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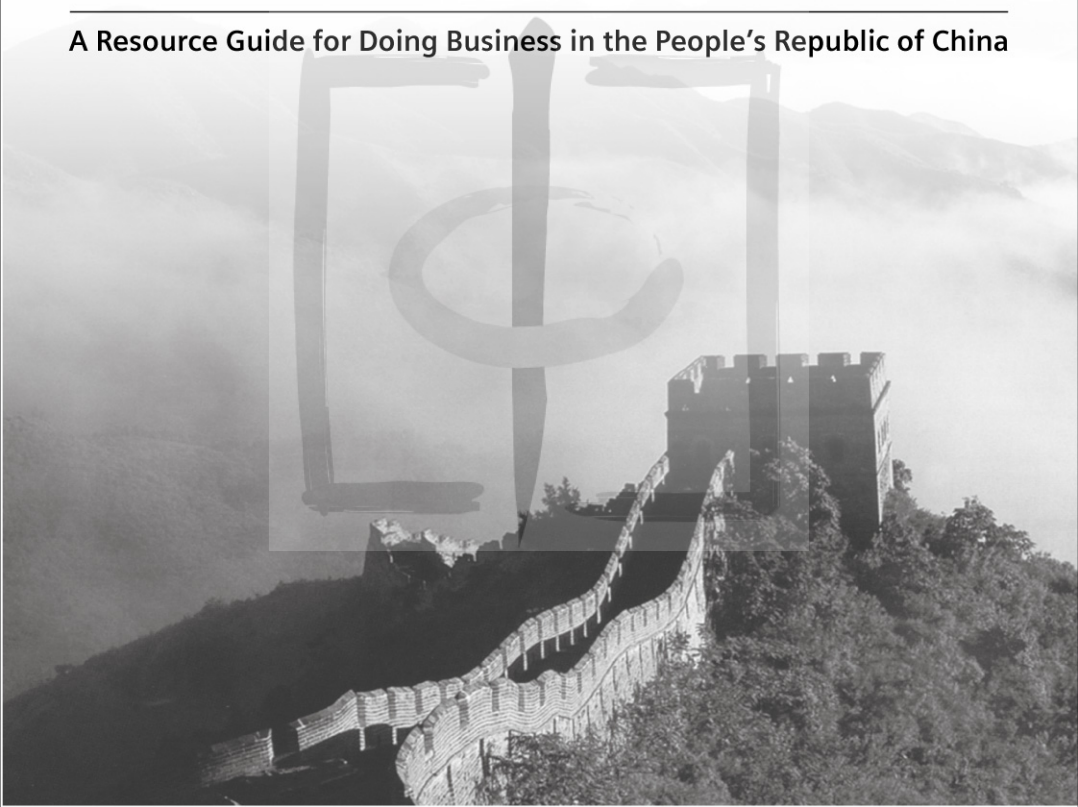
A stylized map of China in shades of blue, with a red dot on the coast. The map is overlaid with a large, faint watermark of the Chinese characters "中国" (China).

China Business Handbook



China Business Handbook

A Resource Guide for Doing Business in the People's Republic of China



Contributed By



**DEZAN SHIRA
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InterChina



英特华





Do You Want to Reach New Customers in the China Market? As the economic downturn affects traditional and domestic markets, China is becoming an increasingly relevant market for U.S. companies in all industries and of all sizes. U.S. companies, many small and medium-sized, exported almost USD71 billion of goods in 2008 to China.

China is buying, building and upgrading throughout the country. American companies can compete for many projects that receive substantial funding from China's central government and multilateral financial institutions. With the middle class exploding and economic growth leading the world, China's demand for consumer products and services spans all industries and reaches into more than 260 cities with over one million people. In particular, China's emerging markets and business centers—from Harbin in the north to Zhuhai in the south—account for 54% of the country's imports and are growing at an average rate of 11%.

However, doing business in China can also be challenging. Our hope with *this China Business Handbook* is to provide U.S. companies with access to more knowledge, information, and expertise needed for success in the China market from U.S. government assistance with initial market entry to strategy, M and A, HR, legal/tax and other services from various business service providers in market.

To access free and ongoing China information, please also tune into *Sinoversity*, a monthly on-line program (www.export.gov/sinoversity.asp) and subscribe to our monthly e-publication *China Pulse* www.export.gov/china/chinapulse/index.asp for frequent, free China updates from Commercial Service and partners.

There are no one-size-fits-all answers to doing business in China. We hope the resources in this handbook and the knowledge/expertise that stands behind them can help you take the next step in entering or expanding your presence in China.

Regards,

William A. Brekke
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General Overview of Doing Business in China

By the U.S. Department of Commerce, U.S. Commercial Service

Market Overview

China has not escaped the recent global economic downturn. With an economy heavily dependent on exports to developed markets, the sharp drop in global consumer demand has had a significant effect on China's economy. In 2007 China's economy grew by 13% and had maintained double-digit growth for most of the past decade. In 2008 Gross Domestic Product (GDP) growth dropped to 9%, perilously close to the 8% growth that many economists believe to be required to feed China's economic engine. Preliminary Chinese economic figures for the last quarter (Q4) of 2008 indicate that this decline is continuing and accelerating.

Overall economic growth in China is continuing, however and U.S. companies are benefiting. Over the past several years, increases of U.S. exports to China averaged close to 10% year on year. In 2008, U.S. exports to China increased by 9.5% from the year prior, according to the U.S. Census Bureau, helping to make China one of the fastest growing foreign markets for U.S. goods. China-U.S. total trade grew to USD409.2 billion, placing

China as our second largest trading partner behind Canada. Although U.S. imports of Chinese goods greatly exceed U.S. exports to China, China remains our third largest export market. U.S. exports of goods to China totaled USD71.5 billion for the year in 2008.

In 2008, inflation, measured by the country's consumer price index, dropped slightly from the year prior to 5.9% but continues to be an economic threat. China's manufacturing base helped the country hit record trade surplus levels of USD297.4 billion in 2008. Foreign investment is strong with China remaining as one of the main destinations for foreign capital investment, though growth began to slide in 2008. China's economic miracle is tempered by a number of looming threats, namely a rapidly aging population and a perilously deteriorating environment.

On November 9 2008, the Chinese government, in order to shore up the weakening domestic economy, unveiled a USD585 billion (RMB4 trillion) economic stimulus plan. USD263 billion, or 45%, of the stimulus package will go toward the construction of railways, highways,

airports and power grids; another USD146 billion will be used for post-disaster reconstruction, which includes rebuilding after snowstorms that hit Central China in early 2008 and the earthquake that struck Sichuan province in May. USD54 billion will go towards rural development and infrastructure projects; USD51 billion has been earmarked for ecological environment; USD41 billion will be used for low-income housing; and the rest will be spent on health, culture, education and innovation.

Despite these remarkable changes, China is still a developing country, albeit one with vast potential. Spread over a population of 1.3 billion, China's colossal economy does not represent a large amount of disposable income for each person. Annual per capita income in China is around USD1,700. Yet, surprisingly, China stands as the world's third largest market for luxury goods behind Japan and the United States. The income distribution within the country is highly uneven with urban centers, such as Beijing and Shanghai, enjoying a per capita income of more than double the nation's average. Some studies estimate that there are now more than 200 million Chinese citizens with a per capita income over USD8,000. That said China's per capita income figures are poised to change dramatically. Over the next several years, many

economists predict a surge in the number of people achieving middle-class status.

Market Challenges

American companies continue to have mixed experiences in China. Many have been extremely profitable, while others have struggled or failed. To be a success in China, American companies must thoroughly investigate the market, take heed of product standards, pre-qualify potential business partners and craft contracts that assure payment and minimize misunderstandings between the parties. The problems of doing business in China can be grouped in four large categories:

- China often lacks predictability in its business environment. A transparent and consistent body of laws and regulations would make the Chinese market more predictable. However, China's current legal and regulatory system can be opaque, inconsistent, and often arbitrary. Implementation of the law is inconsistent. Lack of effective Chinese government protection of intellectual property rights is a particularly damaging issue for many American companies, both those that operate in China and those that do not, have had their products stolen by Chinese companies.

- China has a government that practices mercantilistic style policies. China has made significant progress toward a market-oriented economy, but parts of its bureaucracy still protect local firms, especially state-owned firms, from imports, while encouraging exports. WTO membership will mitigate these tendencies over time – but progress is only gradual.
- China retains much of the apparatus of a planned economy. A five-year program sets economic goals, strategies, and targets. The State and the Communist Party directly manage the only legal labor union. In many sectors of the Chinese business community, the understanding of free enterprise and competition is incomplete. Certain industrial sectors are prone to over-investment. Excessive investment leads to over production, bad debt and declining prices in affected industries.
- Foreign businesses tend to underestimate the challenges of market entry in China. Encouraged by a government eager for foreign capital and technology, and entranced by the prospect of 1.3 billion consumers, thousands of foreign firms have charged into the Chinese market. These companies often do not

sufficiently investigate the market situation - common pitfalls involve not carefully reviewing product standards and conformity assessments, such as China's Compulsory Certification (CCC); not fully understanding legal issues, like protecting intellectual property rights; and not properly vetting local business partners.

It is important to understand that while continued reform is absolutely essential for China to achieve the economic growth it requires and to fully participate in the world trading community, in many areas, the necessary changes have not yet taken place. Companies must deal with the current environment in a realistic manner. Risk must be clearly evaluated. If a company determines that the risk is too great, it should seek other markets.

Market Opportunities

The growth of imports from the United States in many key sectors, such as energy, chemicals, machinery, telecommunications, medical equipment, construction, financial services, and franchising suggests that China will remain an important and viable market.

More detailed information can be found in Chapter 4 on specific industries with strong commercial prospects.

Market Entry Strategy

The U.S. Embassy and the U.S. Department of Commerce welcome contact with American companies to initiate or expand exports into the China market. Two of the primary objectives of U.S. policy with regard to China are (a) growing the American economy by increasing exports thereby reducing the bilateral trade imbalance and (b) ensuring that the Chinese government fully complies with its commitments to the WTO in order to expand our companies' ability to compete on a more level playing field.

A company should visit China in order to gain a better perspective and understanding of its potential market and location. Especially given China's rapidly changing market and large area, a visit to China can provide a company great insight into the country, the business climate, and its people. Chinese companies respect "face-to-face" meetings, which can demonstrate a U.S. company's commitment to working in China. Prospective exporters should note that China has many different regions and that each province has unique economic and social characteristics. One should be careful not to generalize about such a large country.

Continued long-term relationships are key to finding a good partner in China. To maximize its contacts, companies should aim at forming a network of relationships with people at various levels across a broad range of organizations.

U.S. companies commonly use agents in China to initially create these relationships. Localized agents possess the knowledge and contacts to better promote U.S. products and break down institutional, language, and cultural barriers. The U.S. Commercial Service China offers a wide array of services to assist U.S. companies with U.S. exports in finding Chinese partners. U.S. companies are strongly encouraged to carefully choose potential Chinese partners and take the time to understand their distributors, customers, suppliers, and advisors. For more information on CS programs geared to assisting U.S. companies please see: www.buyusa.gov/china/en/howhelpus.html.

