Practical Strategies for Doing Business in China

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Options that a Company has in Expanding its Business to China

- Non-Corporate Forms:
  - Contractual arrangement
  - Representative offices
- Foreign-Invested Enterprises (FIEs)
  - Joint ventures (JVs)
  - Wholly foreign-owned enterprises (WFOEs)

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Contractual Arrangement

- What they are
- Governmental involvement
- Technology transfer agreement
  - United States legal issues
  - Chinese legal issues
    - Technology import catalog and technology export catalog
    - Improvement to licensed technology
- Properly structuring the activities to avoid Chinese income tax

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FIEs

- JV or WFOE?
  - Foreign Investment Industrial Guide Catalogue
    - Encouraged industries
    - Restricted industries
    - Prohibited industries
    - Permitted industries
  - Other considerations

FIE Formation

- Feasibility study report
- Incorporation certificate of the foreign investor
- Articles of Association
- Most recent audited financial statements
- Bank reference letter
- Other

Choosing the Right Investment Vehicle

- What are your objectives?
  - Selling products to China and regional markets
  - Source products from China
    - Selling in China
    - Selling back to the U.S.
    - Selling in other parts of the world

NEW TAX LAWS

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New Enterprise Income Tax Law

- Enacted on March 16, 2007
- Effective January 1, 2008
- Detailed Implementation Rules not yet published
- Main purpose is to unify tax treatment of domestic enterprises and foreign invested enterprises

Key Changes

- Standard tax rate reduced from 33% to 25%
- Eliminates existing widely available tax Incentives
- New tax incentives geared towards encouraged industries
- Introduces dividend withholding tax
- Introduces “effective management” tax residency test
- Strengthens anti-tax-avoidance
  - General anti-avoidance rule
  - Thin capitalization rule
  - CFC rule
  - Continued focus on transfer pricing

Tax Incentives Eliminated

- "2+3" tax holiday for manufacturing enterprises
- Tax half reduction for export-oriented enterprises
- Preferential tax rates for enterprises located in special zones
- Tax refund on profit reinvestment

Grandfathering

- Only available to enterprises established before the new law announcement date (i.e. March 16, 2007)
  - "Establishment" means obtaining business license
- Only covers two types of tax incentives
  - 15% preferential tax rate
    - Gradually move up to 25% over 5 years ("3,2,2,2,1")
  - Tax holiday
    - For those that have started tax holiday, continue to enjoy the remaining holiday;
    - For those that have not started tax holiday, tax holiday starts from 2008

Planning Actions

- Accelerate dividend payments
- Accelerate profit reinvestment
- Secure tax benefits in 2007 to be eligible for grandfathering
- Revisit China holding structure
- Consider tax aligned supply chain planning to manage long-term tax efficiency

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Roadmap of IP Enforcement

- Measures can be taken
  - Private settlement
  - Administrative Enforcement
  - Customs Protection
  - Arbitration
  - Civil Litigation
  - Criminal Prosecution

Administrative Enforcement

- Inexpensive
- Fast track
- But no damages awarded and normally administrative agencies are not well equipped to adjudicate patent infringement
- Administrative agencies can order
  - Cease infringing activities
  - Destruction or confiscation of infringing products and equipment
  - Imposition of fine

Court Enforcement Post-WTO

- More IP cases filed in courts
- Rocket docket: 6 months for trial and 3 months for appeal
- Higher dispute amount and damages award
- More complexity
- More foreign companies involved but mostly trademark and copyright cases
- Fairer treatment to foreign companies by Chinese courts
- More transparent: public hearings and review court records by parties' representatives
- Post-WTO courts focus more on adopting discovery/evidentiary rules
- Courts are open to experts for patent cases
- Judges are eager to learn and adopt international norms in adjudicating cases: if you do not find a similar case in China, bring a U.S. landmark case to court's attention, and it will work
- More and more foreign law firms are allowed to do business in China: increased competition, higher quality of service, and higher standard of professional conduct
- IP right holders become more proactive

