Investing in China: What you need to know

By Mike Ouellette
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Investing in China is like a Chinese finger puzzle. It looks simple enough, but if you don't know what you're getting into, you'll find yourself stuck.

As an expert on direct investment in China, Leo Seewald has a pretty good idea what a Canadian manufacturer investing in the world's biggest market is getting into. A partner in the Hong Kong office of Canadian law firm Goodmans LLP, he has been working as a lawyer in China for five years, but his work experience began as a teenager spending his summers working at a toy factory in China. Fluent in Cantonese and Mandarin, English and German, his principal area of practice is corporate commercial law with an emphasis on foreign direct investment in the People's Republic of China (PRC). Seewald is the editor of the Mergers and Acquisitions and Trade and Manufacturing chapters in Legal Studio's Guide to Doing Business in China. Plant caught up with him during his recent visit to a Toronto event where he shared some insights on investing in the PRC.


Leo Seewald

Plant: How are Chinese companies organized?

Seewald: A foreign investor will mostly do business with three kinds of companies: state-owned enterprises, limited liability companies (LLC) and joint stock companies (JSC). You will find companies that are structured in collective format, but they're actually private companies. When you do your due diligence you discover the guy who claims to be the owner isn't listed anywhere—the town is listed as the owner.

Plant: Is there a difference between investing in an LLC or a state-owned firm?

Seewald: There is a major drive from the central government to privatize these state-owned enterprises. Many of them aren't properly incorporated, if they are incorporated at all. State-owned enterprises often carry historical burdens—they have people on the pay roll who have retired or just don't exist. They don't have proper land-use rights or permits. Not all state-owned companies can actually exercise their own rights over the land they occupy; they have to be approved to do so. Be careful when dealing with these types of companies.

LLCs are the typical business Canadian investors will deal with in China. The structure is similar to LLCs in North America. They must have at least two shareholders, which can complicate things. Often the second share is held in trust, and not truly owned by the individual. These companies also have registered capital. If you want to work with a manufacturing company, the threshold is 500,000 Chinese Yuan (CNY) or $75,939. A consulting company needs at least 100,000 CNY. If you're investing in a company, make sure the money is there, because it could be problematic if it's not.

Plant: What differences in corporate structure should Canadian investors expect?

Seewald: Peculiar aspects of Chinese companies are the supervisory board and the legal representative. When foreigners incorporate companies in China, they must have a legal representative, which by definition, is the chairman of the board. The significance is that when the company signs documents, the legal representative is responsible. In the domestic context and the foreign-owned context, if you are the legal representative, you are taking on significant risk. If that company has a fire, the legal representative is the one going to prison first. That's what they do. They lock you up first, then investigate. When you negotiate a joint venture, often the Chinese party will ask who will be the legal representative. This is a key position of power. If you are dealing with a local company, you want to be dealing with this person. If you are going into a joint venture, you have to decide whether you are going to do it, or the Chinese partner will do it.

Chinese companies are required to have a supervisory board, though some have them in name only. The concept of a supervisory board is to supervise the directors—it's present at all board meetings. They are made up of a representation of staff and workers. So if you have a board meeting where you are determining what the staff is going to be paid, there's the supervisory board watching you. In a private company, it's very uncomfortable. Ask potential partners about their supervisory boards and you will find that most of them don't function properly. There's talk of getting rid of them.

Plant: Can Canadians invest in publicly owned companies in the PRC?

Seewald: JSCs are the only companies in China that actually have shares. The minimum registered capital for this type of company is 10 million CNY. It's designed for listing in either the Shenzhen or Shanghai exchanges and has increased corporate governance requirements. They have annual meetings and are legally responsible for resolutions passed in meetings. In dealing with these, you will likely have a slightly higher level of confidence than dealing with a LLC because they had to go through additional procedures to become a JSC and will adhere to contracts more closely and won't rock the boat, because that could jeopardize their listing chances.

Plant: What is the business climate like for domestic companies?

Seewald: They are dissatisfied with the level of legal and business culture and they feel a complete lack of support from local governments. They also feel overtaxed at a rate of 33 per cent. Foreign companies are taxed much less. At a minimum, foreign companies have two years tax-free and three years of 50% off the standard tax. If you go to a special economic zone in China, you will have a more reduced rate. The local companies don't think its fair, so they design very complicated structures and generally try to avoid taxes. Plus, companies are closely held and take a very short-term approach. Most are looking to get rich fast. That will change over time, but it's the current culture.