China is a challenging market and requires a strong understanding of a firm's capabilities and in-depth knowledge of the market. Before making a decision to enter the China market, potential exporters should consider their own resources, their past exporting experience, and their willingness to commit a significant

amount of time to exploring opportunities for their products and services in China. The U.S. Commercial Service has developed a toolkit to help exporters understand some of these challenges; our “Are You China Ready” assessment is available at: www.export.gov/china/assisting_us_exporters/areyouchinaready.asp.

China is a very large country with multiple economic sub-regions. The U.S. Commercial Service can connect companies to opportunities in China’s major and emerging markets. In addition to trade professionals at U.S. Embassies and consulates across China, CS specialists in “American Trading Centers” (ATCs) in 14 of China’s up-and-coming markets can assist American exporters to identify possible agents, buyers, importers or distributors at government-subsidized prices. These emerging, “second tier cities” account for 54 percent of the country’s imports and are growing at an average rate of 11%.

Information on China’s emerging markets: www.buyusa.gov/china/en/regional_information.html

Overview of all U.S. Government China services/resources: www.buyusa.gov/china/en/our_services.html

Selling U.S. Products and Services

Using an Agent or Distributor

Since World Trade Organization implementation, China has worked towards liberalizing its distribution system to provide full distribution rights for U.S. firms. As it now stands, U.S. companies are no longer required to use domestic import-export agents and distributors for their imported products. The implementation of distribution has greatly improved, reflecting the solution of licensing issues, while the continuing emergence of the foreign-invested enterprise (FIE) and foreign-invested commercial enterprise (FICE) model as a viable trading and distribution platform for foreign companies has also made the situation better (for more information on China’s commitments to the WTO, please refer to the U.S. Embassy website at: <http://beijing.usembassy-china.org.cn>).

Trading and distribution are two separate issues and are, accordingly, covered separately by the WTO implementation documents. Trading covers the rights to import and export products into and from China. Distribution, on the other hand, covers the sale, either wholesale or retail, of products within China.

1. Trading Companies

China’s current regulations are designed to allow manufacturing-focused foreign invested enterprises (FIEs) to become export trading companies that may purchase and export any products or technologies free from quotas, license control or government monopoly. FIEs are able to establish trading companies and to obtain trading rights before the phase-in of distribution rights. Chinese companies that are registered and have RMB1 million (USD146,000) in capitalization can obtain an import/export license.

In late 2005, the Ministry of Commerce (MOFCOM) issued additional documents that fully clarified the application procedures for investors to establish new foreign-invested commercial enterprises (FICEs), for existing FICEs to open new distribution and trading businesses, and for existing FIEs to expand their business scopes. The documents give provincial-level agencies the authority to review and approve applications. Currently, approval for new foreign enterprises occurs at the provincial level, and not the national level.

In March of 2006, MOFCOM issued a notice on “Entrusting Local Authorities with the Examination and Approval of

Commercial Enterprises with Foreign Investment.” While this decision to delegate approval authority to provincial-level authorities for most distribution rights applications has sped up the application process, technical challenges still remain. Existing foreign-invested manufacturers that have expanded their business scopes are limited to distributing goods that they produce. Uncertainty over what constitutes “similar goods” has created difficulties for some companies seeking to exercise their distribution rights. In addition, existing manufacturers that have expanded their business scope to include distribution must ensure that half of their revenue stems from their buy-sell activity.

2. Distributors

A U.S. exporting company that hopes to successfully enter China must gain both trading and distribution rights. Distribution covers: 1) commission agent services, 2) wholesale services, and 3) retailing. New laws and regulations released by MOFCOM at the end of 2006 allow foreign companies to establish wholly-owned distribution entities for chemical fertilizers, processed oil and crude oil, as well as other imported and domestically produced products. Limits exist on products including books and periodicals, pharmaceutical

products and pesticides. Foreign companies may choose one of two ways to acquire trading and distribution rights: they can set up a new, stand-alone FICE or apply to expand the business scope of an existing FIE.

Given the complexities of the Chinese market, foreign companies should also consider using a domestic Chinese agent for both importing into China and marketing within China. With careful selection, training, and constant contact, a U.S. exporter can obtain good market representation from a Chinese trading company, many of which are authorized to deal in a wide range of products. Some of the larger companies have offices in the United States and other countries around the world, as well as a network of offices and affiliates in China. However, given transportation and communication difficulties as well as regional peculiarities, most of these trading companies cannot provide diversified coverage throughout China.

3. Local agents

China is witnessing an explosion in local sales agents who handle internal distribution and marketing. Most of these firms do not have import/export authorization. They are the next layer down the distribution chain, buying foreign products and importing them through entities that have an import/export license by paying a commission. They may be representative offices of Hong Kong or other foreign trading companies, or domestic Chinese firms with regional or partial national networks.

Given China's size and diversity, as well as the lack of agents with wide-reaching capabilities, it may make sense to engage several agents to cover different areas, and to be cautious when granting exclusive territories. China could be viewed as five major regions: the South (Guangzhou), the East (Shanghai), the Central/North (Beijing-Tianjin), West China and the Northeast.

Regions and Sectors to Watch

By Dezan Shira & Associates

Shanghai and the Yangtze River Delta

Blessed with access to the largest sea ports, the east coast was China's first region to develop and is still the primary entry point and sales market for many foreign companies. Proximity to suppliers, access to ports, higher quality of labor, ease of investment, and highly developed infrastructure have long attracted foreign investors, and these days, literally dozens of development zones across the YRD compete for the dollars of many foreign-invested companies both new and long-established. Building on dramatic developments in infrastructure and business culture over the past 20 years, foreign investors certainly have much to look forward to from this dynamic region. However, as a large and extremely diverse area, it is marked by a wide city-to-city variation in economic activity, development levels, infrastructure, investment climates and government attitudes. It pays to take time to do some research and explore the area before setting up an office or factory.

The YRD remains a major driver of growth within China. With 10.4% of China's population and only 2.2% of its area, the YRD contributed 25.4% of its GDP, 36.7% of its foreign trade and 41% of FDI in 2004. Shanghai is a vital commercial and financial center and the most open city in China, but as the city faces infrastructural and environmental problems, an ever-increasing proportion of regional FDI (and indeed domestic investment) is beginning to flow into the rest of the YRD. Jiangsu's economy is second only to Guangdong's in size, while neighboring Zhejiang is the fourth largest provincial economy and the richest province in China in terms of per capita GDP.

Further afield, Anhui is slowly beginning to absorb more spillover FDI and develop as a manufacturing facilities base for the domestic market.

Comparing the Five Major Regions of China					
Economic region	History and culture	Resource strength	Weaknesses	Advanced sectors	Engines for growth
Yangtze River Delta	Commercial and trading tradition, international outlook, long-term development goals	Full production chain, good investment climate, developed transport infrastructure, import-export systems in place	Shortages of energy and electricity, weak sector diversity, lack of core technology	Services, finance, IT manufacturing, petroleum and chemicals, iron and steel, textiles	2010 Expo, located at the mouth of the Yangtze River, known as the Dragon's Head
Pearl River Delta	Commercial and trading tradition, open and market oriented mindset, innovative	Strong production and manufacturing chain, well-developed foreign trade, good transport infrastructure	Limited cultural attractions, absence of capital and technology-intensive sectors	IT manufacturing, electronics, light industry, agriculture, textiles	CEPA, Greater Pearl River region, Zhuhai-Macau-Hong Kong Bridge
Gulf of Bohai	Political center, weak market development	Well-informed, high quality human resources	Lack of market sense, reliance on personal relationships	IT, ITC, agriculture	2008 Olympics, R and D in IT and biotech
The Northeast	Rigid outlook based on state ownership, planned economy	Established heavy industry base, productive agriculture	Outdated economic ideas and structure	Heavy industry, manufacturing, agriculture	Official revitalization policy
West China	Small-scale peasant economy	Rich in energy and minerals, access to river transport	Poor environment, low foreign trade	Energy, electricity, logistics, tourism	Three Gorges project, official "Go West" campaign

Since the Tang Dynasty (618-907), the Yangtze River Delta region has been an area of intense agrarian agriculture and high population density. But in the last two decades, the region has urbanized along with the rest of China. In Jiangsu and Zhejiang, the small towns that used to play such an important role in commerce are disappearing while new cities are emerging and expanding into rural areas. More and more farmers have migrated from their traditional homes to

find urban work, or have changed their production focus to supply the cities. Growth has come in the later stages of China's "opening-up and reform" process – initially it was Guangdong and the South that received the lion's share of FDI and central government attention. Now East China is booming thanks to an attractive location, supportive government policies and access to the huge consumer market that extends from the delta inland to the provinces of Hubei, Hunan and Jiangxi.

Exports around the world are also thriving from this dynamic region.

Six YRD cities placed in the Chinese edition of Forbes magazine's 2005 survey of China's top 10 business cities: Hangzhou (1), Wuxi (2), Shanghai (3), Suzhou (6), Ningbo (7), and Nanjing (8).

In the 2005 China city competitiveness "blue book," five YRD cities were in the top ten overall – Shanghai (1), Hangzhou (5th), Ningbo (6th), Suzhou (7th) and Wuxi (8th). Several YRD cities also ranked high for HR, science and technology and environment.

Yangtze River Delta By Numbers (2007)					
Item	Value Unit	Anhui	Jiangsu	Shanghai	Zhejiang
Population	m people	66.78	76.25	18.58	50.6
GDP	RMBbn	734.57	2,556.01	1,200.12	1,863.8
Proportion: primary industry	%	16.5	6.7	N/A	5.5
: secondary industry	%	44.7	55.9	N/A	54.1
: tertiary industry	%	38.8	37.4	51.9	40.4
GDP growth	%	13.9	14.8	13.3	14.5
Per capita GDP (all residents)	RMB	12,015	33,689	60,158	37,128
Fixed asset investment	RMBbn	510.59	1,227.06	445.86	843.28
Industrial production value	RMBbn	275.21	1,247.36	529.6	904
Per capita disposable income	RMB	11,474	16,378	23,623	20,574
Retail sales	RMBbn	240.37	783.81	384.8	621.4
Exports	USDbn	8.82	203.73	328.48	128.3
Imports	USDbn	7.11	145.94	192.43	48.54
Contracted FDI	USDbn	3.57	43.58	14.87	20.4
Used FDI	USDbn	3	21.89	7.92	10.37

Shanghai

Shanghai has always been referred to as the “dragon’s head” that dominates the Yangtze River Delta group along with the country’s richest provinces – Zhejiang and Jiangsu. As the leading city, Shanghai is working towards becoming an international financial, trade and shipping hub come 2020.

One of the forces shaping this dream has come from preparations for the upcoming World Expo 2010 that will welcome 70 million guests from 200 organizations. Shanghai will prepare for the expo by spending RMB20 billion on building 11 new rail lines and new underground vehicle tunnels, revamping public transportation terminals, improving emission standards and constructing the largest container port in the world.

Shanghai’s rise began when Deng Xiaoping decided to develop Pudong in 1990, making the city a focal point for modernization. The central government poured grants and loans into Shanghai between 1990 and 2002, in turn stimulating foreign direct investment in the city. Between 1978 and 2001, 86% of the total FDI in China went to the east coast provinces, compared to only 9% to the central region and 5% to the west. Buoyed by these investment dollars, Shanghai has experienced the biggest building boom the world has ever seen.

