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A Better Path for Automotive Investment: India or China?

May 20, 2008

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- International law firm with 23 offices in U.S., Brussels, Tokyo and Shanghai
- More than 1,000 attorneys who practice in more than 60 Practice Groups and Industry Teams, including:
  - Transactional & Securities Practice Group
  - Automotive Industry Team
    - 60 attorneys
    - Based in Detroit, but includes lawyers around the world
    - Clients include suppliers, OEMs and capital sources

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About Foley's Detroit Office

- Opened in October 2000
- 40 attorneys who deliver all of the resources of Foley & Lardner to our Michigan-based clients
- Significant practices:
  - Automotive
  - Mergers & Acquisitions/Securities
  - Bankruptcy and Restructuring
  - Supply Chain Contracting and Litigation
  - Labor and Employment
  - Government Contracting and Regulation
  - Healthcare

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INDIA

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Autos/Auto Components - Why India?

- After deregulation in 1991, Indian automotive industry has grown at a rate of 18% per annum
- India is on every major global automotive player's roadmap:
  - 2nd largest two-wheeler market in the world
  - 4th largest commercial vehicle manufacturer in the world
  - 11th largest passenger car market in the world (expected to be the seventh largest by 2016)

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India v. China FDI Comparison

INDIA	CHINA
1991 – Liberalization begins	1978 – Liberalization begins
1992 – FDI inflow USD $2 billion	1992 – FDI inflow US $11 billion
2003 – FDI inflow USD $5.6 billion	2003 – FDI inflow US $53.5 billion
2005 – FDI inflow US $8 billion	2005 – FDI inflow US $60 billion
2006 – FDI inflow $10 billion	2006 – FDI inflow US $69.4 billion
2007 – FDI inflow $14 billion	2007 – FDI inflow $75 billion

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Overview: India's Automotive Market

- The small car (especially the inexpensive "1 lakh car" at about $US2,500) is a key growth strategy
  - Indians view design, development, and manufacturing of small, inexpensive cars as their country's global niche and also as a way to fulfill the needs of India's domestic buyers
- Domestic Opportunities:
  - Participate in the domestic growth opportunities
  - Recent commitment from eight automakers to invest $3.8 billion in India
- Global Outsourcing Opportunities
  - Export of vehicles
  - Exports of components
  - Engineering and design services

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Opportunities in the Indian Automotive Sector

- Fastest Growing Free Market Democracy
  - Young nation with 70% of population under 35 years of age
  - Increasing middle class with increased disposable income (50 million to 550 million by 2025)
  - 8% annual growth rate is fastest of all major economies

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Advantages of Doing Business in India

- English speaking workforce which understands technical drawings and is well conversant in all global automotive standards
- High level of educated youth with good work ethic
- Low cost of labor
- Incentives for foreign direct investment
- Domestic market opportunities (not only viewed as an outsourcing opportunity)

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Automotive Industry Challenges - India

- Infrastructure (disconnected pace of growth of economy and infrastructure)
  - Mainly two-lane roads
  - Port capacity needs to be improved; goods routinely languish for several days waiting for customs clearance.
  - Goods sometimes take twice as long to reach the U.S. as compared to China
- Legal Constraints
  - Enforcement of rights is a slow process; TRO process is well advanced
  - Slow progress in labor regulations; Indian companies with more than 100 workers face daunting impediments to restructuring

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Automotive Industry Challenges – India (cont.)

- Product Quality
  - To become major players in the world market, India's manufacturers need to accelerate the perception that "quality" comes from India

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Automotive Regulations in India

- Indian automotive regulations are closely aligned to the ECE regulations.

Status of Indian Regulations	Number of Regulations
Fully/Partially aligned	43
In process of being aligned	32
Items/Regulations to be covered	39
Total	114

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Automotive Regulations in India (cont.)

- Supplier's have embraced world-class quality standards (ISO 9000, TS 16949, QS 9000, ISO 14001, OHSAS 18001)
- India still lags behind significantly with respect to its safety standards and emission standards
- India is expect to align its safety requirements and emission standards with European standards in 2008/2009 timeframe

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FDI Policies Relating to the Auto Sector

- In 2002, the Indian government formulated an auto policy that aimed at promoting integrated, phased, enduring and self-sustained growth of the Indian automotive industry:
  - Allowed automatic approval for foreign equity investment up to 100% in the automotive sector without any minimum investment criteria
  - Emphasis on R&D activities carried out by companies in India
  - Weighted tax deduction of up to 150% for in-house research and R&D activities

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India's Automotive Mission Plan

- Outlines Development Goals by 2016
  - Goal is to make India the global automotive hub by 2016
  - The Automotive Sector is expected to contribute 10% of India's GDP by 2016
  - By 2016:
    - Attract $35-40 Billion in investment
    - Grow turnover from $35 Billion to $145 Billion
    - Increase export revenue from $4.1 billion to $35 billion
    - Provide employment to an additional 25 million

India's Automotive Mission Plan (cont.)

