoriously hard to sustain even in the relatively stable environments of the U.S. and Europe. But today foreign investors must add to the China mix several other ingredients. Each of these make an EJV less viable, and suggest a WFOE is the better alternative.

First, the Chinese marketplace is rapidly evolving, fragmenting, and becoming more competitive as more and more foreign companies set up operations there. Many new entrants are vying for first mover advantage, and top players in some of the most promising industries, such as consumer packaged goods, infrastructure, construction, chemicals, pharmaceuticals, and electronics, are pursuing aggressive growth strategies with a focus on market share. Some companies are willing and able to sustain losses in order to establish beachheads in China, be they in the form of manufacturing plants, distribution networks, or consumer awareness. The result has been greatly expanded capacity, in some cases over capacity, which in turn has led to price wars -- and thinner operating margins.

Similarly, many foreign companies are attempting to expand nationally in China, an attractive but extremely difficult course. The distribution system in China is currently quite chaotic and undergoing fundamental changes. For example, in Shanghai the major retailers have recently restructured into three groups, the Number 1 Department Store group, the Hua Lian Group, and the Friendship Store Group, which control the majority of retail space in that city of 13 million residents. In restructuring, these retail outlets are also expanding nationally and trying to integrate the wholesale function, traditionally the weak link in China's distribution system, by buying directly from manufacturers.

At the same time, the traditional three-tier (national, provincial, local) distribution system in China is crumbling and giving way to various parallel channels charging different fees and providing different services in every geographic area. Nokia, the Finish company which sells cellular infrastructure and phones in China, recently identified at least six different channels for its phones -- with retail prices varying as much as 20% between them. These examples tell the same story: Getting your product to market in China can be daunting. Expanding its scope even more so.

Exacerbating matters is China's industrial structure, a remnant of China's traditional planned economic system, which was in operation until 1979. The planned system created an enormously fragmented industrial environment. Companies were required to make either a narrow line of products or operate in a narrow market niche. Today, most companies retain this cramped scope. Very few have a national presence, and those that do have already been "cherry-picked" by early entrants, such as Coca-Cola. In other words, the prospects for a EJV partner who brings national scope to the equation are few and far between.

China's planned economic system also left in tact a rather rigid and hierarchical administrative structure. Every Chinese company belongs to and operates under some combination of local, provincial, and central government authority, each with its own agenda (and, hence, conflicting interpretation of rules and regulations). Borders between the authorities are sharply drawn, and many compete with each other for resources and regulatory protection. Hence, if a company -- your EJV partner, for instance -- tries to do business outside its current authority's territory, difficulties often ensue.

Take, for example, China's fixed-line telephone network, which is owned by and operated under the Ministry of Post and Telecommunication. Accordingly, the local operating companies (local PTTs) belong administratively to the MPT. These local companies are all in the market for telephone switching equipment to upgrade and expand the network they operate. Shanghai Bell, Alcatel's large switching equipment EJV in Shanghai, has as Chinese partner under the MPT where its competitors such as NEC, Siemens, and AT&T all partner with entities under competing ministries which are neither involved nor have regulatory authority over China's fixed-line network. It is no surprise that Shanghai Bell has some advantage selling its equipment to the local operating companies and commands a more than 50% market share.

Another aspect of this problem with market access: it's becoming increasingly common that some Chinese partners are unable to find buyers for the EJV's output. In 1993, Matsushita formed an EJV with Hualu Electronics Corporation hoping to capitalize on Hualu's extensive domestic sales network to tap into the domestic market. Originally, the plan was for Hualu to buy 80% of the joint venture's VCR components, which would then be installed in VCRs to be sold in China. Since a brand-new factory has been opened in Dalian in

1994, however, most of the 45 production lines have been idle. Hualu is simply unable to absorb the joint venture's output. The bottom line of this, and many stories like it: access to Chinese markets through an EJV is more limited than many foreign investors had previously hoped, and much more limited than most EJV partners can deliver.