The statistics are as startling as the city’s world famous architecture. According to the Shanghai Statistical Yearbook 2007, the city had only 15 buildings that exceeded 30 stories in 1990, but the number of buildings over 30 stories high increased to 212 in 2000, 652 in 2005, and 734 in 2006. The total number of buildings in the city that have more than eight stories rose from 121 in 1980 to 11,989 in 2006.

Now, the government is focused on supporting foreign-invested companies, improving transparency and efficiency and fostering the most open market in China. The central government is eager to see Shanghai emerge as a center for shipping and finance. The city is building up several key industrial sectors: microelectronics, automotive, chemical, steel, shipbuilding and equipment manufacturing. The Pudong New Area, east of the historical center of the city, is held up as a gleaming new business district, accounting for around 20% of the city’s GDP and aiming to claim one-third more by 2010.

Shanghai will continue to be important considering China’s stated goal of boosting its manufacturing-base economy higher up on the value chain. Already focusing on modern service industries and advanced manufacturing, the mainland’s most modern, cosmopolitan city will surely be instrumental in

China’s effort to become an innovation-driven economy. Shanghai is focusing on gaining foreign investment in six modern service industries: modern logistics and transportation, financial services, exhibition and travel services, information services, professional services auxiliary to manufacturing, and entertainment. Shanghai aims for 85% of GDP to come from its service sector, thereby avoiding direct competition with its nearby neighbors and strengthening its existing advantages. Major global companies have established businesses in the city in the last few years, including Walt Disney, BASF, Munich Trade Fairs and Citigroup.

The city’s suburban areas will continue to attract substantial investment into advanced manufacturing. Shanghai has six major manufacturing bases: Baoshan, in the high-end steel industry; Jiading, in automobile parts; Pudong, Qingpu and Songjiang in microelectronics; Fengxian and Jinshan in petrochemicals; and Nanhui in modern equipment.

Shanghai drafted a strategy for its SOEs as part of the 11th Five-Year Plan (2006-2010) that calls for an investment of RMB500 billion. The city will accelerate construction of industrial bases for micro-electronics, automobiles, petrochemicals and quality steel products, and give priority to Changxing Island shipyard. Shanghai has listed six priorities for SOEs in this period:

- ★ Maintaining competitive advantage in the automotive sector with focus on new energy vehicles
- ★ Constructing port-based equipment manufacturing industry
- ★ Supporting new projects in the chemical zone
- ★ Expanding production of flight panel displays
- ★ Readjusting the structure of the iron and steel industry
- ★ Supporting the solar-energy photovoltaic battery industry

GDP in the Yangtze River Delta 2003 to 2007 (RMBbn)					
	2003	2004	2005	2006	2007
Anhui	397	481	538	614.19	734.57
Jiangsu	1,247	1,551	1,827	2,154.9	2,556.01
Shanghai	625	745	914	1,029.7	1,200.12
Zhejiang	940	1,124	1,336	1,564.9	1,863.8
Total	3,209	3,902	4,615	5,363.63	6,355

Shanghai's GDP rose 13.3% in 2007, the 16th straight year the city's economy has expanded by more than 10%, according to the Shanghai statistics bureau. This rise came despite official efforts to slow over-investment. The city continues to reign as China's commercial center, its trade hub and its most internationalized city (10% of Shanghai's workforce is employed at a foreign-invested company).

Infrastructure improvements made in 2007 have helped solidify Shanghai's position as China's commercial center, especially the expansion of the subway system to eight lines, the opening of Terminal 2 at Pudong International Airport, the continued development of the Yangshan Deepwater Port and the opening of the Exhibition and Distribution Center in Waigaoqiao.

Furthermore, the government has made efforts in recent years to ensure a stable and adequate power supply, improve ADSL capacity with international internet service providers, address IPR infringement, tackle traffic congestion by improving transportation infrastructure and introduce stricter measures against industrial pollution.

The Greater Yangtze River Delta
Some experts, and possibly some of the top of the Chinese leadership, believe

Shanghai's economy is becoming overstretched and unsustainable. This, rising land and labor costs and other issues mean that Shanghai is losing some of its former gloss and many investors are looking farther inland to Jiangsu, Zhejiang and even Anhui provinces.

Jiangsu

Jiangsu was a trading center as early as the Song Dynasty (960-1279) and is the gateway to Central China. Its administrative capital of Nanjing was one of the six ancient capitals of China. Situated at the south bank of the lower reaches of the Yangtze River, Nanjing has been prominent in China's history and culture and is one of the 15 sub-provincial cities in China that enjoy jurisdictional and economic autonomy that is only slightly below a province.

Suzhou, another of Jiangsu's prominent cities, is renowned as a garden city that is rich in history and a modern center of cotton, silk and wool production. Wuxi, a tourist city traditionally known as the "land of fish and rice," and nearby Taihu Lake, the third largest freshwater lake in China, have also become popular tourist destinations.

Jiangsu is second only to Guangdong in GDP and one of the wealthiest provinces in China, but the 2007 GDP per capita of

RMB33,689 belies a north-south divide. Booming southern cities like Suzhou and Wuxi enjoy a GDP per capita around twice the provincial average, while towns and cities north of the Yangtze haven't fared quite as well. The provincial government has tried to even things out by moving some labor-intensive industries from the south to northern cities such as Xuzhou, Huaian, Yancheng and Suqian.

Historically, Jiangsu had a stronger light industry sector but began to develop heavy industries including chemicals and construction materials after 1949. Heavy industry overtook light industry in 1993 and the economy now largely revolves around machinery, automobiles, electronics and chemicals manufacturing. In recent years, the government has been focusing on fast-developing technology and capital intensive industries like electronics and telecommunications and smelting and metal pressing. Jiangsu has also been moving towards the development of new and high-tech products, especially those from Taiwan. Information technology, new material and heavy petrochemical, and the new medicine industry have become particularly significant for the economy. In the last few years Jiangsu has become an important IT manufacturing base. Many Taiwanese IT manufacturers are increasingly attracted to investing in

cities such as Kunshan and Wujiang. Furthermore, the government has been pushing Jiangsu's private sector, which now accounts for over 90% of the province's total industrial output, and is developing the tourism industry.

Zhejiang

Zhejiang's golden age began in 1100, when the modern provincial capital of Hangzhou was the capital of the Han Chinese Southern Song Dynasty. Renowned for its prosperity and beauty, Hangzhou may have been the largest city in the world by 1275 with an estimated population of 1 million. Marco Polo famously described Hangzhou as the "finest and noblest in the world" on a 13th century visit. By 1860, in the aftermath of the Taiping Rebellion, the city was destroyed and its population decimated, but Hangzhou managed to rebuild to match its former reputation of luxury and opulence in Chinese culture.

Southern Zhejiang is not suitable for farming and was traditionally underdeveloped, but hard work and low labor costs have transformed the area into a major export hub.

Over the last 10 years or so, major industrial production bases have popped up in cities like Hangzhou, Ningbo, Wenzhou, Jiaxing, Huzhou and Shaoxing.

Light industries are playing an important role in the province's industrial sector, but since 2000, heavy industries like electric equipment and machinery, equipment in common use, raw chemical materials and chemical products etc., have also developed rapidly, accounting for more than 50% of industrial output in the last few years.

The economic success of recent years has been largely home-grown as opposed to built on investment from the central government or huge inflows of FDI. That's changing as big multinationals move out of Shanghai, but the entrepreneurial spirit among people here is already dubbed "the Zhejiang model." There is an emphasis on small businesses responsive to the whims of the market, large public investments into infrastructure, and the production of low-cost goods in bulk for both domestic consumption and export.

This spirit has made Zhejiang into one of the richest provinces in China, in large part due to a diverse manufacturing industry. Specialization is a key trend in Zhejiang's small manufacturing cities – Qiaotou makes 15 billion buttons, 60% of the world's supply, and 200 million meters of zippers; Datang churns out eight billion pairs of socks annually, one-third of the world's supply; Ningbo makes 1.4 billion suits a year, and is a national center for

plastic injection molding machinery. Shaoxing produces textiles, Hangji makes toothbrushes, Shengzhou makes ties and Xiasanshu cultures freshwater pearls. Mark-ups of 100 or even 300% are not unusual when the goods reach Europe or the United States. However, some economists are worried that with a growing number of small businesses producing cheap goods in bulk, the province will be unable to move into more sophisticated or technology oriented industries, one of the central government's priorities for the future.

Accordingly, the local government is aiming to develop high-tech industries – particularly biotechnology, medicine, new materials and other related industries – while encouraging service sectors like logistics, finance, tourism and exhibitions and cultural and real estate services. Preferential policies to investors and improved bureaucratic procedures are another trend designed to attract more FDI.

With rapidly growing ports in Ningbo, Wenzhou, Taizhou and Zhoushan and the new Hangzhou Bay Bridge, the longest sea-crossing bridge in the world, there is much to be optimistic about. Furthermore, with constant infrastructure improvements since 2001, the government is certainly doing its best to tackle any obstacles to the province's development.

Anhui

A bit to the west of what most economists set as the YRD's economic radius, Anhui, is looking to become the newest member of the regional collective. To date, it has been more famous as the home of Chinese President Hu Jintao than as an FDI hotspot. Actually, Anhui is one of China's poorest provinces and has not seen a lot of outside capital investment at all. But that may change as Central China continues to rise and foreign direct investment pours into the provincial capital of Hefei.

The economy has potential for development and has benefited somewhat from its proximity to Shanghai and other large cities in the YRD. The province's strengths are its vast raw material resources, which include East China's largest reserves of coal and iron, and its status as a major producer of tea, rice, cotton, beans, wheat and peanuts. Anhui-based manufacturers have previously tended to focus on the electronics, textiles, tobacco, alcoholic beverages, and household chemicals industries. But in recent years, primary industry has accounted for a much larger proportion of the province's output – 16.5% in 2007 compared to less than 7% in Jiangsu and Zhejiang provinces.

Nevertheless, Anhui is still lagging in economic development: its GDP in 2007 was around one-third that of Zhejiang

and Jiangsu provinces. Mountainous terrain and weak infrastructure make transporting goods from Shanghai and other major cities time consuming, leaving wealth concentrated in industrial regions close to the Yangtze River, such as Hefei, Wuhu, and Ma'anshan. The government will have to invest more money if Anhui is to compete with its wealthy neighbors for the investment and new business that continue to flow into the other provinces of the YRD.

Looking to the Future

The YRD's long-term economic policies include:

- ★ Strengthening economic integration between YRD cities, particularly in terms of traffic network construction, unifying markets, environmental protection, information sharing, financial cooperation and talent exchange
- ★ Improving the regional logistics network by focusing on the overall layout of transport infrastructure such as roads, sea routes and ports
- ★ Jointly building the first inter-provincial tourism area in which cities work together to promote regional tourism brands, integrate tourism resources, share information and provide unified and convenient tourism services

★ Developing the YRD region into an economic center with the strongest overall integrated competitiveness

The future of the Yangtze River Delta lies in how it manages its evolution from an investment-driven region to an innovation-driven and service industry leader. Currently, the region is still the first choice for FDI. But Shanghai, Zhejiang and Jiangsu have been pressured to funnel more investment into outlying areas to spur the growth of new city clusters surrounding the region. At the same time, multinational companies are opting to move industrial operations to second-tier cities to cut land, utility and labor costs.