- Joint Government/Industry Effort
  - Substantial investment in infrastructure ($500 Billion)
  - Revised Labor Laws
  - Increased Tax Incentives
  - Effort to reduce costs of power and fuel

Form of Investment

- Investment in the Indian Automotive Industry can be in various forms:
  - 100% subsidiary; 100% FDI through automatic route allowed in automotive sector
  - Joint Ventures with local firms
  - Technology support or sharing agreements

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Intellectual Property

- Historically IP protection has been harder in India than in the United States
- Over the past decade, India has enacted successive amendments to its Patent Act to enhance the protection of intellectual property
  - Advanced and speedy process for enforcement of intellectual property rights
  - Separate tribunals for IP enforcement

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Bribery and Corrupt Practices

- Historically, corruption was viewed as a widespread problem for U.S. companies doing business in India
  - FCPA
  - Indian laws against bribery
  - Government of India recently established the Central Vigilance Commission to investigate corruption

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Dispute Resolution

- Litigation in the Indian court system is usually a long process
  - Commercial disputes follow the adversarial common law approach familiar to U.S. companies
- Alternative Dispute Resolution is preferable to litigation
  - Chose a venue outside India (New York or London); although Indian companies prefer Hong Kong or Singapore
  - Insist on having U.S. law govern the dispute (expect resistance)

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Dispute Resolution (cont.)

- Enforcing US Judgments in India
  - There are two alternative ways in which foreign judgments can be enforced in India
    - Execution Decree – judgments from "reciprocating territories" can be enforced directly by filing for an execution decree (includes UK and Canada **BUT NOT** United States)
    - Lawsuit based on Foreign Judgment – judgment from "non-reciprocating territories" can be enforced only by filing a lawsuit in an India Court for a judgment based on the foreign judgment (foreign judgment is evidentiary only)

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What Successful OEMs and Suppliers are Doing in India

- Start small, build up gradually
- Work closely with Indian suppliers/partners to build capability: Manufacturing Processes, Quality Systems, Logistics
- Long-Term Contracts for small and medium sized Indian Companies to give comfort in making large investments
- Managing exchange risk

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CHINA

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The Chinese Auto Market

- Today is characterized by:
  - Rapid rise in sales volume
  - Production overcapacity
  - Too many players (and growing)
  - Falling prices; Increasing costs
  - Lip service paid to consolidation (mostly)
  - Export expectations (“Go Out” Policy)

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Today's Focus Areas

- Rising labor costs: Increasing wages and costs of compliance
- M&A Activity in China: Undercurrents working against consolidation
  - National security implications in M&A regulations and new Anti-Monopoly Law, and
  - Conflicts of interest resulting from state ownership

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Current Labor Environment

- Non-payment of overtime and under-funded pension obligations in SOE sector (most of domestic auto industry remains state-owned)
- Delinquent payment of salaries
- Use of temporary workers w/o contract is common (not in the Auto industry)
- Resulting in . . .

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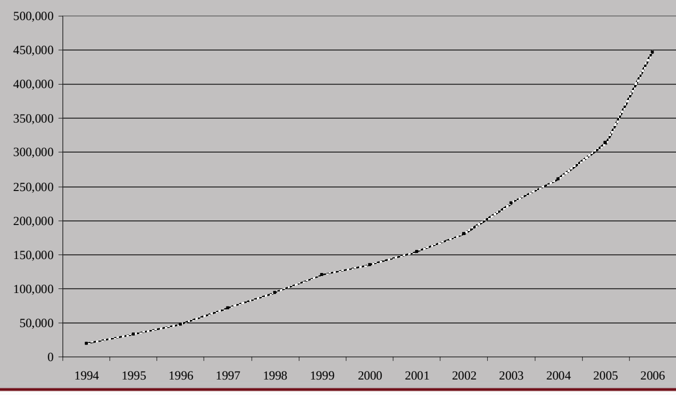
Rising Labor Strife (1)

Figure 1: Arbitrated Labor Disputes, 1994-2006

(Compiled from China Labor Statisical Yearbook, various years and additional data at www.molss.gov.cn)