Advice to U.S. Companies

- Acquire China related IP assets if there is a strategic need
- Carefully select local partners/licensees
- Strategically decide what to disclose in China
- Record R&D activities in China to preserve U.S. patent rights
- Carefully select internal local IP personnel and seek for external help when necessary
- Relationship building with local partners, licensees, distributors, customers and government
- Custom measures in both U.S. and China
- Enforce proactively within budget
- China market is too important to lose

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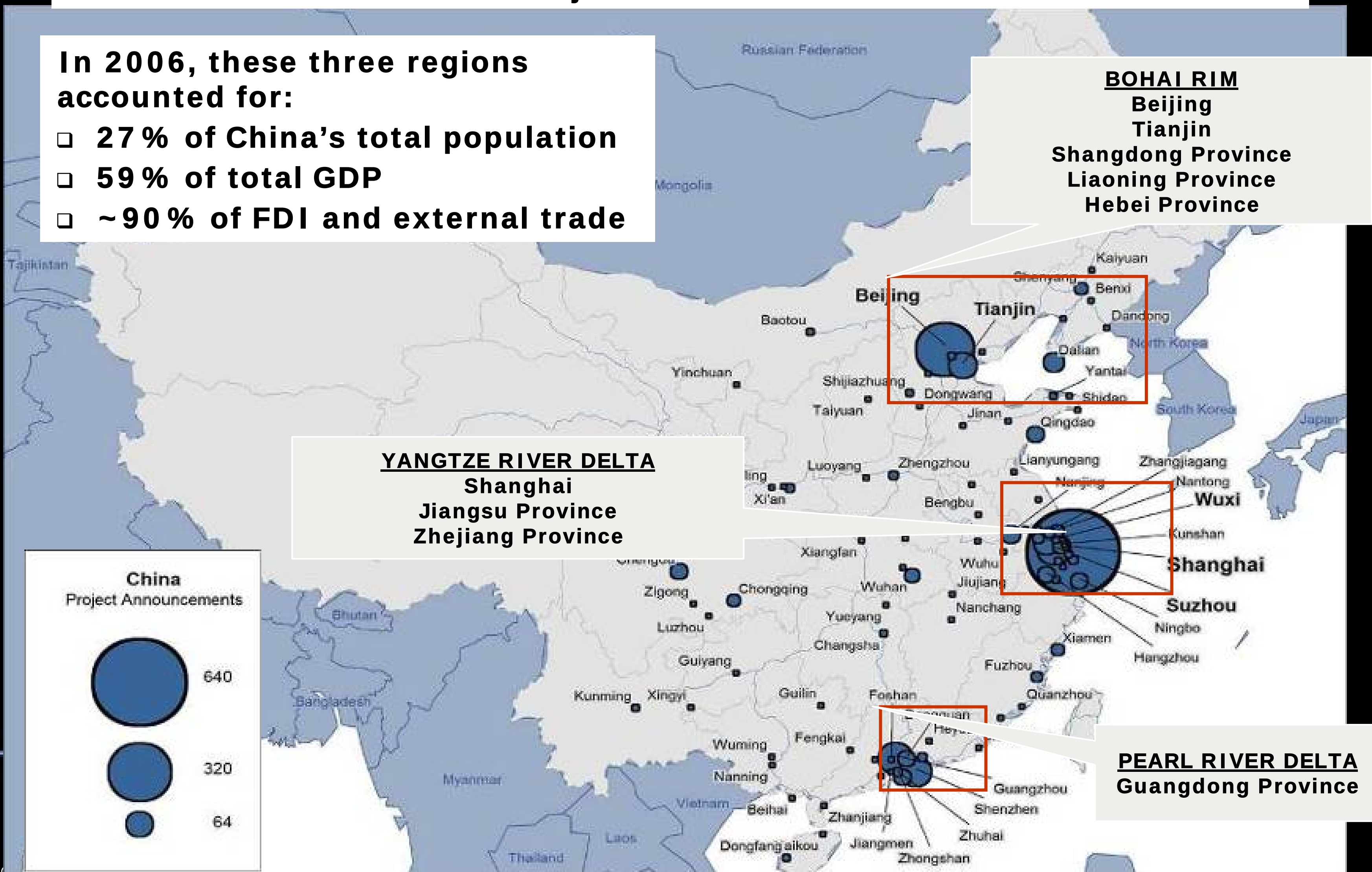
China’s Three Major Economic Regions