Chinese Premier Wen Jiabao has said that the Yangtze River Delta should pave the way toward economic and sustainable development, innovation and international competitiveness. Indeed, rerouting investment will allow those regions to focus on innovation as a way of coping with the liberalizing market brought about by the country's WTO membership.

Mr. Wen also listed the region's goals for its next stage of development: upgrading and optimizing industrial structures, promoting education and innovation, integrating major regional infrastructure projects, balancing the development

of urban and rural areas, optimizing urban planning, prioritizing harmony and promoting reform and opening-up to the outside world. To facilitate this shift, there are efforts to place a regional financial integration system referred to as the "common policy" that will allow efficient corporate capital flow, inter-city services, financial infrastructure upgrades and professional training. This will allow funds from the region to easily flow to the less-developed areas outside it.

According to a State Council approved blueprint, five high-speed railways are set to be built linking the ten biggest cities in East China. The plan says improvement of the transportation network will eliminate provincial and trade barriers. Upon completion the YRD region will be equipped with 300,000 kilometers of highways and 4,200 kilometers of freshwater navigation channels by 2020.

For Zhejiang Province alone, railway development in the next five years will come at a cost of RMB150 billion. This transit system will allow what China Daily calls a "one-or-two-hour economic circle" for shuttling people between cities.

The same blueprint also outlines the development of an international shipping center and container transportation system in Shanghai by 2020 along with

auxiliary ports located in Ningbo and Suzhou. There are also plans of building a major navigation channel centered on the Yangtze River and the Beijing-Hangzhou Canal. This year construction of an RMB11.6 billion bridge spanning from Haining in Jiaying, Zhejiang Province to Shangyu, Shaoxing is set to begin. The bridge will support the transportation network linking new cities and towns springing up around the YRD region.

The Yangtze River is also facing serious pollution, and international companies will have to be increasingly aware of their impact on the environment as they turn inland. The Chinese government has unveiled a detailed plan to limit pollution in China's lakes by 2010, and pesticides with highly toxic residue and detergents containing phosphorous have been banned near large lakes. Heavily polluting factories will see their doors shuttered and strict limits on fish farms will be strictly enforced. As the government moves to curb pollution, companies will find themselves coming under closer scrutiny from the State Environmental Protection Agency and local officials who want to be seen as combating the growing problem. Companies who plan to move into the region, as well as those already established, must be prepared to implement comprehensive environmental

due diligence in order to ascertain their environmental liability.

Like the rest of China, Shanghai and the YRD region are poised for major growth but must address big challenges in order to make good on these opportunities. The YRD is certainly in another league compared to West and Central China, but the government has realized that further huge investment are necessary in order to keep up with the pace of the booming economy. With some of the aforementioned ambitious projects all due to be completed in the next few years, it certainly looks as though the YRD will continue to be an attractive location for setting up new business.

Business Advisory

By Dezan Shira & Associates

Choosing Your China Structure

Foreign investors have several choices when it comes to structuring a China enterprise: the representative office, the joint venture, the wholly foreign-owned

enterprise and the foreign-invested commercial enterprise. Each has different features that can help or hinder your China venture, so using care and foresight to choose the right structure will be invaluable for long-term success.

Choosing your China structure				
Type of structure	Legal status	Common purpose(s)	Pros	Cons
Representative office	No legal personality	Market research, planning longer-term ventures, liaison with home country companies	Inexpensive to set up Allows exploration of the market and liaison activity	Complex registration for the size of organization Cannot invoice locally in RMB Must hire staff from local agency
Joint venture	Limited liability legal personality (in most cases)	When restrictions require a local partner, or when they can offer e.g. sales and tangible benefits distributions channels	Use of existing facilities and workforce Use of existing sales/distribution channels	Management can be awkward Inheriting staff liabilities Over inflation of assets or sales in planning Exaggeration of assets or sales by the Chinese partner during JV setup negotiation Technology transfer/IP/ management risks Split profits
Wholly foreign-owned enterprise	Limited liability legal personality	Most manufacturing businesses (for China sales or export), service businesses	100% ownership and control More flexible business scope Security of technology/IP Development of own infrastructure Insertion of existing company culture Allowed to convert RMB into foreign currency for profit repatriation	Need to fund total investment capital requirement Development of China sales operations on your own
Foreign-invested commercial enterprise	Limited liability legal personality	WFOE or JV mainly used for trading, distribution, and retail	A specialized structure for trading, retailing and distribution	High registered capital requirements for trading Still requires a proper organizational structure on the ground

Representative offices

Representative offices are useful and inexpensive vehicles for establishing a presence in China, assuming you proceed with care and avoid some common errors. Before 2004, when completely foreign entities could only buy and sell in free trade zones, ROs allowed foreign companies to effectively purchase goods in the mainland for sale to clients in the rest of the world. Now, they are useful to many companies because they have no capital requirement and can be set up on a shoe-string budget that only covers rent on an office, utilities and salaries. You can then liaise between the parent company abroad and potential clients or suppliers or conduct market research, preparatory work for a holding company, quality checks and supplier identification for a fraction of the investment needed for another type of foreign-invested enterprise. The setup process also allows foreign businesses to get working visas, get residence permits and legally employ staff, paving the way for more substantial investments in the future. They are also popular entry vehicles for international traders buying local goods for export, or for firms wishing to sell foreign goods domestically.

These benefits do come at the cost of some limitations, however. For example, ROs cannot engage in direct business

activities and any income derived from business transactions is not allowed to go through the RO's local bank account. They cannot invoice for any products or services either. Setting up an RO can be somewhat complicated, so doing research is key to avoiding these common mistakes:

Failing to obtain proper certification for office rental – Chinese landlords must obtain a certificate granting permission to rent to foreign entities, but many don't want to do so as it will place them in a higher tax bracket. However, an RO application cannot go forward without this document in place, so if it's missing you may lose time or even money if you've paid a deposit on the office space.

Choosing the wrong government agent in Shanghai – Shanghai has a unique rule requiring that all applicants get registration certificates via government agents, adding another layer of costs and administration. Applications are taken out of the hands of professional service firms and given to agents, so choosing a larger, and perhaps more expensive, agent is recommendable as they tend to provide better service.

Failing to clarify details regarding bank accounts – Many clients authorize their agent to open the bank account, even though they can actually do it themselves.

Many agents simply open the accounts without consulting the client on how to manage them, leaving things open to security breaches or conflicts of interest. Obviously, wiring money into an account if the client isn't fully aware of the details of the signatories and chops is dangerous. ROs must apply to a foreign service entity designated by the local government in order to employ local staff. FESCO is the most well-known HR service provider and has branches in major Chinese cities, but lately competing agencies have mushroomed. Do research on whether these newer companies have official approval and provide quality service.

Joint ventures

Joint ventures were the first and most well-known business entity open to foreigners in China, but they have since fallen out of favor with international investors as more flexible options have become legal. Indeed, JVs must be approached with care. Thousands of unhappy partnerships and broken dreams litter China's business history, and a marriage analogy is often appropriate – as a Chinese idiom goes, “same bed, different dreams.” One major Western oil company once said, only partly in jest, their JV was a win-win situation – meaning the Chinese won twice. Recently, however, JVs are beginning to come back into favor as more foreigners

are again choosing to set them up. They often sound quite appealing and many Chinese factories are likely to make offers if they are looking for long-term security in foreign sales via an overseas partner or access to western technology.

A JV is a limited liability company formed between a Chinese company and a foreign investor in which the foreign party or parties own more than 25% of shares. It is not a merger between a foreign and Chinese company, as is commonly misunderstood; rather, the JV is a new entity, partly owned by both sides, in which liability of the shareholders is limited to the assets they brought to the business. Liability does not, for example, extend to the parent companies. Note that a Chinese individual cannot normally be a shareholder in a JV.

A JV may be the best fit if the partner has something tangible to offer. They can serve as an entry vehicle into an industrial sector that is otherwise restricted to 100% foreign investment. Alternatively, they may have an established distribution network, brand reputation, a special manufacturing process, or other assets such as land or special licenses. To avoid the problems that have done in many JVs in the past, check out the partner's assets thoroughly for quality, restrictions and true ownership. This includes

land, buildings, equipment and staff in addition to intangibles like management, technology transfer and sales and distribution logistics.

Wholly foreign-owned enterprises

In 1986, the Chinese government wanted to encourage export-oriented manufacturing activities and attract advanced technology to China. Thus, the wholly foreign-owned enterprise was born, freeing up foreign companies from much of the burdens of the joint venture. Foreigners had previously only been allowed to set up businesses by going through a Chinese partner, but WFOEs allow foreign investors 100% ownership in limited liability companies in mainland China. WFOEs offer more flexibility and control while eliminating the risks involved with taking on a local partner. Since then, the government has tended to widen the scope of business open to WOFEs and more industries will be similarly liberalized in due course in line with the terms of China's WTO membership. The WFOE's popularity has been steadily increasing along with this liberalization: by 2005, WFOEs accounted for 71.2% of total international investment, as opposed to 27% in 1995. Keep in mind that in general international terminology, a company with joint investment from several parties might be called a joint venture. But Chinese law

will always regard a company that has no local partner as a WFOE, even though different foreign parties may be jointly investing in it.

Foreign-invested commercial enterprises

As of 2004, foreign direct investors can get their own import-export licenses and establish fully operational, 100% foreign-owned retail and trading companies that can buy and sell in China. These are called foreign-invested commercial enterprises, or FICEs, and are a special category of WFOE. FICEs are inexpensive to set up and can help foreign investors combine a purchasing and export facility with sourcing and quality control activities – increasingly vital in China following scandals over substandard foods and toys. The result is greater control and flexibility than what a purely sourcing-based overseas venture allows.

The regulations governing FICEs apply to the following activities:

- ★ Import/export, distribution and retailing
- ★ Retailing – i.e. selling goods and related services to individual persons from a fixed location, as well as through TV, telephone, mail order, internet, and vending machines

- ★ Wholesaling – i.e. selling goods and related services to companies and customers from industry, trade or other organizations
- ★ Representative transactions on the basis of provisions (agent, broker)
- ★ Franchising

However, if the company is distributing certain products - books, periodicals, newspapers, automobiles, medicines, salt, agricultural chemicals such as pesticides, crude oil and petroleum- it may be restricted to 49% ownership or other limitations. Investors in these restricted industries should keep an eye out for more open regulations in line with the Chinese government's tendency toward liberalization in recent years.

Intellectual Property Rights in China

China is now notorious for a massive counterfeit industry that creates and sells virtually any imaginable product – watches, DVDs, CDs, clothing, art, toys, and electronics - for a fraction of the price of the original brand. Counterfeiting is so widespread that some estimate it accounts for 15 to 20% of all the products made in China. Tourists and frugal Chinese consumers may love these products, but they can do serious damage to businesses – European manufacturers estimated that

in 2006, IPR infringements cost them one dollar for every five they made in China. The film and fashion industries aren't the only ones who should be concerned about intellectual property rights either - counterfeiting affects products in all industries and is not restricted to luxury goods or famous brands. The government has launched campaigns against counterfeiters and tried to create awareness that stealing intellectual property actually is a crime, but fake products of all kinds are still ubiquitous in China.