Access to Chinese markets is also being hindered today by what was once thought to be the great door-opener: guanxi. Guanxi has been long touted as an invaluable asset to foreign investors. This assertion is still true. But more and more foreign companies are finding out that the scope of the guanxi of their Chinese partners is limited or may take them in directions that are difficult to control, or simply may not be strategically opportune. In addition, some companies are finding guanxi may actually not be cost-effective. The Danish company Novo Nordisk, in negotiating with two potential pharmaceutical partners, realized it could get all the approvals and access to the bureaucracy in Beijing on its own. It ended up creating a $125 million biotechnology WFOE in Tianjin.

Finally, foreign investors today are being faced with different perceptions and expectations on the part of the Chinese than had previously been known. For instance, it is now commonly understood that most Chinese companies lack the business experience to keep up with the speed and scope of change in the Chinese marketplace. Sales and marketing are still largely approached with an order-taking mentality. And, not surprisingly, the whole concept and practice of free-market competition is alien to many Chinese. A significant portion of foreign companies have found it hard to keep their Chinese partners motivated for a fight, particularly when a comfortable market position and level of operating profits have been attained. Krohne, a German manufacturer of electromagnetic flow meters, for instance, was a pioneer in entering China in 1985. It negotiated a minority equity stake in an EJV with a local partner in Shanghai. Within five years, the EJV was responsible for 60 %

of the installed base of flow meters in China, and was enjoying a significant operating profit. This market position delighted the Chinese, who took it as a signal to relax their efforts, causing enormous anxiety to Krohne managers. They saw the company's success as an invitation to competitors, and strongly urged their Chinese partners to step up actions and investments to protect against the coming onslaught. Today, unable to come to an agreement about the best direction for the company in China, Krohne and its partner are in legal negotiations. Krohne, anxious for more managerial control, is hoping to sharply increase its equity stake in the venture.

Another area of conflicting perceptions and expectations today has to do with technology spillover. Indeed, this perhaps the grayest of many gray areas in doing business with China. The desire for technology is one of the reasons China has opened its markets in the first place. Foreign companies are expected to share "what they know" with emerging Chinese companies. But how much? Chinese companies, naturally, want as much as possible. Foreign investors, however, are reluctant to give away advanced and proprietary technology for fear that it will be copied -- especially in light of China's sporadic enforcement of intellectual property rights.

In addition, it is now widely acknowledged that most Chinese companies seek profits on a much shorter time horizon than foreign investors. This orientation most likely arises from concerns that the China's experiment with capitalism may not last; these concerns may in fact be legitimate given China's swinging pendulum of government policy in recent times. Meanwhile, foreign companies entering China are sometimes willing to sustain losses for growth, as noted above, or more typically desire to reinvest their profits for further expansion.

Differences of opinion about profit-taking has led to tensions in many an EJV. In fact, they ended up destroying the 1990 partnership between an American division of Saint Gobain, the diversified French group, and a

Shanghai tool manufacturer. The Chinese partner considered the EJV a subsidiary, and sought a quick profit from it. By contrast, the division of Saint Gobain viewed the EJV as a vehicle for strategic entry into China, spending $10 million to launch it. Not surprisingly, when market conditions hit a rough period soon after the partnership was formed and the joint venture began to lose money, the Chinese lost interest in the deal. (In fact, they neglected the project so completely, that morale problems led to a rare strike by workers.) St. Gobain's division meanwhile scrambled to keep the venture alive. Finally, after years of legal wrangling and central government involvement -- and an additional $20 million of investment by the division of St. Gobain -- the company bought out its Chinese partner and turned the EJV into a WFOE in 1996, the first such conversion in Shanghai.

This case, in fact, illustrates the major advantages of WFOEs: They offer foreign investors markedly increased flexibility and control. They allow managers to expand as quickly as they want and where they want -- obviously within the constraints of the Chinese system, but without the burdens of an uncooperative partner. WFOEs also mean foreign companies set up, manage, and protect their own processes and procedures, which enable greater strategic, operational and cost oversight. WFOEs are also faster to establish than EJVs; according to Chinese regulations, local authorities are required to respond to initial project proposals within 30 days. EJVs on the other hand, can take years of negotiations to get up and running. In short, WFOEs deliver efficiency and effectiveness to an economic system where both are in short supply.