Number of FDI Project Announcements 2002-2004

In 2006, these three regions accounted for:

- **27% of China’s total population**
- **59% of total GDP**
- **~90% of FDI and external trade**

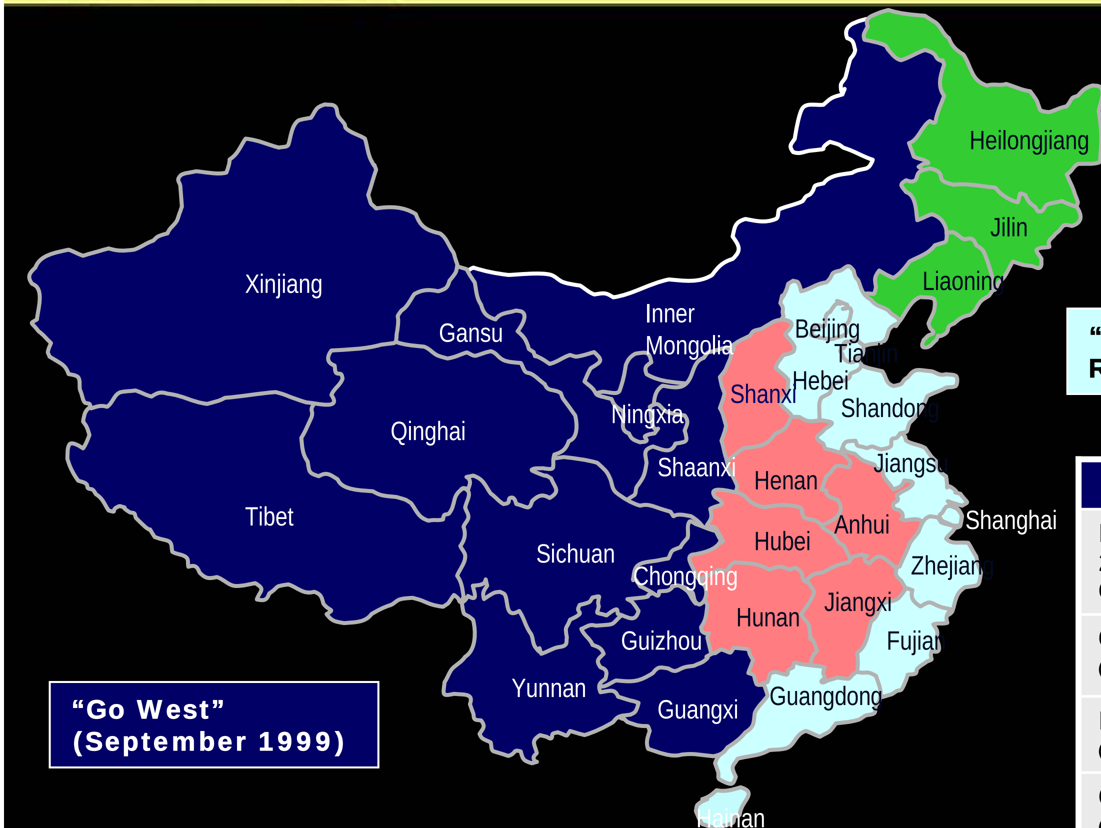


Competition between Developed Regions is Often Intense

Metric (2006)	Nine Cities of the Pearl River Delta	16 Cities of Yangtze River Delta (including Shanghai)
Population	44	82 (of which Shanghai is 16)
Land Area (sq. km)	41,248	93,860 (6,340)
GDP (US$b)	225	516 (154)
GDP per capita (US$)	5,248	5,484
Average Annual GDP Growth (1979-2004)	16	14
Total Trade Volume (US$b)	527	550 (227)
Utlized FDI (US$b)	12	26 (7)