Plant: How does that culture affect foreign investors?

Seewald: Corporate structures in Chinese companies are incredibly complex. If you get at the corporate structure of small and medium-sized enterprises (SMEs), you'll see that they have root companies with all kinds of subsidiaries that are very difficult to follow and see who owns what, and how much. They also do a wide range of things—some do everything from mining to milk production. In doing due diligence, you have to figure out which one of these companies you are actually dealing with and which ones you want to joint venture with.

Plant: Do Chinese companies understand due diligence?

Seewald: When you start to do due diligence on a Chinese company, you will notice that they are very reluctant—they don't understand it. And because of this oppressive tax regime and business structure, they don't want to tell anybody about anything. Ask them for basic corporate documents. If they are even unwilling to hand those over, your due diligence process will be extremely difficult. You really need to walk them through it.

Plant: What are accounting practices like?

Seewald: There are obviously accounting issues with companies in China. Many companies run two sets of books. When companies want to go public, we look at their financials and find they have almost no profit. It's like "…Your records show that you have had five years of almost no profits, but when you go public you want to show how profitable you are—you have a fundamental problem here." They tell us this is not the real ledger. When companies start looking for foreign investment, they will make presentations on their financials, then say, "Do you like these numbers? The real numbers are even better!" Due diligence in accounting is extremely important.

Plant: What shareholders rights can investors expect?

Seewald: Minority shareholder rights won't affect most companies if you are just going to invest, but if you do become a shareholder or a joint venture, these issues become relevant. Most companies don't understand the concept of minority shareholder rights. Internally, Chinese companies are quite good. If there are five shareholders and they are all family, those shareholders will be told what's going on. The problem comes with small minority shareholders. We worked with one company that sold 10% of its shares to about 600 people four years ago. They didn't even know where these people were; they didn't track them. The other problem was the majority owner also owned another company, and they were working together. We told him he had to separate these two companies and draw clear lines between them so you could deal with them separately. He said, "you see that wall over


PHOTO/JOE TERRETT

The Great Wall isn't the only place attracting crowds to China. As the world's hottest market and one of the least costly places to manufacture, China is attracting much interest from foreign investors.

there? Everything on this side belongs to the 600 shareholder company and everything on the other side belongs to my company." You can guess where all the real assets were. That was his attitude towards shareholder rights.

Plant: So family is big in Chinese business. Should investors look at a potential partner's sourcing habits?

Seewald: In a joint venture or other dealings with PRC companies, watch for non-arms length transactions. In most cases this is not seen as a problem in China. We have this in Canada as well, and as long as the correct procedure is followed, there's no problem. But there is no procedure in China. And because you deal with people you know and that are related to you, it's inevitable that you will have these kinds of transactions. From a legal prospective, if you are going to set up a joint venture factory and want to source from different local suppliers, make sure your joint venture partner doesn't source from [someone] who will overcharge you. If you acquire a family business, be very careful. Even if you have done due diligence and the financials are good, maybe the previous owner's uncle ran production, his cousin handled security and his aunt did the accounting. That's what kept the integrity of that company going. Maybe they will leave, or they have no loyalty to you. I've seen it. I worked in a Chinese toy company when I was 17 and it started out as a family-owned Hong Kong company. When a US company bought it, it was a phenomenally profitable company. Within a matter of two years the entire family infrastructure disappeared and the company almost went bankrupt.

Plant: How should investors incorporate legal research into due diligence?

Seewald: People say China has no laws. That's absolutely not true; there are a lot of laws in China. But they aren't universally implemented and are unclear. Sometimes you have a policy that's not yet a law, and it's implemented in some areas and not in others. It requires definite legal due diligence. In one area you will require a permit for a [particular] procedure. You go to your partner and ask for the permit, they will tell you in this part of the country, we don't need it. Do they really not need it, or do they not have it and are telling you it's not needed? That requires a lot of work. You have to go to the local government and ask if such a permit exists, and determine if it's needed.

Plant: How do investors find credit and debt information?