So ubiquitous, in fact, that seven in ten European companies doing business in China say they have been victims of IPR theft. The situation has improved somewhat in line with the terms of China's accession to the World Trade Organization, but IPR infringement is still one of the major risks for any foreign company here. There is no need to ignore the problem or surrender any intellectual property to counterfeiters; and indeed, doing so could be increasingly costly. Even companies that aren't doing business in China may have a compelling case for filing for IPR here as Chinese counterfeiters are increasingly exporting their products to third markets. However, surveys conducted by national chambers of commerce reveal that many companies from the United States and Europe

currently do not use existing legal measures to defend their IPR – a vast majority have not even filed for their IP rights. In reality, there is much that can be done to proactively protect their intellectual property in the China market.

Overview of China's intellectual property laws

The quality of Chinese IP laws has risen to meet international standards, but enforcement has lagged behind and remains a major problem. There is some hope that the situation will improve in the near future. Western countries have reacted to poor enforcement by threatening to initiate WTO procedures against China for non-compliance. Private companies have also pursued their causes, as in early 2009 when several major fashion brands successfully pressured Beijing's Silk Street Market to shut down vendors of counterfeit goods. Additionally, the Chinese government's stake in curbing IPR infringement goes beyond simply making good on the WTO's conditions. The government wants China to become an innovative country and sees intellectual property as an increasingly strategic resource in national development and a core element in international competitiveness. As such, the State Intellectual Property Office revised the national patent law in 2008 to expand patent protection. All companies doing business in China

should familiarize themselves with the new terms of this law, and further discussion of its details and implications will follow.

As an international investor, you may already be familiar with some of the major international agreements regarding IPR. China has signed onto most of the major WIPO agreements, including:

- ★ The Madrid System for the International Registration of Marks, which allows property holders to apply for trademarks from one centralized, international entity and receive a bundle of trademark rights from many member countries. See the Madrid System's list of member countries
- ★ The Berne Convention for the Protection of Literary and Artistic Works, which promotes equal enforcement of international copyrights. This agreement is often called the Berne Convention. It requires that members recognize the copyrights of other member countries just as they would in their own country. See the Berne Convention's list of member countries
- ★ The Paris Convention for the Protection of Industrial Property, which allows inventors to file for patents in several countries with the same priority date, thereby

reducing the risk of losing novelty while waiting for other patents. It also allows the inventor to wait for the results of the first filing before spending money on further filings in other countries. See the Paris Convention's list of member countries

Getting legal protection for intellectual property: copyrights, patents and trademarks

In addition to the international standards, current IPR law in China is based on three major national regulations protecting trademark, copyright and patents. Explicit legal rights are essential to protecting IP in China; without them, there is no legal foundation to prevent someone else from using your company's logo, products or designs. Therefore, a combination of technical safety measures and legal intellectual property rights are ideal for warding off counterfeiters.

Copyright registration

The following works are protected under China's copyright law:

- ★ Literary works
- ★ Oral works
- ★ Musical, drama, quyi, dancing
- ★ Fine art, photography
- ★ Movie, television, and video works
- ★ Engineering design, product design with illustrations
- ★ Maps
- ★ Other works protected by laws and administrative regulations

Unlike patents and trademarks, copyrights don't have to be registered with the Chinese bureau. Because China is a member of the Berne Convention, work will be automatically protected in China as long as the creator's country is also a member or the work has been first published in a member country. Registering can be helpful, however, to serve as evidence if legal enforcement actions do become necessary. Each province or municipality has a patent office with jurisdiction over the registration of works of authors or other copyright owners.

Foreign copyright owners who want to apply for copyright in China must submit the following documents to the State Copyright Bureau:

- a) Application forms
- b) Notarized identity certificate of applicant
- c) Introduction of the work
- d) A pledge letter of right
- e) Sample of the work;
- f) Documents showing the copyright, i.e., copyright page and agreement;
- g) Power of attorney.

Trademark registration

Even though China is party to the major international agreements like the Madrid system, trademarks and patents are only protected in China if they are

registered with the Trademark Office of the State Administration for Industry and Commerce in Beijing. An authorized trademark agency must file on behalf of a foreign company. A list of trademark agencies can be found here.

China uses the International Classification of Goods and Services, which sets out 45 classes of goods and services, meaning owners must apply separately for each category in which protection is sought. It's also wise to register a trademark in both the original and in the Chinese language, as another company might register the Chinese version if the trademark is only registered in the original language.

The TMO typically takes 24-30 months to make its decision due to the rapid increase in applications since the law was enacted in 1982. After acceptance, the TMO publishes the mark in its journal, beginning a three month "opposition period" during which the public can challenge the application. Assuming no objections are raised, the TMO will issue a registration certificate. An applicant with a rejected trademark application may apply for review to the Trademark Review and Adjudication Board within 15 days of the date on which they receive notification, or may institute proceedings in the People's Court within 30 days.

Once registered, a trademark is protected in China for ten years from the date the registration is granted. The registration can be renewed indefinitely for additional ten year periods, but renewal procedures must be started no later than six months after the expiration date. Under Chinese law, use of the trademark is mandatory. Three consecutive years of non-use from the day of grant puts the trademark registration at risk for cancellation. The cost of filing a trademark application per mark per class for any language is approximately USD480, including the agent fees, official fees and disbursements.

Patent registration

Hoping to increase China's competitiveness in science and technology innovation, authorities revamped the national patent law in December 2008. China Daily reported that the new law sets out a stricter patent application and strengthens patent protection by raising fines for counterfeiters, clarifying the legal process and strengthening administrative powers to investigate patent violations. It also incorporates infringement determination standards, extends the scope of patent infringement exemptions and further clarifies stipulations on compulsory licenses.

The standards of absolute novelty, inventiveness and practical applicability must be met in order to get legal patent rights.

Absolute novelty means that before the date of filing, the same invention or utility model has not been publicly used or known. Absolute novelty is a new addition to the 2008 patent law and reflects a higher standard than the previous law. It should make it more difficult to get patents in China for products that have already been released elsewhere.

Inventiveness means that the invention has prominent substantive features and represents notable progress compared with the technology existing before the date of filing.

Practical applicability means that the invention or utility model must solve a technical problem and be made or used industrially to produce positive, effective results.

Patents can be obtained for designs, utility models and inventions. Design patents protect ornamental or aesthetic aspects such as shape, surface, patterns, lines or color. Industrial designs are applied to a wide variety of products: technical and medical instruments, luxury items like watches and jewelry, houseware and electrical appliances, vehicles and

architectural structures, textile designs and leisure goods. Utility models, which are like patents but shorter-term and easier to get, can help protect inventions in China. Utility models and designs are only subject to a preliminary and often superficial examination, and the Patent Office will only look deeper if an invalidation procedure is filed, usually parallel to court infringement lawsuits.

Applications for patents are examined more thoroughly than utility models or designs. Many foreign applicants can designate China when they file a Patent Cooperation Treaty application. The PCT is a WIPO organization with 137 member nations that allows inventors to file for IP rights for all member states together. As a first step, WIPO asks a national or regional patent office to submit an international research study of the application. In case of a PCT application entering the Chinese national phase, substantial examination must be applied for within 36 months from the first national application upon which the PCT is based. If the application was already filed abroad, eventual search reports should be made available to the Chinese Patent Office (i.e. WIPO search reports).

An application form, detailed description of the product and an abstract should be directly submitted in Chinese to the filing office of SIPO in Beijing, or to a patent

agency established by the State Patent Office in cities like Shanghai, Shenyang and Chengdu. Foreign companies cannot apply directly for a patent and must go through an ad hoc appointed Chinese patent agent (see a list of agents).

Foreign investors operating RandD centers or other forms of invention development contracts in China should note that national applications are mandatory when inventions are made in China by Chinese citizens or a Chinese entity. Inventions developed by a Chinese sister company or RandD center of a foreign company might belong to the Chinese entity and as such must be filed for patent in China before being filed abroad. In many instances foreign companies comply with this provision by letting the Chinese sister company file for a Chinese patent and subsequently filing a PCT application. However, contracts might also be construed to create direct ownership of the invention and therefore allow the foreign mother company the right to apply for patent directly, thereby circumventing the Chinese patent law.

If the application materials are in place and other formalities met, SIPO will publish a preliminary approval of the application within 18 months or earlier if a request is made. Next begins a “substantive examination” that can take as long as two

to four years. For utility models and design patents, the application will be carried out much faster - designs can take 10-12 months, utility models about 12-18 months - because these are merely checked for formalities and published in SIPO's journal, not examined for substance by SIPO.

Patent applications with up to 10 claims cost about USD1,650, including official fees and fees for a Chinese patent agent but excluding translation fees. After approval, a registration fee of approximately USD150 and the first annual fee of USD110 must be paid. Patents for invention are granted for a period of 20 years from the date of filing, while utility model and design rights get 10 years. Patent holders pay annual maintenance fees and can lose rights if they fail to comply with the fees. Applicants who are rejected can request a re-examination from the Patent Reexamination Board within three months from the date of receipt of notification. The PRB's decision can be appealed to the People's Court within three months from notification.

Additional steps to protect IPR

There's no substitute for legal protection, but avoiding legal battles with basic preventive strategies should be your first line of defense. While filing for patents or trademarks does entitle you

to defend yourself legally, these rights will not completely protect the content of your intellectual assets. It is highly recommended, therefore, to combine IP rights with other protection mechanisms.

Carefully monitor intellectual property

It's not easy in a huge market like China, but detecting counterfeiters early on will help contain the damage. Watch the internet and relevant publications, visit trade fairs and exhibitions and do on-the-spot market research. The longer an infringer has to establish counterfeit products, the higher the cost of fighting them and the more damage is done to name recognition, trust in the brand and market share. If need be, specialized investigation agencies can monitor your IPR and secure evidence that will be accepted in court.

Adopt a strict confidentiality policy

Preempting any legal battles with a careful policy of strict confidentiality is one of the best protection methods, particularly for long-lasting products or technologies. Think of how Coca-Cola has managed to keep secret its famous recipe much longer than the lifetime of a patent would have allowed. Keeping access to IP confidential is a simple and effective way to protect recipes or production procedures for any product that can't be simulated easily.

Prepare a company procedure for handling IPR theft

Outlining a company procedure on how to handle potential IPR infringement problems is an integral part of IPR planning. Developing a plan will help create awareness inside the company towards the threat of infringement and will prevent a hasty and perhaps imprudent response should any IPR threats surface.

Use security measures

It can be difficult to keep technology confidential when products are in the market as many technological traits can be re-engineered. In these cases, a variety of protection measures can be applied for all kinds of products. Security experts recommend using three to ten security features and changing them on a regular basis in order to stay one step ahead of potential copiers.

Some of the most common safety measures according to the level of sophistication are (1 low, 4 high):

1. Holography, watermarks, temperature sensible colors, color-shifting ink, mechanisms to prevent unauthorized opening
2. Invisible, UV/IR reflecting color, micro writing, colors that are only visible with filters, radio-frequency identification (RFID) tag

3. Bar code, matrix code, encrypted matrix code
4. Digital watermarks, taggants (either a radio frequency microchip used in automated identification and data capture or a chemical or physical marker added to materials to allow various forms of testing), cryptographic data protection

Security measures can serve two purposes: preventive protection against counterfeiting, or a means of generating evidence in case of a lawsuit or administrative action against illegal copies. Preventive measures include all features that can be recognized by non-experts (see Level 1 in the table), such as safety features on money bills. Measures that provide evidence are usually hidden and demand a complex procedure. Continuous tracking of each product guarantees the highest standard of protection against counterfeiting. However, the implementation of such a complex tracking system is expensive and may not be justified, even when the positive secondary effects such as quality control and logistics are considered.