Source – IMF, National Bureau of Statistics, Shanghai Municipal Government, "The Greater Pearl River Delta" 3rd Edition

Uneven Development Means Different Regional Development Policies



"Rejuvenate the Northeast" (October 2003)

"Open Up and Reform" (1978)

"Go West" (September 1999)

"Go Inland" (September 2006)

	East	Northeast*	Central	West
Population (m, 2005) and as % of China's total	455 (34%)	107 (8%)	359 (28%)	347 (27%)
GDP (US$B, 2005) (% of total)	1,41 (55%)	222 (9%)	481 (18.8%)	433 (17%)
Per Capita GDP (US$, 2005)	3,094	2,058	1,386	1,200
Cumulative FDI (1979-2005), as % of total*	86%	N/A	9%	5%
FDI in 2005, as % of total	88%	N/A	8%	3%

* For FDI, NBS includes Liaoning & Jilin in East, Heilongjiang in Central

Sources: National Bureau of Statistics (NBS), MOFCOM and local trade & investment promotion agencies

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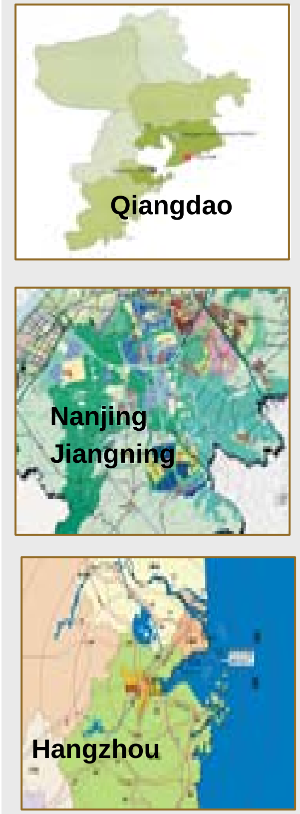
China’s Complex Network of Investment Zones

- Zones tend to have a industry, functional, and even country orientation
- Three tiers (State, provincial, municipal/township) have developed since the first zones opened in early 1980s:
  - State-level zones
  - Provincial-level zones
  - Municipal/township-level zones
- Site Selection Challenges
  - often Involve Making the Right Trade-Offs
    - Political Transport
    - Real Estate Labor
    - Utility Suppliers



