

Setting Up an F&F Business in China

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China is the biggest economic story in the world today with many people already describing the 21st century as "China's century." The sheer pace and scale of modernization has set China's ascent apart from any other historical example. It is therefore not surprising to see so many foreign companies clamouring to take advantage of the economic colossus China is set to become. At the end of 2004, over 500,000 foreign invested enterprises, including over 400 Fortune 500 companies, had entered into China.

It should not be forgotten, however, that China remains a developing country and still has significant weaknesses:

underdeveloped infrastructure, poorly defined legal and banking systems and considerable bureaucracy. In an unfamiliar environment these can lead to a multitude of previously un-encountered problems.

As a consequence, and true for any new business venture, successfully opening in China will require careful research and planning. The subject of creating a successful business in China has spawned an entire



industry of its own with countless publications available for reference. It should however be mentioned that while an abundance of information now exists on China, much of it is unreliable and one should ask the same questions of many different people before forming any firm opinions.

In the light of this fact, this article's aim is to arm the individual with an introduction to the main issues likely to be faced when first opening in China so that remedial steps can be taken in anticipation of their occurrence.

Which Format Should We Use?

Assuming that the resolution to establish a presence in China has already been made, first the requirements of your operation need to be identified, since these will largely dictate your company's format in China.

In the past, foreign companies wanting to establish themselves in the China market were forced into a joint venture with a Chinese state-owned firm which all too often had dilapidated equipment, old technology and poorly trained management.¹ Fortunately today, for most industries (including the F&F) in China there is a broader list of venture formats to choose from, including Wholly Foreign Owned Enterprises (WFOEs), Foreign Invested Commercial Enterprises (FICEs) and Representative Offices (RO), each with individual strengths and weaknesses. Here we consider two of the most often used — the RO and WFOE.

The key deciding factor as to which of the two to use is often whether or not you need to invoice locally for materials supplied. Typically if the answer is no and you just need a local presence to manage goods being sold by the parent company, or you wish to coordinate sourcing activities or market research to "get a feel" for the domestic market, then you should probably establish a Representative Office.¹

A second important consideration is that of financial commitment and risk. For many, China still represents a high-risk market within which to operate. Consequently, investing large sums of money from the outset with limited

understanding of the local market may put some off from incorporating a FICE or WFOE, since these require significant levels of financial commitment.

Representative Office (RO)

A Representative Office provides a lower risk alternative to these since it is not a legal entity in its own right but a branch office of the parent company and thus does not require any registered capital to be lodged in China. Unsurprisingly, therefore, there are limitations placed upon the activities of ROs, which may make them unsuitable for your operation:

- As already mentioned ROs are not allowed to invoice or receive money locally. This is typically circumvented by invoicing from the parent company in a foreign currency, however it should be noted that there is a growing trend for China-based customers to want to pay their bills in RMB. Since foreign companies are not able to apply for RMB bank accounts (even Hong Kong companies may not apply for RMB accounts unless operating in several specific industries of which F&F is not one), and increasingly customers are requesting to pay in RMB, then you will need to consider establishing a WFOE or FICE, both of which are capable of invoicing in RMB and receiving money locally.
- The import and export license system is an important administrative measure in China's foreign trade management. Despite continuing relaxation, a license is still required for import and export. Since ROs are not legal entities in their own right, they are not permitted to apply for these licenses. This problem can be sidestepped either by cooperating with a local import/export company that can handle these operations on your behalf (typically for a 5% commission) or by making use of a bonded zone.
- ROs must be located in Grade A buildings, which are unfortunately the most expensive. Therefore, before signing anything ask to see a copy of the landlord's "Right to lease to a foreign Representative Office" or "zu lin xu ke zheng" certificate.
- Hiring local staff must be done through a Government-approved human resources and payroll agent such as FESCO. These agents are responsible for ensuring mandatory welfare payments are paid by the employer, which, including their fees, typically raises, local staff salaries by 50%.

Wholly Foreign Owned Enterprises (WFOE)

If, however, you are planning to manufacture in China without the help of a local partner, then it is likely that a WFOE will be your vehicle of choice. Their popularity arises principally due to the varied scope of activities they may conduct and their independence from a Chinese partner. There are however several important points to note when considering a WFOE:

- The "Catalogue for the Guidance of Foreign Investment Industries," published by the Ministry of Commerce of the People's Republic of China, categorizes different industries as "encouraged," "permitted," "restricted" and "prohibited" to foreign investment. A number of sectors of the F&F industry including, but not limited to, "development and production of fruit drinks," "production of dairy products," "fine chemical production" and "natural and synthetic spice and spice derivative production" are given "encouraged" status which brings

with it a number of advantages as well as allowing for the application of WFOE status. These advantages include VAT and Custom Duty exemption on imported equipment, VAT refund on domestic-made equipment and increased tax holidays or turnover tax refunds. For the complete English version of the latest MOFCOM Catalogue for the Guidance of Foreign Investment Industries please visit

<http://english.mofcom.gov.cn/aarticle/topic/lawsdata/chinaforeigntradelaw/200501/20050100015843.html>.