Responding to IPR infringement

IPR infringement cases should be handled with care – a hasty reaction or vague accusations could trigger a lengthy legal battle with bad results for

the rights holder. Most importantly, think through each step and identify which of the available options will be most strategically advantageous to your case. Preparing for such events will make handling them much easier when the time comes. Consult legal experts when appropriate and remember the following rules of thumb:

- ★ Gather as much information about the counterfeiter as possible
- ★ Define the strategic issues that demand immediate action
- ★ Decide at the management level whether to fight the infringer immediately or monitor development further
- ★ Discuss thoroughly the available channels for fighting the counterfeiting activities
- ★ Compare the costs and consequences of different scenarios in for responding to the infringer

The IPR environment is certainly less than ideal, but the situation is improving and many methods of defense, both legal and practical, are already available to foreign companies. Governments and major international brands are likely to keep up the fight in pressuring the Chinese government to enforce its existing laws, and China itself is discovering its own vested interest in protecting IPR as well. Being informed on China's laws and the

international standards as well as keeping up on changing laws and enforcement trends will be invaluable to any foreign investor in China.

Addresses and links

State Intellectual Property Office

No. 6, West Tucheng Road, Haidian District, Beijing 100088, China

Phone: +86 10 62085588

Website: www.sipo.gov.cn (English version available)

Patent agencies in China

Website: www.acpaa.cn/english/Patent-p.asp. (English version available)

World Intellectual Property Organization (WIPO)

No. 34, Chemin des Colombettes, Geneva, Switzerland

Phone: +41 22 3389111

Website: www.wipo.int

Trademark Office of the State Administration for Industry and Commerce

No. 8, Sanlihe East Road, Xicheng District, Beijing 100820, China

Phone: +86 10 68052266

Website: www.ctmo.gov.cn (English version available)

Trademark agencies in China

Website: <http://sbj.saic.gov.cn/sbsq/dljg.asp> (Chinese only)

National Copyright Administration

No. 85, East Fourth South Avenue,

Beijing 100703, China

Phone: +86 10 65127869

Website: www.ncac.gov.cn (Chinese only)

Copyright Protection Center

Wuhua Building, 5/F, No. 4A,

Chegongzhuang Avenue, Beijing 100044, China

Phone: +86 10 68003887

Website: www.copyright.com.cn (Chinese only)

Music Copyright Society of China

Jingfang Building, 5/F, No. 33,

Dongdansantiao, Beijing 100005, China

Phone: +86 10 65232656

Website: www.mcsc.com.cn (English version available)

China Audio and Video Association

No.51 NanXiaoJie ChaoYangMen,

DongCheng District, Beijing 100001, China

Phone: +86 10 6512 2882

Website: www.chinaav.org (English version available)

Staffing

General conditions and salaries

Working hours must be in accordance with the local regulations, which normally are eight hours per day and 40 per week (if an extension is required for special reasons, it must not exceed three hours a day and the total extension per month must not exceed 36 hours). The company shall also cover the employee's welfare, normally including pension, medical insurance, unemployment and injury. For overtime payments, the labor law states that employees must not receive less than 150% of their normal wage for extensions of regular working days; not less than 200% in extensions on days of rest; and not less than 300% for extension of statutory holidays.

In comparing labor costs in different cities across China, please note that more inland or remote areas may have lower workers wages, but also may have fewer skilled employees.

Professional employees are constantly searching for better pay, opportunities and living conditions, so expect to pay higher salaries to retain skilled junior and middle management. High turnover can also be an obstacle to developing your organization, so note that more and more companies are now poaching good employees within similar industries more frequently.

The company normally provides meals. You can budget for an internal canteen or simply subcontract the provision of meals to a third party. RMB10 per day per person seems to be a good estimate for one employee's daily breakfast/lunch/dinner expenses; office staff often receive a similar allowance. Please note this figure, as it will amount to quite a sum every month for larger workforces!

Manufacturing companies also normally provide lodging, and a budget of around RMB50-60 per person per month is reasonable. We have seen up to 16 people crammed into a tiny cubicle. Be fair to your workforce and you will gain in terms of lower staff turnover and better attitude at work. The trade unions and the local media will not hesitate to highlight poor conditions.

The Labor Contract Law

In June 2007, China's top legislature, the National People's Congress, adopted a new labor contract law that became effective January 1, 2008.

The draft, first submitted to the top legislature for deliberation in 2005, will protect workers' legal rights by demanding a written contract. Under the new law, if employers don't sign a written contract with their employees within a year of the employee's start date, it should

be taken as having signed a labor contract of no fixed term.

It is the country's first law governing the establishment, revision, and termination of labor contracts in the People's Republic of China. This new law is designed to mitigate poor working conditions, minimize labor-management disputes, and stabilize the job market. Under the previous labor contract system, employers could terminate contracts without notice, withhold workers' wages, and refuse to renew contracts. The new law is decidedly pro-worker, and includes many provisions that protect laborers who are in a disadvantaged position in the market economy.

Some of the key points of the new law are:

Fixed term contracts

- ★ A written contract between the employer and employee is required; if no contract is provided then the employment relationship will commence from the employee's first day of work. A written contract should be signed within one month of starting work, and an employer who fails to provide such a contract after one month will be forced to pay the employee twice their monthly salary.

- ★ The law only allows for two continuous fixed term contracts. Any further contracts must be, in general, open term contracts.

Severance payments

- ★ An employer must pay severance to any employee whose fixed-term contract is not renewed to the amount of one month of salary for each year served, unless the employee rejects a new contract on equal or improved terms. If the employee's monthly salary is three times higher than the average monthly salary of the previous year for this region then the employer is only obligated to pay a severance equivalent to three times the average monthly salary for each year served.
- ★ In cases of unlawful dismissal, the severance payment outlined for lawful dismissal is doubled to two months' salary for every year of service.

Mass layoffs

- ★ Employers will be required to listen to the opinions of unions and/or employees regarding mass layoffs - defined as the laying off of 20 or more employees or no less than 10% of total staff - and give 30 day's advance warning, under certain specific situations provided by law, i.e. if the company has been restructured according to the bankruptcy law; or in

the cases that an employer adjusts the way in which the company carries out its business, changes the nature of the business or makes technology based changes.

Non-Competition agreement

- ★ Employees who leave a company can be bound to a non-competition agreement for up to two years following termination, providing that corresponding economic compensation is paid to those employees on a monthly basis during the effective period of the non-competition agreement
- ★ This may apply only for senior managers, senior technicians and other people who have knowledge of the trade secrets of the employer

Probationary period

- ★ The maximum probation period is based on the term of the contract, thus:
 - One month, if contract term is less than one year
 - Two months, if contract term is less than three years
 - Six months, if contract term is more than three years
- ★ However, in the exception that the labor contract has a specific purpose or is based on a specific project, this probationary period may not apply

- ★ Employers shall pay their employees at least 80% of their contractual salaries during the probationary period. This figure shall not be lower than the minimum salary set by the government for this particular region or provided by the employer for the same position

Labor unions

- ★ The role of labor unions has been strengthened. The current laws, which require employers to notify labor unions prior to terminating a labor contract for any reason, are still in effect. Employers that do not have established labor unions are required to notify the union at the next higher level. Unions are also allowed to engage in collective bargaining and enter into collective contracts.
- ★ A company is required to gain approval for its employee manuals, and company rules require a consultation with the labor union, workers' congress, or by workers' representative assembly or equal negotiation, before implementation
- ★ If the labor union or an employee is of the opinion that the rule or regulation is inappropriate then it should be improved after consultation
- ★ The labor bureau has the right to order an employer to change company rules that violate laws and administrative statutes

Employing Chinese staff

While it may be very useful to have a nice and efficient local Chinese person help with all aspects of setting up China operations – all business licenses, offices, bank accounts, handling all documentation; the language and bureaucracy are almost unintelligible after all – is it normal business practice anywhere to have one person in control of all aspects of country operations?

No, it isn't; and with very good reason:

- ★ Although a Chinese employee may in fact be honest and helpful, he or she may not necessarily be competent in international business areas. Foreign companies have different reporting structures and are administered differently from Chinese ones. In reality, foreign businesses in China face far more scrutiny than Chinese companies. If your employees, good as they are, are not familiar with the regulatory aspects of operating and maintaining an international office or business in China, chances are there will be issues on which your company will immediately be out of compliance. That can be costly. Additionally, there are circumstances where the employee may deliberately keep the company out of compliance to obtain benefits or other leeway later in case of any future conflict

- ★ Having one person in control of all corporate documents and/or banking is very common, but the risks are obvious. One can lose all ability to operate the company, not to mention all investment, if the employee decides to walk out of the door.
- ★ Inserting family and friends into a company's supply chain is very common in China. One needs to audit purchasing and sales departments regularly to ensure employees are not placing orders with companies owned by friends or relatives that are then charging the business at rates well over the market odds
- ★ An employee could set up a parallel business, and it has happened that "trusted employees" have established a mirror company with a similar Chinese name, and then diverted all orders to that business instead.

Employing expatriate staff

There are some common pitfalls when it comes to hiring expatriate staff as well:

- ★ Hiring lawyers with no China experience – this is expensive and not very effective, especially if their Chinese language capabilities are minimal. They may look good on paper and their firms may have a China presence, but what about their individual experience in China? International lawyers are great at

international work like cross-border structuring and so on, but far too many lack the actual qualifications and expertise in areas of Chinese law they will need to deal with. China has had private lawyers now for 15 years, so go to a firm that has the real thing.

- ★ Hiring personnel on their language skills alone – a new kid just out of language school will have not be an expert on China issues, so don't expect miracles. Young graduates do have skills of course, but don't weigh them down too much with managerial responsibilities before they have had time to adjust to a commercial business environment. A management development program designed to maximize on their language skills yet introduce them to your business will reap greater rewards both for you and for them.
- ★ Overlooking the "China guys" – expats of note are those who really know their way around, and can steer you away from all the problems we have identified in this issue. They will have a good grasp of the language, and may well have settled down with family here. You cannot survive in China without knowing how to get on, and this is a question of experience as well as patience, tenacity and people and communications skills. They are available, especially since many of the established multinationals

are localizing, making expatriate engineering and other talent perhaps more available in China than ever before.

Good recruitment practice

Incorporate all the normal checks and balances that you would back home to all staff, irrespective of nationality.

- ★ Check both oral and written language skills – some Chinese staff have their friends write their English CVs, while many expats overstate the fluency of their Chinese. Note also there is no such thing as "fluent Mandarin" and that regional dialects can enhance or limit the ability of your staff to operate locally
- ★ Check all backgrounds and references – this is often neglected and often regretted later. Follow up those qualifications and references
- ★ Pay staff properly – if you want to retain them, go beyond just the mandatory welfare payments and pay enough to keep them motivated and keen on continuing to work for you. China may be the current center of cheap manufacturing, but there is no reason to be cheap when it comes to staff, or else you'll end up spending more time on recruitment operations than on your actual money-making operations.