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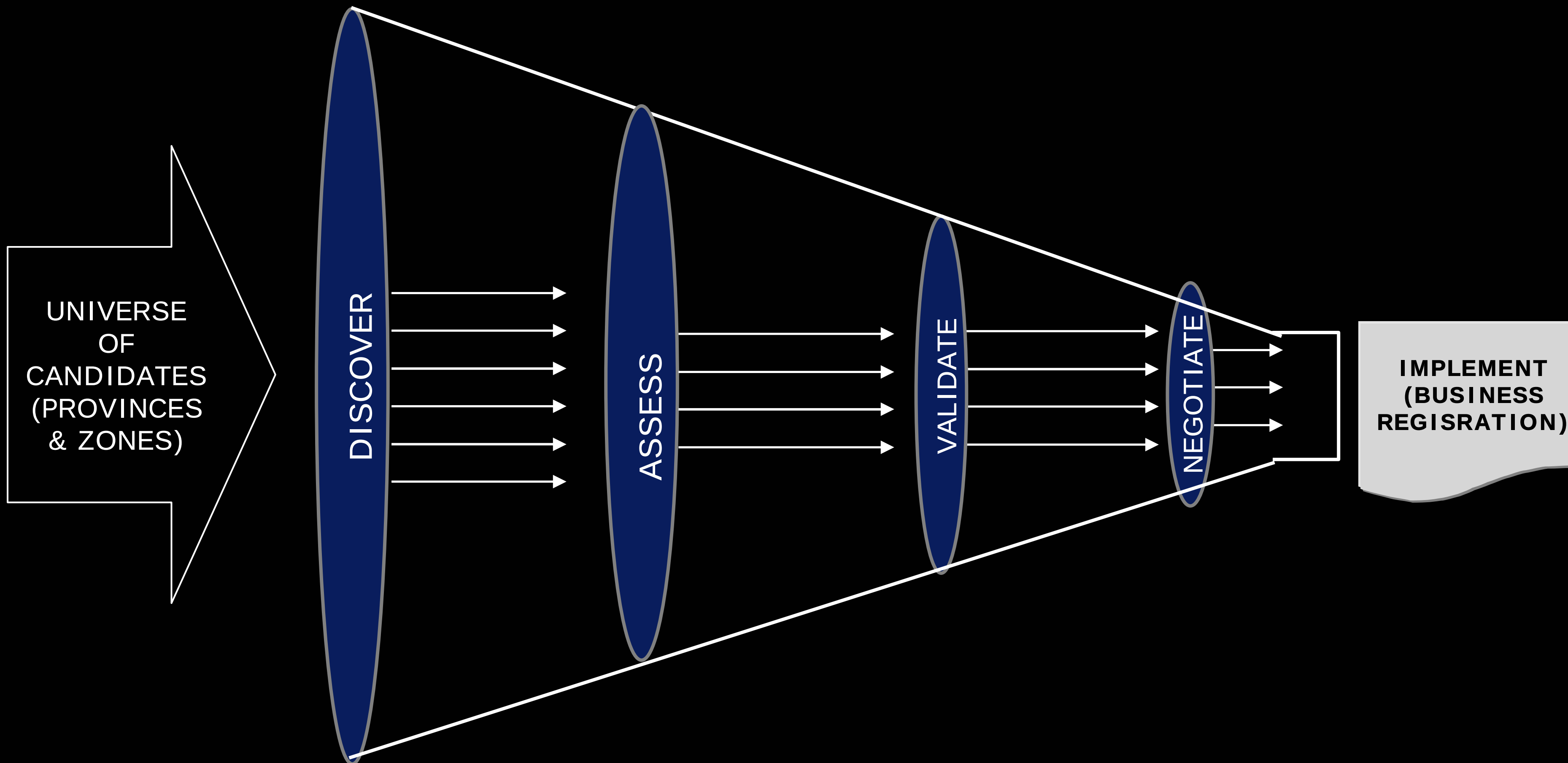
Deloitte's Approach

Based on Our Tried and Tested Location Selection Methodology



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DEALING WITH U.S. EXPORT CONTROLS

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U.S. Export Regulations

- International Traffic in Arms Regulations (ITAR)
  - 22 CFR Parts 120-130
  - Controls on Things that Go “Boom” (Munitions Items)
  - Department of State, Directorate of Defense Trade Controls (DDTC)
  - Arms Export Control Act (AECA)

- Export Administration Regulations (EAR)
  - 15 CFR Parts 730-774
  - Controls on Dual-Use Goods and Technology (items with a commercial and military utility) and purely commercial items
  - Department of Commerce, Bureau of Industry and Security (BIS)
  - Export Administration Act (EAA)

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U.S. Export Regulations

- Foreign Assets Control Regulations
  - 31 CFR Parts 500-597
  - U.S. Economic Embargoes (e.g., Cuba, Iran, and Sudan) and Prohibitions on Dealing with Terrorists and Drug Traffickers
  - Department of the Treasury, Office of Foreign Assets Control (OFAC)
  - Various statutes and Executive Orders

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Overview - Scope of U.S. Regulations

- Controls on Items – U.S. Regulations reach:
  - All direct exports of products, technology, software or services from the United States.
  - Any release of technology to foreign nationals in the United States.
  - Foreign manufactured products containing U.S. origin raw materials, components, software or technology.
  - Re-exports of U.S. items from any location—jurisdiction follows the items.

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Overview - Scope of U.S. Regulations

- What is an Export?
  - Any item sent from the U.S. to a foreign destination (e.g. China).
  - An "item" includes commodities (computers, servers, other equipment) software, and technology (design drawings, technical specifications, technical assistance).
  - Technology is "deemed" to be exported when provided to non-U.S. nationals within the United States.
  - How an item leaves the United States does not matter for export control purposes.
    - Hand carry
    - Air/ocean
    - Electronic
    - In person

What are the Legal Requirements?

