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Don't rush your plan - an effective China strategy takes time

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Insurance giants Manulife Financial Corp. and Sun Life Financial Corp. are carving their niche in China with an eye to a market of 1.3-billion people. Furniture maker Shermag Inc. is importing cheaper, traditionally styled home furnishings from there. And Conspec Controls Ltd., a gas-monitoring equipment maker, operates a subsidiary in that country to sell technology to Chinese coal mines.

Whether it's the lure of China's vast market or access to cheap labour, experts agree that doing business with the economic giant isn't easy and companies need to do their homework before embarking on a China strategy.

"The road to China is not paved with gold," warns Alex Taylor, director of planning at Ottawa-based firm Dai Group, an international business-consulting firm. "It is higher risk than investing in North America -- but the payoffs can also be greater."

China's entry into the World Trade Organization nearly three years ago has meant a seismic shift from a central-planning to market economy, including a gradual reduction in tariffs and other barriers in doing business there.

But China is still a developing country and people forget that, Mr. Taylor says. "They go to Shanghai, to Nanjing Road, where they see the skyscrapers. . . . That's not representative of China . . . and is not where the factories are going up."

Margaret Cornish, executive director of the Canada China Business Council, agrees that investing in the Middle Kingdom is tough, and a "China strategy" should have support from the top brass. "You can expect to lose money, possibly for three years."

While graft and corruption were a problem in parts of China in the early 1990s, the upside now is that "the business environment has evolved substantially . . . and those issues are much less problematic," Ms. Cornish adds.

Despite the challenges, some Canadian firms that are part of a global supply chain need to go to China because their key customers have shifted most of their production to that cheap-labour country, and now want cost savings from their old suppliers, says Randall Chan, director of the China services group at accounting firm Deloitte. "Many of these companies are going to China for life-and-death reasons."

More companies are investing in China by setting up a wholly owned foreign enterprise or subsidiary these days, but some are still opting for the traditional joint-venture partnership. It was once the only way to do business there, and still is for certain "sensitive sectors," such as publishing, telecommunications and banking.

Toronto-based Lingo Media Inc., a supplier of English texts to China's primary schools with a Chinese partner, prefers to pursue the joint-venture route again to enter the wholesale-distribution business that has historically been closed to foreigners.

With an eye to more relaxed rules for that industry expected in December, Lingo-Media chief executive officer Michael Kraft says he is negotiating to buy a majority stake in two Chinese media distributors to "get us to the mark that much quicker."

Joint ventures can speed up entry into the China market and ease the financial burden, but experts advise doing due diligence. Canadian firms may think they are negotiating with a "mom-and-pop" operation when the potential partner could be owned by a Chinese competitor, Ms. Cornish cautions. "It's difficult to see corporate linkages in China."

Mr. Taylor says it is complicated to negotiate a good joint venture, noting it requires a lot of time managing that relationship, or *guanxi*. "It's your network of personal relationships," he says. "People in China like to be friends with who they do business with."

Burlington, Ont.-based Conspec Controls negotiated joint ventures for its gas-detection business with two state-owned Chinese companies in the 1980s, but ended up dissolving them in 1998 to create a wholly owned Beijing subsidiary in 2001.

"It was not working out for us," recalls Conspec president Enzo Ucci. "The business practices of our partners were not on the up and up. . . . We had one guy who started a restaurant, for example, with the company's funds, and was purchasing cars."

Mr. Ucci says that Conspec also faced competition from former employees who had blueprints for its "older" technology, but the company is now taking steps to protect its newest generation of products. "Our engineers here are doing things, and making it extremely difficult to duplicate in electronics."

Gerald Deyell, a partner at Blake Cassels & Gradon LLP in Calgary, acknowledges that intellectual-property violation is a big problem in China.

Companies need to make sure they are dealing with "reliable people," says Mr. Deyell, who is responsible for his firm's China initiative. "Enforcement of rights is more difficult."