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Rising Labor Strife (2)

- 2007: Approx. 30% increase in labor disputes as compared to 2006
- 1st Q 2008 saw 90% increase in labor disputes as compared to 1st Q 2007 (New LCL and EPL)
- Percentage of arbitrated suits going to litigation exceeds 50% in major cities
- Employees are more aware of their legal rights
- New labor laws give employees more rights and protections

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Skills and Scarcity

- Labor shortages now reported in many coastal areas
- Entry-level workforce is still plentiful in most areas, but skill levels are low
- Scarcity in skilled technicians, engineers, and middle to senior managers is severe
- Wuxi City surveyed 700 foreign firms and found a shortage of at least 10,000 technicians

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Rising Wages and Benefits Burden

- Since 2004, MOLSS mandates at least 1 increase in local minimum wage every 2 years
- In practice, has occurred 1-2 times per year
- Some companies report 50-150% increase in salaries annually
- Base salary, rate and frequency of increase more pronounced among skilled workforce

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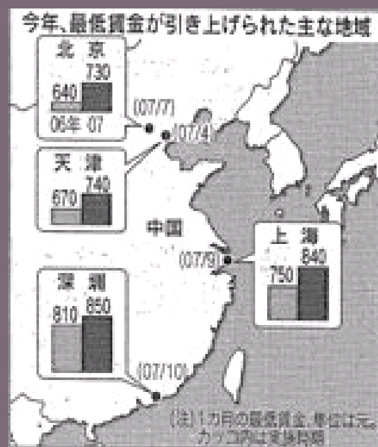

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Mandatory Welfare Payments for Chinese Employees

City	Manager	Worker	City	Manager	Worker
Shanghai	52%	86%	**Beijing**	53%	67%
Suzhou	47%	75%	**Tianjin**	47%	59%
Nanjing	46%	73%	**Dalian**	56%	67%
Guangzhou	62%	98%	**Chongqing**	40%	54%
Shenzhen	31%	46%	**Xian**	40%	59%

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The Government Reacts to the Labor Strife: A New HR Landscape

- Labor Contract Law
- Employment Promotion Law
- Enhanced Efforts to Unionize FIE Sector

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Labor Contract Law (“LCL”)

- Effective from January 1, 2008
- Sets standards for:
  - Mandates written labor contracts
  - Provides procedures for Lay-offs
  - Increases likelihood of paying severance
  - Includes new limitations on use and length of:
    - Probationary Periods
    - Non-Compete Covenants

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Probationary Periods

- Minimum salary during probationary period is 80% of starting salary for regular workers in the same position
- Shorter probationary periods
  - 1 month for non-technical personnel
  - 2 months for technical personnel
  - 6 months for senior technical personnel (but only where the term is greater than 3 years)

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Restrictive Covenants

- LCL includes monetary penalties against an employer if it recruits and employs an employee who has not terminated or dissolved their existing contract
- Non-competes remain lawful but duration capped at 2 years

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Mandatory Open Term Contracts

- Where labor relationship formed without written contract, law will deem this to be a open term contract
- If requested by the employee, employers also must enter into open term contract if:
  - Employee has been working for employer for 10 years consecutively, or
  - A contract with a fixed term has been renewed 2 times

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Employment Promotion Law

- Also effective January 1, 2008
- Mainly a government policy statement concerned with:
  - Increasing employment, and
  - Non-discrimination

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EPL Notable Mentions

- Article 10 provides for officials to receive commendations and rewards for increasing or promoting employment
- EPL prohibits discrimination based on gender, ethnicity, disability (age left off the list)
- Article 47 requires enterprises to allocate training funds to provide vocational skills training and continuing education
- Article 62 provides workers who are discriminated against the ability to file suit in Chinese court

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Pressure on FIEs to Unionize

- By law, employees in any company with 25+ employees can form a union under the auspices of the ACFTU
- High profile cases - Wal-Mart and Foxconn unionized
- SOE privatization and nascent domestic private sector make the FIE sector an easier and wealthier target
- ACFTU is only legally permitted union; operates as independent, enterprise-level union
- MOFCOM: Goal of 70% unionization by end of 2008

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Impact of Unionizing

- ACFTU collects from each company 2% of gross monthly payroll (based on ALL employees)
- ACFTU typically organize social, educational and cultural outings, like trips to the Great Wall
- Unionization enhances CCP's ability to police political activities and maintain social stability

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Better to Cooperate?