- License requirements are dependent upon an item’s technical characteristics, the destination, the end-user and the end-use.
- In all cases, an exporter:
  - Must screen against prohibited destinations, end-users, and end-uses.
  - Must contend with recordkeeping, reporting, and other procedural requirements.
  - Must keep current — the ITAR, EAR, and OFAC regulations are frequently amended. For example, in June 2007, the BIS amended the EAR to reflect significant changes in U.S. licensing policies for exports and re-exports to China.

FOREIGN CORRUPT PRACTICES ACT

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FCPA

While the FCPA applies to all international operations of U.S. companies, FCPA compliance in China poses a unique risk and challenge given the prevalence of state-owned or state-controlled entities ("SOEs") in that country as well as certain cultural norms and expectations of doing business in China

www.fcpaenforcement.com

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FCPA 101

- Anti-bribery provisions
  - Covered entities
  - Broad elements
    - Anything of value
    - Obtain or retain business
    - Foreign official
  - Third party payment provisions
- Books and records and internal control provisions

Recent China FCPA Enforcement Actions

- Schnitzer Steel Industries, Inc.
- Diagnostic Products Corporation
- InVision Technologies, Inc.

Common denominator = expansive definition of "foreign official"

Unique Challenges in China

- Prevalence of SOEs
- Cultural norms and expectations
- Travel issues

Managing the Risk

- Issues to consider
  - Interaction with “foreign officials”
  - Sales and marketing expenses
  - Go to market strategy
  - Price concessions
  - Personnel issues
  - Competitor practices

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Underlying Factors for Corruption in China

Vague and Rapidly Changing Regulations

↓

Bureaucratic Discretionary Power

↓

Inconsistency in Interpretation

↓

Selective Enforcement

↓

Compliance Diversity

↓

Loopholes/Traps

危机

Wei *Ji*

"Danger & Opportunity"

- Conserve
- Contain

Pre-Acquisition

- Comply
- Compete

Post-Acquisition

Vigilance for FCPA violations – past, present and future – is integral to each of the "Four Cs"

Lessons Learned

- In most cases, subsidiary management not adequately supervised by head office
- Significant decisions made locally without head office consultation
- Significant lack of appreciation of corruption risk by local management – cultural issue?
- Local management can often make the wrong decision as a result of poor understanding and undue influence or even blackmail
- Any aspect of the business that touches government is at risk of corruption (e.g., tax, customs, immigration)
- "Heads will roll" and business will be lost

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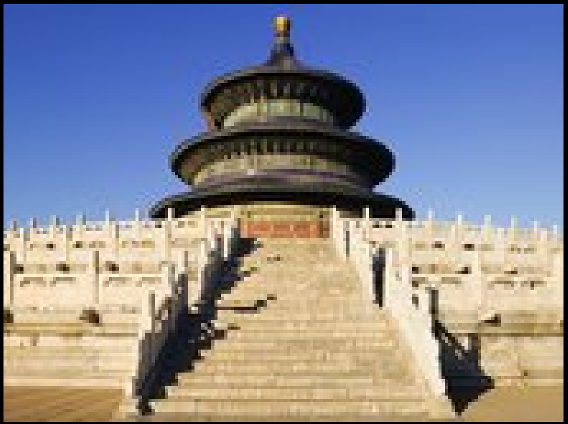
Protecting Your Company: Best Practices



- Update corporate policies and procedures
- Adequate internal FCPA controls are required
- Training
- Global "Hot-line" – encourage employees, agents and even competitors to report misconduct
- Detect Early and Investigate
- Foreign Agent Contract Provisions and Certification
- Periodically evaluate by external resources *(Caremark Decision and Sentencing Guidelines)*

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M&A in China

- Understanding the culture and business practice in China
- The role of government
- Choosing the right local partner