But with this enthusiasm, some notes of caution must be sounded.

First, a WFOE begs the question of guanxi. Can all companies follow the Novo Nordisk example and make the necessary political and social connections themselves? The answer is no. However, some sophisticated foreign investors are increasingly relying on agency agreements with Chinese parties to make liaisons on their behalf, and to help in procuring land, materials and services. These companies identify exactly where connections will help and who has them, and then engage the Chinese individuals, companies, or organizations with the access to the decision-making authorities as "advisors" on short-term contracts.

In addition, WFOEs do raise important questions about cultural and economic sovereignty. Naturally, the Chinese don't want foreign companies taking advantage of their country. A WFOE, if it is perceived as a foreign island, is particularly vulnerable to criticism in this context. It is critical that WFOE managers recognize this concern and address it. One way to do so is to localize production -- that is, to buy as many parts and components from local Chinese suppliers. Another is to hire Chinese managers. Motorola, for instance, has only ethnic Chinese managers, very few of them holding U.S. passports. Foreign companies can also be active in social responsible projects, such as financing community movie theaters. (Along similar lines, several foreign companies have recently shown their commitment to public safety by buying new cars for their local police departments.) WFOE companies can also nurture local brands. Coca-Cola, for example, recently transferred the trademark of its new Tian Yu Di fruit drink to Tianjian Jinmei Beverage Co., a local producer of concentrate. This move was warmly received as an example of the company's sensitivity to being an outsider in a country where it is valued to be a piece of the puzzle instead of a hammer on a nail. Indeed, if you behave like a hammer as a foreign investor in China, the nail will probably be into your own coffin!

Finally, it is important to note that WFOEs simply are not permitted in some industries, such as financial services and insurance. In general, they are prohibited in all the service sectors. But then again, the regulatory environment is still very much evolving, with more sectors opening up for foreign investment every year. The reason: China simply lacks the skills and resources to develop most of its industries on its own. I believe that if neither national security nor political and social stability are threatened, investment access will eventually be given, and with it increasingly the approval of WFOEs.

WFOEs in Action

Today, WFOEs operate in all those areas where EJVs currently are approved: manufacturing of machinery, instruments and equipment, electronics and computers, communications equipment, and in the light industries, such as textiles, foodstuffs, and packaging. In some sectors, such as the automotive and telecommunications industries, heavy regulations do apply, which typically implies that EJVs are a safer bet. However, as Motorola has proven in Tianjin and GM has proven in Guangzhou, WFOEs are possible even in regulated industries as, respectively, telecommunications and automotive components.

But more important than what the rule books say word-for-word is the principles that underlie them. As noted above, China wants and needs its foreign investors to bring something of value to the table. If they do, my experience has shown that time and time again, the form of investment is largely negotiable. It is in this way that WFOEs are just as feasible as EVJs the way to enter the market of the Middle Kingdom.

So, what's of value?

Articles 5, 6 and 7 of China's Provisional Regulations on the Guidelines of Foreign Investment, promulgated on June 27, 1995, illustrate the government's concern for not just national security, social welfare and stability, but for the environment and the use of the nation's scarce arable land. They also show the government's interest in improving technology in the "priority" sectors of agriculture, energy, transportation, and industrial raw materials. Likewise, several other technologies are highly attractive: those which improve product quality and raw material efficiency (including recycling), provide products and materials in short supply domestically, and develop resources in the hinterland and/or have the potential for export.

A word about export. Some investors mistakenly believe that there are higher export quotas for WFOEs than EJVs. In reality, WFOEs probably do export more of their production; this is, however, not a result of Chinese regulations, but an outcome of approval negotiations. Unless the venture brings something China wants, Chinese approval authorities will demand an export quota of at least 50% from WFOEs as a kind of "fee" for not working with a Chinese partner. Moreover, they use this fee as a way to rationalize their approval of the WFOE to higher government authorities in the bureaucracy.