Seewald: The process is slow—you often have to go to local governments to get documents, you need permission from the company you want to acquire. Credit searches and litigation searches are difficult to do in China. The banks don't share information with anybody, nor do they compile the information in a useful way. Litigation searches are almost useless because you have to go to each individual court where the company has operations and see if anything has been filed against them.

Plant: Can you find local lawyers to help?

Seewald: Legal opinions in China are an issue. Large firms like Goodmans or King and Wood are insured, but most small lawyers aren't. In the west, when you ask for an opinion, you draft it with tremendously onerous provisions and you ask the other side to sign it, knowing they will cut it down to what they are willing to give you. In China you draft a very onerous opinion letter and they sign it without much thought!

Plant: What if the company has its debt guaranteed?

Seewald: There is a big problem in smaller businesses with circular guarantees (companies guarantee each other). There is such a mess with some of the companies and their borrowing practices and guarantees that companies are having a problem recuperating. China doesn't have proper bankruptcy law. You have this circular paperwork with the burden spread out over several people.

PHOTO/JOE TERRETT

Finding financial information about a Chinese company is a slow process. You often have to go to local governments to get documents.

Plant: How do the regional and federal governments interact?

Seewald: For foreign companies it comes into play when you make an investment and it's unclear what level of government you need to get approval from. In the local context they clash on tax and operations. A local government may be very eager to have factories set up in its area. It will promise tax incentives, like no tax for the next five years. But that local government only has a 3% portion of the 33% tax. It can't wave the federal government tax, though it will promise to. Beijing is cracking down on it but it's still a very common way for local governments to attract investment. Certain industries require a company to be a joint venture, not a wholly foreign-owned enterprise. Again, the local government wants this company in its area, and it gives approval for the foreign-owned firm to conduct a type of business that is not allowed according to national laws. The risk, then, is the Beijing government will actually check.

Plant: Once a company invests in China, can it sell some of it's assets?

Seewald: If you set up a wholly foreign-owned enterprise directly from the Canadian company and you then want to sell half of it to another company, there are transfer taxes for the transferred shares. You also need approvals. It's not impossible to do, but it takes more time. If you had done the initial investment through a Hong Kong company, then used that company to set up the enterprise, you would just sell the shares. There is no approval required, no transfer tax, and you can do it overnight, because Hong Kong doesn't care if you transfer shares.

Plant: Sounds like there's a lot to consider. How should a Canadian investor navigate through these rules?

Seewald: Get competent legal advise and learn the practices in China. Things aren't laid out very well there. Because there are a lot of different laws that are applied differently in different regions, you need to be familiar with what's expected of you, and if things go wrong, you need to develop a relationship with local government so you know you can call people. Let's say you are importing a machine and the paperwork wasn't done properly. In Canada there is a set procedure to deal with that. In China, using the set procedure may result in your machine languishing for months in the customs lock up. If you know a local official because you dealt with him on other matters, you may get some action.

Plant: What's the recipe for success?

Seewald: You need people who are going to spend the time to learn how things are done. Have some of your own people in China as well. Companies that fail in China don't dedicate enough resources to the culture. They don't send their own people over, or they change too many people and the result is they never get familiar with the local procedures and customs. They are always relying on their joint venture partner or consultants to help them. In the long run, that's detrimental.

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CME/PBB Mission 2005 opens doors to China

Interested in doing business in China? Canadian Manufacturers and Exporters (CME) and PBB Global Logistics, a Fort Erie, Ont.-based logistics provider, are heading up another trade mission to the world's fastest growing economy and biggest potential market.

"During Manufacturing 20/20, the largest consultation in history on the future of Canadian industry, manufacturers told us that China is affecting their business and their bottom line," said CME president & CEO, Perrin Beatty. "If you want to be here tomorrow, you better have a China strategy today. We must start to focus on the opportunities available in the Asian Tiger. With a population of 1.3 billion people, there is unprecedented market potential."

Running from Oct. 12-26, the China Trade & Technology Mission 2005 will visit Hong Kong, Guangzhou, Shanghai, Nanjing and Beijing, where participants will experience factory tours, one-on-one meetings with potential business partners, meetings with key government and industry stakeholders and visit passes to China's largest trade fair.

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