China's New M&A Regulations

- Applicability
  - Equity deal
  - Asset deal

China's New M&A Regulations *(con't)*

- Governmental approval
  - Approval authority: Ministry of Commerce (MOFCOM) or its local branches, generally depending on the total investment amount
  - MOFCOM approval is required regardless of total investment amount for certain transactions
  - Approvals from other agencies may be required, e.g., State-Owned Assets Supervision and Administration Commission

China's New M&A Regulations *(con't)*

- Restrictions on round trip investment
  - Traditional deal structure preferred by foreign venture capital and private equity funds
  - Restrictions imposed by the new M&A rules
  - Alternatives under the new M&A rules

China's New M&A Regulations *(con't)*

- Anti-trust review
  - Filing is required if foreign acquisition of a Chinese company meets any of the following conditions:
    - Chinese market turnover exceeds RMB1.5 billion (US$200 million);
    - Foreign investor has acquired more than ten Chinese companies in related industries in the most recent year;
    - Chinese market share exceeds 20%; or
    - Combined Chinese market share exceeds 25%.
  - Filing is required for M&A outside China if:
    - Chinese assets exceed RMB3.0 billion (US$400 million);
    - Chinese market turnover exceeds RMB1.5 billion (US$200 million);
    - Chinese market share exceeds 20%;
    - Combined Chinese market share exceeds 25%; or
    - One party will hold equity interests in more than 15 Chinese companies.

The Deloitte Difference

Cross-Border Teams for Cross-Border Deals

M&A Advisory Services

Strategy	*Target Screening*		*Transaction Execution*					
					Integration			
Merger Strategy Development	Target Screening & Identification	Preliminary Due Diligence	Synergy and Value Driver Quantification	Negotiation of Letter of Intent	Implementation Planning		Implementation and Transaction Closing Preparation	Closing and Execution of Implementation Plan
					Definitive Due Diligence	Negotiation of Final Transaction		