Inheriting staff in joint ventures

When entering into a JV or acquiring a Chinese business, you may find yourself taking on significantly more than you bargained for in terms of staff liabilities. Here we outline how to avoid these staffing situations, which are particularly prevalent in China's state-owned enterprises.

Employee contracts and terms

Review all employee contracts and personnel records when inheriting staff, checking that the employees actually exist, scrutinizing contracts and identifying all costs of employing them. Details of any recorded misdemeanors should also be scrutinized as well as time-keeping/productivity records.

“Ghost” employees

It is not uncommon for someone within the company to be claiming and receiving salaries for employees who have long left the company, retired, or even died. Check that all contracts and the payroll are matched with specific, individual identification of each employee.

Qualifications and longevity of staff employment

Sometimes the staff members that get transferred to joint ventures are incompetent or come with significant pension/termination liabilities, which the JV will pick up backdated to when the

employee joined the Chinese party, not the JV. Termination is a minimum of one month's salary for every year of service. Do you really want to be inheriting staff with 12 years service? Consequently, you could inherit huge headaches if these are not fully identified and assessed.

Hidden employees

Some Chinese operations hide their true staff overheads by making off-the-record payments. However, staff still have legal claim as employees of the business. Ensure that the headcount and payroll match, and request a written statement from the Chinese side taking on liabilities for any staff not individually identified in any transfer of assets.

Labor unions

Make sure you have identified their charter, and payments that have been made to the union. The business has a liability here of 2% of all staff salaries to be paid to union funds so ensure you know what this is, and again, that it matches up against payroll.

Pension fund

Has this been properly administered and are the assets that should be in the fund all accounted for? You need to check with the relevant government departments that all is in order and get a statement accepting that retrospective liability is signed off by the Chinese side.

Managing China Supply Chains

Supply and pricing are still very different concepts

Many companies have come to think that sending out quotations on product is the way to measure new opportunities. In China, the price received on a quotation is not the true cost of an opportunity. Logistics, lead times, material prices, exchange rates and quality considerations are just some of the factors affecting cost, and understanding this is more and more important in developing a good supply chain strategy.

Immensity is now diversity in the China production market

China has thousands of factories. Years of development have seen the growth of industries and investment in technology, resulting in great diversity. Factories producing the same product are now very different from one another. They can range in size from five employees to thousands of workers. Equipment used for production ranges from antiquated to world class. Facilities range from open-air sheds to temperature controlled buildings. This diversity shows in pricing, whether cheap or expensive, but it also shows in other areas such as consistency and quality. Understanding all elements of diversity and their effect on production

are increasingly important in supply chain management.

Labor versus material

Cost is a result of the amount of labor and material going into a product, and balancing these will be crucial for continued success. Recent shifts in material markets are driving prices up in all markets. China's historical strength has been labor, and with recent shifts in material markets driving prices up, it will continue to be so. Labor reform is changing this advantage, but compared to material it is still the main money-saving factor.

VAT

Value-added tax used to be a main factor keeping costs low and encouraging exports from China, since most suppliers who exported products were given an average VAT refund of 17% up until a few years ago. Now that VAT refunds are gone or significantly lower, cost are higher because local suppliers must pay higher taxes, even when exporting. Knowing where products fall in the VAT refund%ages and how much this will affect costs savings is important.

Growth is fast, change is slow

While growth in China is still at break-neck speed, the actual changes seen at a single factory location may or may

not be keeping pace with changing strategies. Implementation of new quality procedures, use of new machines for increased precision and less material waste, or any number of new requirements must be followed closely to see that they are integrating well. Fast change is still a new concept in China, so the ability to measure this versus expected return is crucial.

Know your suppliers

No matter where you find your supplier, continually visiting their facilities is still crucial to good sourcing. Face time is becoming the equivalent of face itself. Credibility increases, processes are continually reviewed and suppliers will be less likely to get away with mistakes if purchasers are present to control how money is spent.

Quality and system are still dual concepts

There are many requirements for quality depending on product choice. China has made a concerted effort to bring factories into worldwide quality systems, but quality and system are still dual concepts in China. Quality is a mentality; system is a way by which it is achieved. As more suppliers move toward quality systems it is still important to remember to balance purchasing requirements with continued oversight on quality control.

Service is an increasing function of your relationship

Contracts have always been seen as the start of negotiations in China. This is still true. The strength of the relationship between supplier and purchaser will affect how and when contracts are fulfilled and whether assistance with quality issues, engineering, and technical support is provided. With ever-changing rules in China, the strength of your *guanxi* will increasingly determine your success.

It's a question of when, not if

Remember that problems are inevitable when managing supply chains in Mainland China and adjust your expectations accordingly – plan ahead for the frustrations, misunderstandings, renegotiations, quality problems, bad materials, missed deadlines, payment issues, midnight panic calls, product swapping, excuses and Maotai lunches.

Looking Beyond the Initial Investment

By Dezan Shira & Associates

China's Emerging Middle

Class

China's middle class is on track to number 700 million by 2020, accounting for of the largest and most dramatic rises in living standards in history. The country's vast population and rising GDP are meeting to form a massive group of consumers, and the potential is intoxicating to many who dream of selling to this emerging market. It's true that Chinese consumers – by and large young, fond of foreign brands and still formative in terms of taste and spending habits – have great potential as spenders. But attempts to sell to this group should involve much more strategy than simply setting up shop in Shanghai and hoping 1.3 billion people will bang down the door to buy what you're selling. In fact, getting Chinese customers to spend money can be tricky, as market researchers and the Chinese government alike are finding out. As in any market, successfully selling to China's middle class requires an understanding of the consumer as well as the big economic picture that shapes their decisions.

Economic growth in major emerging countries, most notably India, Brazil and China, has caused a surge in the number of middle class households in recent years, and now the world is on the verge of an unprecedented situation: as much as 90% of the global population will be middle class by 2030, according to the Economist magazine's projection. No longer are rich countries like the United States, Western Europe and Japan the sole, or even main, targets for consumer products. Companies all over the world are realizing that this rising middle class is the future and are rushing to grab a share of these vast markets. At the forefront of this scramble for market share is the Chinese consumer. Indeed, rising disposable income means millions and millions of Chinese are consuming in ways they never have before: driving cars, going out to eat, shopping, traveling and buying and decorating their own homes are just a few of the lifestyle changes that mean great business opportunities in many industries.

Hand in hand with rising disposable income is a trend toward urbanization, a mass migration of rural residents who

are leaving the countryside to find jobs and a higher living standard in cities all across China. In 1990, 74% of China's population lived in rural areas, and by 2035, 70% will be living in cities. but 70% will be living in cities by 2035. Within the next ten years, 300 million more Chinese are expected to move to cities, until more cities grow to a population of 3 million and 23 cities will claim 5 million residents. By contrast, only 35 cities in all of Europe today have 3 million residents. Market researchers and consultants have identified the growth of these provincial cities and "country towns" as the key to reaching the new wave of Chinese consumers.

Who, and where, are China's consumers?

In the most general sense, middle class means any household earning a stable income that covers basic needs with some left over for discretionary spending. But what exactly does this mean in China? Quantifying the middle class is tricky because China's cost and standard of living vary greatly from place to place, meaning the middle class could currently number anywhere between 100 million to 250 million depending on the standard used. The common international standard of USD10,000 a year may be appropriate for a household in Beijing or Shanghai but could actually be quite high for a second-

or third-tier city with low living costs. The China State Information Center counts households earning RMB50,000 (USD6,227) per year as middle class and projects 25% of the population will fall into this category by 2010. However you count them, most agree the group will see huge growth in the next few years, complementing the buying power of the millions of rich households already earning over RMB250,000 a year. The consulting firm McKinsey projects that in addition to a huge middle class, China will have 4 million wealthy households by 2015, the fourth largest number in the world after the United States, Japan and the United Kingdom.

McKinsey's market research data shows that on average, the Chinese wealthy are much younger than in the United States and Japan, are well-educated and are self-employed. In the United States, income tends to peak between the ages of 45 to 54, but this will most likely not be the case in China due to higher education levels among the younger generation. The wealthiest consumers in China will likely be between the ages of 25 and 44. McKinsey found that of China's wealthy, 80% are under 45, compared to only 30% in the United States and 19% in Japan. 50% of wealthy households were not wealthy just four years ago, and the firm predicts that more than half of those that will be wealthy by 2015 are not now.

Some aspects of the Chinese consumer may be difficult to pin down, but one thing is clear: they are thrifty spenders who prefer to save as much of their earnings as possible. In 2006, Chinese households saved an average of 24% of their disposable incomes, a stark contrast to Americans, who saved less than 1% on average. This stunningly high savings rate is likely due to a combination of the cultural value placed on frugality and the lack of social benefits like free education, universal health insurance and retirement benefits. The Chinese leadership has realized that having domestic consumption below 50% in proportion to GDP has left the economy too dependent on exports for growth, and has taken steps to promote consumer spending in recent years. Foreign companies who want to market goods or services in China should be aware of this attitude when developing a market entry strategy.

It's important to understand who Chinese consumers are, but where they are may be the key to reaching them. The middle class are currently concentrated along the coast of China, mostly in major southern and eastern cities, but this distribution will expand inward as incomes rise and more rural residents move to cities. Beijing, Shanghai, Guangzhou and Shenzhen have so far retained around 30% of China's wealthy, and the

remaining rich are concentrated in the surrounding eastern and southern regions. But urbanization and rising per capita GDP mean these four cities are just the tip of the iceberg: second-tier cities will transform the Chinese market, accounting for three-quarters of the growth in wealthy households in the next seven to eight years, McKinsey projects. Foreign brands that have already been successful in the big four east coast cities have made the new consumer class emerging in the second- and third-tier cities central to their strategies.