In reality, however, higher export quotas on WFOEs are not a major obstacle. In fact, apart from the 70%-or-higher export quota in Article 11 to secure approval of projects in *restricted* industries, the rules and regulations on EJVs and WFOEs do not contain specific percentages for how much a foreign company doing business in China needs to export or how much it is allowed to sell domestically. The EJV regulations stipulate only that "exports are encouraged," which is typically interpreted as more than 50%. Lower percentages can be negotiated when the products are urgently needed in the domestic market or they substitute products currently imported and, hence, save China's hard currency. Similar principles hold for WFOEs -- although in practice, Chinese approval authorities have tended to stick to a minimum 50% export quota. On the other hand, I know at least of one WFOE recently approved in Shanghai that has a no export quota whatsoever, given the advanced technology involved.

Also helping the WFOE cause is the fact that a gradual process of liberalization is going on in China with more and more sectors opening up for foreign direct investment. Although some sectors are likely to remain closed, local governments in particular are showing some "give" in their interpretation and implementation of laws and regulations, often with the objective of forcing Beijing's hand in relaxing or changing rules. For example, some WFOE retailers exist --even though this is a sector closed to foreign investors. Such retailers have no import/export rights (for which State Council approval is needed). Some do not even have a retail license from the Ministry of Internal Trade, operating instead under a real estate management license provided by the local government. The foreign investors behind these operations prove that WFOEs are only a matter of trying -- of pushing the limits and experimenting. This may make many corporate attorneys squirm, but that is to be expected of this breed!

Not All or Nothing

You may be wondering, if WFOEs make sense from a business and practical perspective, why even bother with an EJV? The answer is that decision between a WFOE and an EJV is not necessarily an "either/or" one. Sometimes a Chinese partner does have a strong distribution network, or operates in a restricted sector that is attractive a foreign investor. If a situation like this is the case, foreign companies can, for instance, configure a production operation which is a WFOE surrounded by EJVs that market and sell their products in China. The Motorola operation in Tianjin is exactly that. Since 1993, Motorola has been laying the groundwork for the US's biggest manufacturing venture in China. Its $300 million-plus commitment to China focuses on pagers, simple integrated circuits, cellular phones, and eventually also automotive electronics. The production site in the Tianjin Economic Development Zone is a WFOE; marketing and sales of the products will be done through various EJVs with local partners.

Another possibility is to consider an EJV and a WFOE as a natural sequence: initial entry and operation as an EJV with a fixed time period at the end of which the foreign partner takes over the assets from the Chinese partner and continues to run the operation as a WFOE. This is certainly an attractive alternative if the added-value of the Chinese partner is significant but limited to the early stages of the EJV. Some EJVs have integrated this option in the termination clause of the EJV contract.

Finally, it is possible to structure a WFOE under the legal umbrella of an EJV. In other words, the project would be an EJV legal entity but run and operated as a WFOE. Many foreign partners that have increased their equity stakes in existing are going in that direction, in some cases turning their Chinese partner into a silent partner with a minority stake.

New Bed, New Dreams

In 1996, the Chinese leader Deng Xiaoping exhorted his countrymen to embrace and accelerate economic reform if China was to avoid the fate of the Soviet Union and other fomer socialist republics now grappling with free-market systems. "I'm afraid the opportunity may be lost," Deng said, "If we do not seize it, it will slip away."

The same advice might well be given to foreign investors considering the WFOE option. For if EJVs are a case of same bed, different dreams, WFOEs offer a new arrangement for foreign investors, and new hope for a more effective way to work and grow in a country with great promise.

But, just as in any competitive market, turning dreams into reality is challenging. China's complexities redouble that challenge. But foreign investors who can let go of the conventional wisdom that joint ventures are the only way to do business in China have a new way to reap the Middle Kingdom's vast opportunities. WFOEs are that way, there for the taking, for companies willing to seize the day.

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