Problems in finding the right partner has led more foreigners to set up wholly owned subsidiaries. That means a company has no partner with whom to share costs, and startups in China can be financially daunting for smaller firms.

The Canadian International Development Agency's industrial co-operation program, however, offers grants to fund feasibility studies and reduce other costs under certain conditions. For example, Conspec received a \$90,000 grant in 1999 to do a feasibility study on whether to start a China subsidiary, plus \$450,000 to help defray start-up costs.

Other issues to watch for include:

Foreigners in China often import expensive modern equipment instead of buying cheaper machinery and taking advantage of the low-cost labour to do the job, says Alfred Lau, head of the China desk at accounting firm KPMG. "You could lose money for a number of years before you recover the cost of that plant and machinery."

Canadian exporters face credit risk dealing with more "quasi-private or private companies" in China as opposed to firms that usually had the backing of the state, says Mark Bolger, regional manager for Asia and the Pacific at Export Development Canada.

"Some of them [Chinese companies] have very good credit transparency," says Mr. Bolger of the federal agency, which provides credit insurance to exporters. "Others, it's a question of, 'What financial statements do you want to see?'"

Canadian firms that want to source goods from China because of cheap labour costs should consider potential hostile reaction by rival domestic manufacturers in this country, warns Greg Somers, an international-trade specialist with Ogilvy Renault.

"There are various trade remedies that a Canadian company . . . can take against those imports," and that is a financial risk to be reckoned with, Mr. Somers says. "You risk having your imports into Canada . . . being priced out of the market."

Last August, Ottawa slapped tariffs of about 50 per cent on Chinese-made barbecues selling for \$100 to \$500, and the duties could become permanent if the Canadian International Trade Tribunal rules the domestic industry was hurt by the imports.

A China strategy needs to go beyond the political and economic environment, and incorporate sensitivity to quirks of Chinese culture, adds Mr. Chan of Deloitte.

"When [Chinese] people say 'yes,' it doesn't mean that they agree," he says. "It's just acknowledging what you have to say. . . . If you walk away thinking that you just cut a deal, and that the guy agreed to all your terms, you are going to be shocked the next morning to find people at your door wanting to negotiate."

Says Mr. Chan: "We do see many mistakes being made in the exuberance of the rush to China."

THE FIRST STEPS

Check out competitors

Study your target market, or hire a consultant to do so.

Visit China and attend major trade fairs. It's a diverse country and doing business in downtown Shanghai differs from working in western China.

Make contacts with potential customers, local government officials, suppliers, Chinese competitors and Western firms to understand the competitive drivers of your target market.

Hire professionals

China's fast-changing laws and regulations can affect your market. Hire Canadian legal and accounting firms doing business in China, or China-based firms, to help navigate the bureaucratic maze.

You may need advice, for example, on the trade law that came into effect July 1 and now permits companies to engage in foreign trade after registering with certain government departments. Previously, foreigners had to meet specific criteria and apply for government licences.

Accounting firms can also advise on the tax implications of different business structures, and available tax incentives.

Have a sound strategy

Draw up a business plan and figure out how the China venture fits in your overall strategy.

Determine the strengths and weaknesses of your major Chinese and foreign competitors. If you are an exporter, you want to be in a region with good transportation. If you want to sell in China, you want to be close to customers.

Have a Plan B, in case local government officials impose unexpected changes on your operations, such as an environmental assessment that requires soil cleanup.

Watch out for trade action

Develop a contingency plan in case domestic competitors file "anti-dumping" or other trade complaints in Ottawa against your cheaper Chinese imports. If they are successful, you could face preliminary, and then permanent, duties on your imports if the domestic industry was deemed to be hurt by them.

Hire a trade lawyer to calculate potential duties and determine the financial risk you face should you lose, or whether you could establish a successful defence.

Weigh joint venture vs. subsidiary

Understand the pros and cons of these business structures for your investment in China.