- Not worth risk of government blacklisting or negative publicity
- Most companies co-opt union by making sure mid-level managers are elected to leadership in the enterprise union
- In disputes, union typically acts as mediator between labor and management (non-confrontational)

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Legal Powers of Unions

- Despite historical passivity, unions have significant legal powers
  - Company is required to consult with union on fundamental matters, such as restructuring
  - Union representative is required to attend meetings that discuss matters directly related to worker rights and interests

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M&A Trends in China

- 400% increase in aggregate deal size over past year
- Average deal size remains small (US$25.1million)
- China's desire for domestic "multinationals" now equated with "national security" (new M&A regulations effective Sept. 2006)
- Added layer of scrutiny to be added by new Anti-Monopoly Law which mainly will <u>only</u> pertain to foreign sector (Aug. 2008)

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New M&A Regulations

- The M&A regulations pertain to:
  - Typical merger and acquisition transactions by foreign entities
  - Foreign acquisition of any amount of equity interest in a domestic Chinese company
  - Foreign acquisition of the assets of a domestic Chinese company
  - Share swaps and other special purpose vehicles related to offshore listings and investments

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Regulatory Improvements

- Local authorities delegated most approvals
- Regulations include timetables for many governmental approvals
- The regulations provide more detail and transparency to the approval process

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New Restrictions

- The regulations restrict those investments involving foreign acquisition of
  - Chinese technology
  - "Famous" trademarks or brand names, or
- Where the investment affects state security, or
- Where the investment lessens competition within the Chinese market (To be further complicated when new Anti-Monopoly Law becomes effective Aug. 1, 2008)

General Requirements (1)

- Deals may be structured as equity or asset deals
  - Equity, as in US, puts you in the "shoes" of the target
  - Asset, allows you to quarantine liabilities and only buy certain desired assets
- Important because of risks associated with conducting due diligence in China

General Requirements (con't.)

- All deals require approval of the MOFCOM or provincial level authorities
- Cannot accomplish through M&A what you are not permitted to do generally (Industrial Investment Catalogue)
- All asset sales must be according to appraised value
- Consideration must be paid within 3 months after closing (unless extended, in which case 60% must be paid within 6 months and the balance within a year)

Anti-Monopoly Review (1)

- Where a proposed acquisition of a domestic company involves a "significant impact on the Chinese market" the transaction must be reported to MOFCOM
- "significant impact on the Chinese market," means:
  - Any acquirer had current year revenues in China of more than RMB 1,500,000,000
  - The foreign investor acquired more than 10 enterprises in related industries in China in one year
  - Any of the parties to the acquisition (including affiliates) already controls at least 20% of the Chinese market; or

Anti-Monopoly Review (2)

- "significant impact on the Chinese market," means (con't):
  - The acquisition will cause the Chinese market share of any of the parties to reach 25%
  - If MOFCOM agrees with a competing domestic enterprise or relevant functional authority or trade association that the acquisition would involve a very large market share or otherwise materially affect market competition

Anti-Monopoly Review (3)

- If MOFCOM believes that the transaction may result in an over-concentration harming legitimate competition, they must convene hearing to decide whether to grant their approval of the proposed transaction within 90 days of receipt of notice

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Anti-Monopoly Review (4)

- Generally, if the proposed acquisition involved certain specified criteria, the acquiror must submit its acquisition plan to MOFCOM before going public with such plan
- MOFCOM then examines whether the acquisition will result in an over-concentration

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Anti-Monopoly Review (5)

- Exemptions from review are available if the acquisition would:
  - Improve the conditions for fair market competition
  - Restructure a loss-making enterprise and preserve employment
  - Introduce advanced technology, add management talent and improve international competitiveness of the enterprise; or
  - Improve the environment

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Conflicts of Interest

- Most players in domestic Chinese auto industry are state-owned (or public with majority state ownership)
- Most are owned by local-level government, whose approval is also necessary if consolidation is to occur
  - Auto sector targeted by many localities as desired industry to promote in their region
  - If local company acquired, results in loss of potential industry player and may result jobs loss

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Conclusions

- Successful foreign auto companies in China are dual-purpose (export platform and domestic market-focused)
- China as an export-only platform no longer presents same cost advantages
  - Rising land, labor, logistics, and material costs

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Conclusions (con't.)

- Many foreign companies in good position to succeed as consolidation gathers momentum
- PRC Government will continue to control "market forces" operating in auto sector
  - Restrictions on export licenses
  - Registration now required for development and sale of alternative fuel vehicles and technologies
  - National security and other anti-monopoly reviews
  - Conflict of interest caused by state ownership

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QUESTIONS?

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