Commercial DD

Integrity DD

Forensic/FCPA DD

Financial & Operational DD

Tax DD

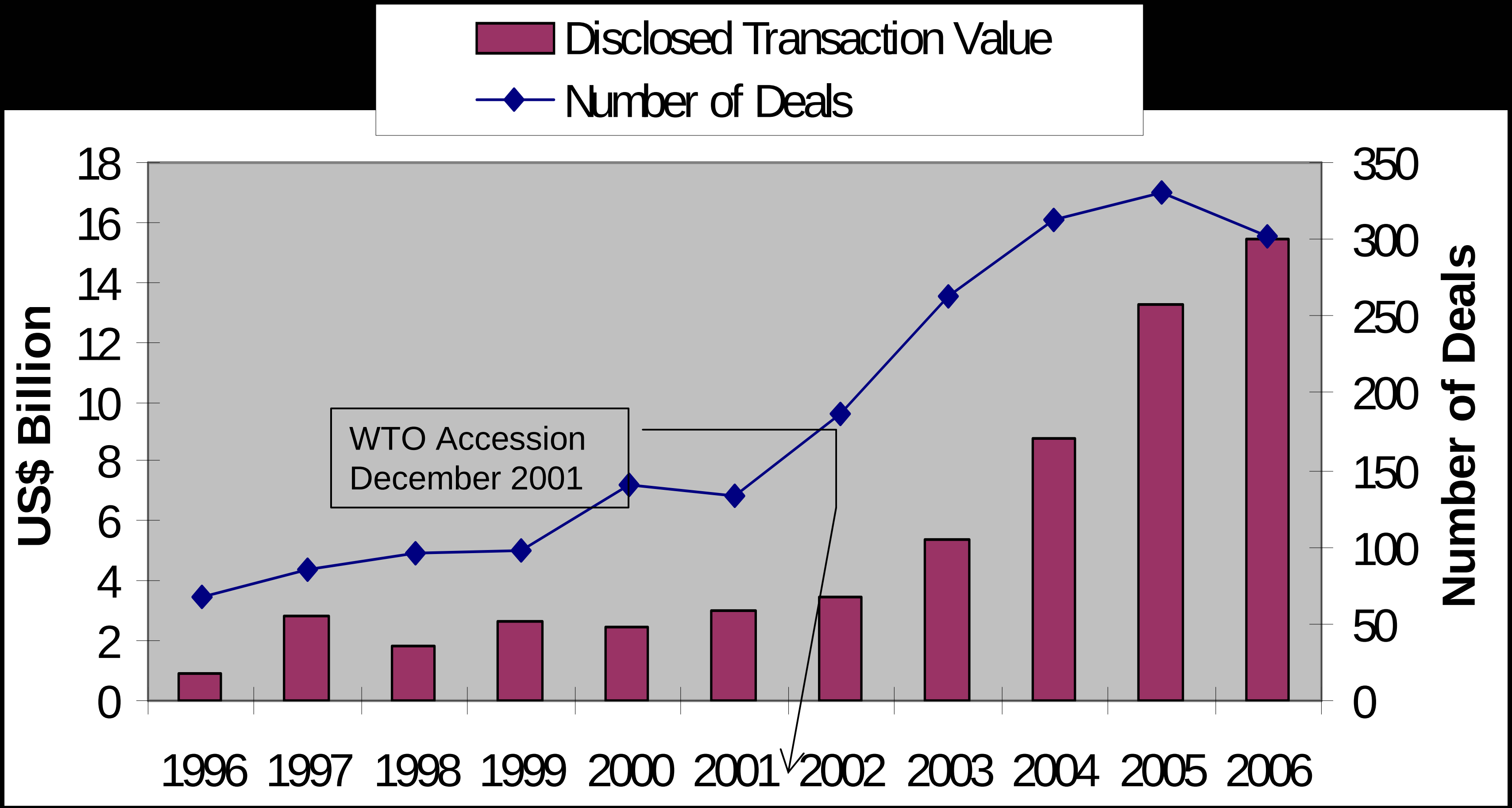
Human Capital DD

Post-Merger Integration Services

Deal Makers | Strategy Specialists | Industry Specialists | Forensic Specialists | Accounting/Tax Specialists | HR Specialists | Integration Specialists

Deloitte Teams – Multi-Lingual & Multi-Cultural

Cross-Border M&A into China (1996-2006)



Source: Thomson Financial, EIU

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A Diversifying Marketplace

Largest Cross-Border M&A Deals into China in 2006 with Disclosed Value, by Value

Date & Status*		Acquirer	Deal Size (US$mm)	% Acquired /Sought**	Target Company	Target Business
11/16	C	U.S.-China investor group led by large U.S. financial services firm	3,100	85	Large provincial bank	Banking
11/15	C	Global telecom equipment manufacturer	882	49 (100)	Major telecoms JV	Telecom equipment
1/23	C	European brewery	730	100	Provincial brewery	Malt beverages
11/22	C	Large European bank	648	5	National bank	Banking
5/20	W	US-UK financial investor group	624	30	Large paper company	Paper mills
1/4	C	Heavy industry conglomerate	527	20	Metals firm	Primary metals
6/8	C	Large Asian airline	524	10 (20)	National airline	Air transportation
1/24	C	International express delivery giant	400	50 (100)	Local JV partner	Express delivery services
3/8	P	Financial investor group	341	98	Large pharmaceutical producer	Pharmaceuticals and textiles
6/20	C	Global coatings company	290	80	Paint manufacturer	Paints
2/7	W	Australian insurance group	277	24.9	Property insurer	Insurance
8/31	C	Large telecoms company	254	51	Media holding company	Internet real estate services
4/14	P	Financial investor group	251	100	Food processor	Processed food production

* C= Completed; P=Pending; W=Withdrawn **Numbers in parentheses indicate % owned after completion of deal, if different than % acquired

Source: Thomson Financial

= Indicates deals with financial investor involvement

Five Questions Companies Should Ask

- At what point should we walk away from a deal?
- What is an acceptable price to both parties?
- How should the deal be structured?
- Does the deal present a compliance risk?
- How can the acquisition be integrated in to the global organization?

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