- When establishing a WFOE, it is vital to determine your current and planned future business activities as accurately as possible since changes are subject to further approval by local authorities which can be both time consuming and expensive.
- The amount of registered capital required is an often-misunderstood aspect to establishing a WFOE. First, it should be pointed out that there is no minimum requirement as such and the actual amount committed can be a combination of two assets: cash and equipment. However, an application for a WFOE is unlikely to succeed when very low levels of registered capital are pledged, particularly in a city such as Shanghai where the requirements are higher than in Shenzhen or Tianjin, for example. The important point to understand when considering the minimum registered capital of a WFOE is that in the event of insolvency, when the initial funding from the parent company has been fully utilized as operating capital, a cash injection from the parent company is subject to restrictions imposed by local authorities and it is likely that some form of penalty will be imposed. Consequently, when applying for WFOE status, ensure that sufficient registered capital is committed so as to cover the WFOE through until such a point that it should be profitable.
- Profit repatriation should quite rightly be a key concern for any parent company wishing to establish overseas operations. Under the key articles of association for a newly registered WFOE, there is no profit repatriation article! This needs to be built in, essentially giving the parent company the right to bill the WFOE for management services, royalties, licensing agreements, interest on loans, R&D costs, sales and marketing cost allocations and so on. If you don't have these drafted in from the outset it becomes difficult to overlay the service contracts into articles and obtain approval for this mechanism.¹

Where Should We Set-Up?

Up until very recently there has been little to encourage foreign investors to seriously consider opening up anywhere other than first-tier cities. Typically accepted as being Beijing, Shanghai, Tianjin, Shenzhen and Guangzhou, almost all foreign invested enterprises initially opened shop in one of these. However, with the transformation of China's so-called second-tier cities, many are now looking elsewhere.

Factors affecting the choice of location by foreign investors include:

- A need to drive down the price for land, labour and energy and other elements of manufacturing costs. Why pay \$200/sq m in Shanghai when you can pay \$30 in Nanjing or \$15 in Dalian? Shanghai's rising costs, in particular, have driven many investors to seek alternative locations up the Yangtze.
- For manufacturing suppliers, the fact that many of the large foreign manufacturers are already in these cities forces the suppliers either to move with them or lose out to domestic competition.

- Government policy, such as the “Go West” campaign and the strategy to revitalize the Northeast. About \$10 billion in foreign direct investment has poured into the Western region during the past five years.
- For those selling products to the domestic consumer, rising personal incomes and sophistication in second-tier cities.
- Improved facilities, such as development zones and transport links.
- Road access will be significantly improved with the country’s mileage to rise from 1.9m km in 2005 to 2.3m km in 2010 — this will connect all.



In spite of these improvements, problems do undoubtedly still remain. Nanjing, for example, is promoting itself as China’s “chemical city” and with a friendly government, dedicated chemical industry park and lower labour costs, many big names have already moved there. However in private, some executives say that when it comes to logistics, Nanjing still suffers when compared to Shanghai. One manager of a major European chemical manufacturer says that his

company had considered moving to the industrial park in Nanjing, but picked Shanghai because of its international airport.²

It should be said that cities such as Nanjing are making enormous efforts to remedy these problems, with over RMB 200 billion planned in infrastructure improvements there alone. All this means that investors today have a far greater number of locations to choose from. With cities facing fierce competition from one another in their efforts to attract MNCs, it should be increasingly possible to find a location that will cater to your specific requirements.

Who Should Run the Operation?

For companies considering opening abroad serious thought should be given to who will fill key staff positions. While it may seem desirable to employ locally, given the significant expense of sending a senior-level executive (normally with the family in tow), differences in management understanding, perspectives and objectives may mean that this is not necessarily the right choice.

There are numerous horror stories where local staff have taken advantage of a foreign employer’s trust, resulting, at the very least in huge amounts of wasted money and lost time, and unfortunately often in the collapse of the enterprise. It should be pointed out that these scenarios are not limited to senior level local staff but anyone with access to the company chop (stamp) and business license, both of which are required for the daily affairs of running a company in China. Taking the time to properly research the background of any new employee and ensuring that there are adequate measures to prevent such situations occurring is essential in a country where high staff turnover and low employee loyalty, particularly amongst younger people, is prevalent.

If, like the majority of foreign enterprises in China, you choose to have an expatriate overseeing the operation, you should be prepared to pay higher salaries than for an equivalent position in the parent company’s head office, particularly if they will not be living in a first-tier city. Many will also expect benefits to be included alongside their basic salary package typically including a housing allowance and medical and dental insurance.

How Do We Implement These Decisions?

Planning, no matter how effective, is incomplete without a visit to the country or city of choice. For China this is particularly true. With so much information available regarding almost every aspect of modern China, a visit will allow you to experience everything first hand and highlight what is actually applicable to you.

Furthermore, take the opportunity to speak to expatriates living there already, as most will be working in foreign-invested enterprises and all will certainly have useful anecdotes they can recount.

Finally, professional assistance should be sought at an early stage. The application process for even the most simple of tasks is a potential minefield if carried out alone. A good first port of call is probably your country's China Chamber of Commerce, which can be found in many of the first-tier cities in China.

In addition to this, a reputable consultancy firm should be brought onboard to carry out a full review of your plans. There are thousands of these operating in China today, both local and foreign, and the complexity of your plans, extent of your budget and personal involvement and understanding of the process being undertaken should dictate which you decide to use.

From this introduction it is hoped that a basic understanding of (and solutions to) many of the issues encountered when opening in China has been provided, together with arming the reader with the necessary facts to progress that much more rapidly in whichever direction they choose. In every instance a combination of thorough research, careful planning and professional guidance should make the process a far more efficient and less frustrating experience.

References

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