Joint ventures, which can give foreigners a leg up in the market and help defray investment costs, require due diligence to find the right partner. The risk is dealing with someone who ends up being a competitor or is indirectly owned by a competitor.

A wholly owned subsidiary enables you to have control over your business, but you are on your own in cracking the Chinese market. Be sure to plan an exit strategy because foreign companies need government permission to declare bankruptcy and it is more difficult to do so with a partner.

Hire and retain top managers

Make sure that you hire the right personnel, such as Chinese-speaking staff with the appropriate managerial skills.

Your general manager, who will oversee your China operations, should be someone you trust and who is familiar with local rules and regulations.

Because of fierce competition for managers with the right skills from both foreign and Chinese rivals, be sure you are not dependent on a single employee, and offer attractive wage-and-benefits packages to retain key people.

Find ways to protect property rights

Have a strategy to protect your intellectual property because enforcement of rights is difficult in China.

To prevent software or other technology from being duplicated by your Chinese partner, customers or competitors, keep the blueprint for your latest generation in Canada.

Educate your Chinese employees about the importance of protecting property rights.

Take advantage of grants

The Canadian International Development Agency's industrial co-operation program will help finance feasibility studies for ventures that will have a positive impact on job creation, technology transfer, local procurement, capital investment and creating new export markets for that country. Firms with annual sales of at least \$700,000 can apply for grants ranging from \$100,000 to \$150,000.

Another grant is available for the implementation phase to cover costs like training, environmental, social and gender-equality management plans.

Buy credit insurance

Protect yourself from potential non-creditworthy companies when exporting products to China. You can buy export-credit insurance from the Export Development Corp. or private insurers that will pay you most of what is owed in case the Chinese buyer does not pay. China's entry into the World Trade Organization has sparked a host of new, private companies -- some with questionable creditworthiness -- compared with dealing with traditional state-backed firms.

Understand cultural nuances

Pay attention to the importance of personal relationships and other cultural differences that could play a key role in doing business. It can be little things. In Chinese, there is a difference between saying "yes" or "*shi*" [pronounced "sher" in Mandarin], and "yes, I agree with you." The first "yes" is merely an acknowledgment of something you are saying, and should not be interpreted as the person agreeing to your terms. Otherwise, you could wind up with a rude surprise.

USEFUL RESOURCES

Federal government

Canadian International Development Agency's industrial co-operation program:

<http://www.acdi-cida.gc.ca/inc>

Export Development Canada: <http://www.edc.ca>

International Trade Canada: <http://www.infoexport.ca>

Canada-China business relations

Canada China Business Council: <http://www.ccbc.com>

Asia Pacific Foundation:

<http://www.asiapacificbusiness.ca>

Legal firms

Blake, Cassels & Graydon LLP: <http://www.blakes.ca>

Davies Ward Phillips & Vineberg LLP: <http://www.dwpv.com>

Ogilvy Renault: <http://www.ogilvyrenault.com>

Stikeman Elliott LLP: <http://www.stikeman.com>

McCarthy Tétrault LLP: <http://www.mccarthy.ca>

Goodmans LLP: <http://www.goodmans.ca>

Borden Ladner Gervais LLP: <http://www.blgcanada.com>

Perkins Coie LLP: <http://www.perkinscoie.com>

Baker & McKenzie: <http://www.bakernet.com>

Jun He Law Offices: <http://www.junhe.com>

Accounting firms

Deloitte: <http://www.deloitte.com>

KPMG: <http://www.kpmg.com>

Ernst & Young: <http://www.ey.com>

Pricewaterhouse Coopers: <http://www.pwc.com>

Dezan Shira & Associates: <http://www.dezshira.com>

Consultants

The Balloch Group: <http://www.ballochgroup.com>

Chreod Ltd.: <http://www.chreod.com>

Dai Group: <http://www.daigroup.com>

Capgemini: <http://www.capgemini.com>

McKinsey & Co.: <http://www.mckinsey.com>

Shanghai Direct: <http://www.shanghaidirect.com>



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