The emerging cities in North China

	City	2001	2004	2007
Population (in millions)	Qingdao	7.105	7.31	7.58
	Tianjin	9.14	9.33	11.15
	Dalian	5.55	5.62	6.08
GDP (in RMB billion)	Qingdao	131.6	216.38	378.65
	Tianjin	182.67	293.19	501.83
	Dalian	123.56	196.18	313
Per Capita GDP (in RMB)	Qingdao	N/A	N/A	N/A
	Tianjin	19,986	31,550	45,829
	Dalian	2,700	N/A	51.62
Per Capita Disposable Income of Urban Residents (in RMB)	Qingdao	8,731	11,089	17,856
	Tianjin	8,958	11,467	16,357
	Dalian	7,418	10,378	15,109
Retail Sales (RMB billion)	Qingdao	35.29	60.55	119.92
	Tianjin	83.27	105.3	160.37
	Dalian	53.42	64.52	98.33

The emerging cities in the Yangtze River Delta

	City	2001	2004	2007
Population (in millions)	Suzhou	2.1	2.21	2.4
	Hangzhou	6.29	6.52	7.86
	Wuxi	4.36	4.47	4.62
	Nanjing	5.53	6.9	7.41
GDP (RMB billion)	Suzhou	176	345	570
	Hangzhou	156.8	251.5	410.39
	Wuxi	136	235	385.8
	Nanjing	115.4	191	327.5
Per Capita GDP (in RMB)	Suzhou	30,000	57,992	79,407
	Hangzhou	25,000	38,858	61,313
	Wuxi	31,246	N/A	65,203
	Nanjing	20,671	N/A	44,852
Per Capita Disposable Income of Urban Residents (in RMB)	Suzhou	10,515	14,451	21,260
	Wuxi	9,454	13,588	20,898
	Hangzhou	10,896	14,565	21,689
	Nanjing	8,848	11,602	20,317
Sales (RMB billion)	Suzhou	39.2	62.51	124.55
	Wuxi	39.08	57.92	113.48
	Hangzhou	45.9	70.43	129.63
	Nanjing	46.6	71.14	138.05

The emerging cities in West China

	City	2001	2004	2007
Population (in millions)	Chengdu	10.2	10.6	11.12
	Chongqing	30.97	31.44	28.16
	Xi'an	6.95	N/A	8.31
GDP(RMB billion)	Chengdu	149.1	218.57	332.44
	Chongqing	175	266.54	411.18
	Xi'an	73.4	94.04	173.71
Per Capita GDP (in RMB)	Chengdu	14,665	N/A	26,527
	Chongqing	5,655	9,608	14,622
	Xi'an	N/A	N/A	21,017
Per Capita Disposable Income of Urban Residents (in RMB)	Chengdu	8,128	10,394	14,849
	Chongqing		9,221	13,715
	Xi'an	6,705	8,543	12,662
Sales (RMB billion)	Chengdu	62.75	87.53	1357.2
	Chongqing	69.93	95.5	166.12
	Xi'an	36.59	50.65	92.16

With the four major economic investment cities already saturated with advertising and shopping malls, a group of second-tier cities has emerged as attractive alternatives or getting a foot in the China market. In the western cities of Chongqing and Xi'an, per capita disposable income more than doubled between 2001 and 2007. Disposable income in Chengdu led both cities at RMB14,849 in 2007. In eastern Chinese cities that feed off spillover growth from Shanghai, the rise in per capita GDP during the same period has been dramatic: from RMB30,000 to RMB79,407 in Suzhou, RMB25,000 to RMB61,313 in Hangzhou, and equally significant increases in nearby Nanjing and Wuxi. In North China's vacation town and port city of Qingdao, retail sales hit RMB119.92

billion in 2007, up from RMB35.29 billion in 2001. In Tianjin and Dalian, two more major secondary cities of the north, indicators such as retail sales, GDP per capita and per capita disposable income showed similarly strong growth. Of these ten cities, Suzhou claims the smallest population by far with 2.4 million residents in 2007, while Chongqing leads with over 28 million residents.

These and many other untapped provincial cities and "country towns" of more than a million residents will be critically important in the race to reach the Chinese middle class. Not only are those consumers hungry for more variety of foreign goods, but profit margins could be much higher as real estate, labor and advertising cost a fraction of the Beijing

or Shanghai prices. Limiting yourself to first-tier cities may mean losing out on this long-term potential.

Chinese consumer spending: challenges and opportunities

Now that Chinese consumers have more money, the billion dollar question is how they will spend it. Up to this point consumer spending has been worryingly low. That inflation in the prices of real estate, food and gas prices is outpacing the rise in wages, unemployment has soared following the global financial crisis and consumers still save on average a quarter of their earnings to offset the lack of a social safety net for major costs like healthcare and retirement have exacerbated the situation. Though Chinese culture may see frugality as a virtue, such large-scale reluctance to spend has been a vice for China's economic leaders. They had long realized that economic growth was far too dependent on exports – they accounted for as much as 70% of growth before 2009. Then, exports dropped off about 25% amidst the global economic downturn of 2008-09, dealing a serious blow to the economy and making it painfully clear that stoking domestic consumer spending will be the key to maintaining strong economic growth in the future. Without it the stunning economic growth of the past years could turn to stagnation.

Given this situation, it may come as a surprise that China is a hot spot for big international luxury brands like Tiffany, Rolls Royce, Gucci and Louis Vuitton. But with sales declining in the United States, Europe and Japan, luxury brands have found that Chinese customers are buoying global sales amid an economic downturn, and will likely keep spending so that China becomes the world's largest luxury goods market by 2014. Sales of luxury brands are proof that Chinese customers, though frugal, are willing to spend on the right products, and will sometimes pay much more for a foreign brand if they think it is better quality and therefore a better investment. Scandals involving shoddy, fake and sometimes even poisonous domestic goods that shocked American and European consumers have shaken Chinese consumers as well. Foreign retailers have cashed in on this preference, and have also found that the young generation of affluent Chinese aspires to own name brand foreign goods. This opportunity is not just for high-end luxury retailers, but also for many other industries that are poised to see significant growth in recent years.

The automobile market is one of the hottest industries in China now, as owning a car and a home are seen as the two most important assets. Auto sales in China totaled 9.38 million in 2008.

China had already overtaken the United States as the biggest car market in the world, even earlier than projected despite a climate of slowing economic growth. Home ownership has also risen and along with it spending at international home décor retailers like Home Depot, IKEA and BandQ has spiked. Food, clothing, household products and personal care products are also likely to see skyrocketing sales, as is already evident from steady spending at Carrefour and Wal-Mart stores across China. In the service sector, Chinese are spending more on domestic and international travel, life insurance and education. The national government is taking steps to encourage consumer spending and has met some success by offering tax incentives and discounts on various consumer products. Tax incentives for cars with small engines and relaxed regulations on real estate investment recently brought about a spike in spending. The government also offered discounts to some 200 million rural households to buy household appliances like televisions and refrigerators in early 2009 as part of an attempt to stimulate spending. While these policies will not solve all the challenges in marketing to China's new middle class, they will be useful in prodding spending further along in the direction it is already heading – up. Although big issues like a lack of a social safety net will not change overnight, the government's need to free up consumers

to spend will likely bring about some large-scale policy changes in the coming years. Chinese society is changing at a fast pace and consumer spending habits will inevitably change with it, offering plenty of opportunities to forward-looking foreign companies that are interested in this market.

Sector Opportunities

By InterChina Consulting

Overview

Sector	Opportunities	Forecasted Growth	Growth Drivers
Healthcare	Plentiful <ul style="list-style-type: none"> Medium and low-end medical equipment for Chinese rural and community healthcare institutions. Pharmaceuticals Sourcing of pharmaceutical RandD solutions, APIs, and test rounds in China. 	High <ul style="list-style-type: none"> The Chinese government will significantly invest in healthcare infrastructure for rural and community healthcare institutions and therefore the medium and low-end medical equipment sectors represent a huge market potential in the next couple of years. China will become the 3rd largest pharmaceutical market within 10 years. More and more multinational pharmaceutical companies will aggressively set up or expand their RandD capacity in China to develop drugs for the domestic and global markets. 	Favorable
Energy and Power	Plentiful <ul style="list-style-type: none"> Supply and demand gaps in fossil fuels. Equipment supplies for traditional and new energies; sourcing opportunities (solar) Long-term opportunities in renewable energy technology such as wind and solar. Other clean energy and technologies such as coal bed methane. 	High <ul style="list-style-type: none"> Objectives stated in China's 11th Five Year Plan (2006-2010): growth in renewable, clean energies and technologies required for diversification of China's energy mix. Many technological barriers faced by Chinese companies, handing the initiative to foreign companies. We believe there will be further acceleration in governmental spending and capacity build-up in 2009 and 2010 as the country is still lagging behind its ambitious 5 year plans. 	Favorable
Automotive and Components	Several <ul style="list-style-type: none"> Services to Chinese carmakers. Component manufacturers with advanced technologies. Energy saving or pollution mitigating components. Companies active in the aftermarket, such as auto clubs, auto refit and roadside assistance services. Companies have leading technology on components for alternative energy vehicles, such as PCU and BMS. 	Medium <ul style="list-style-type: none"> There are no quick wins in China's automotive sector. However, InterChina expects average sales growth of 9-12% for the next 5 years, and this growth will continue to create opportunities for foreign companies. Specific drivers in 2008 will be Chinese carmakers striving to export into developed markets and wanting to improve product quality; and multinational carmakers implementing global sourcing structures. 	Mainly Favorable
Environmental Infrastructure	Difficult, But Some Remain <ul style="list-style-type: none"> Drinking water purifying plants especially in less developed west of China and smaller cities. Sewage treatment, including specialized treatment. Solid waste treatment. 	Medium <ul style="list-style-type: none"> Low current treatment levels, rapid urbanization and Chinese government's green development strategy are the main drivers. Although the Chinese government has invested significantly in city sewage systems, utilization of such systems with new pipelining and new sewage treatment plants in less developed cities will require urgent help from foreign companies. In addition, specialized sewage treatment e.g. cement factory sewage, paper/pulp mill's wastewater treatment, is a very fast growing market niche. In solid waste treatment potential exists for non-landfill treatment methods, urban garbage collection and sorting systems, and industry waste treatment. 	Favorable

Sector	Opportunities	Forecasted Growth	Growth Drivers
Food and Beverage	Difficult, But Some Remain <ul style="list-style-type: none"> Products with high quality standards and products reflecting a "foreign" image. Specific opportunities in frozen food, processed meat and meat processing machinery, cheese and dairy ingredients, pastries, and condiments. Niche markets for imported products to serve the growing middle class. Consolidation process will offer acquisition opportunities. 	Medium	Favorable <ul style="list-style-type: none"> The competitive landscape has been distorted massively by food quality scandals in 2008, having a long-term impact on the competitiveness of different players. The entire FandB industry is at the verge of a massive upgrade of its product quality and process quality. At the same time, continued and fast growth due to changing consumption habits, rising incomes, greater urbanization, and increasing preferences for western lifestyles and awareness on food safety. Improving government norms, and sanitary and production requirements may present foreign investors with special advantages. High degree of fragmentation of the industry and the consolidation of retail channels will drive consolidation in FandB.
Machinery and Machine Tools	Several <ul style="list-style-type: none"> High-end machinery and machine tools. Machinery used in environmental protection projects. Machinery tailored towards smaller plants and factories, allowing higher flexibility for producers. 	High	Favorable <ul style="list-style-type: none"> Aviation and military industry will drive very high-end (high accuracy) machinery. Component manufacturing and mass-production factories in various sectors will drive the demand for automated and high-end machinery. Governmental incentives are likely to spur further machinery investments. Environmental protection projects include wind energy and hydropower, together with water treatment. However, local competition in all machinery sectors will be increasingly favored by governmental initiatives and policies.
Chemicals	Selected <ul style="list-style-type: none"> Industry-oriented intermediate petrochemicals. High-performance chemicals, including niche specialty chemicals such as pollution treatment chemicals. More MandA activities might be observed as a better option to enter or expand in China. 	Medium	Likely Favorable <ul style="list-style-type: none"> The potentially stagnating economy might dampen the development of the chemical sector because of the possible slow-down of growth in major customer segments such as steel, automotive, etc. However, value-added products such as high-performance chemicals will still enjoy impressive growth, including niche specialty chemicals such as pollution treatment chemicals. In addition, the stagnating economy might see more companies selling, either proactively (seeking a chance to exit) or passively (experience short-term operation problems). This presents a good opportunity for chemical players with long-term mentality for sustainable development to acquire companies with better synergies at a lower price
Luxury Goods	Several <ul style="list-style-type: none"> 1st-tier brands 2nd-tier brands with right market strategy in the short term. More opportunities for the 2nd-tier luxury brands in the medium to long term as Chinese consumers obtain more sophistication. 	High	Mainly Favorable <ul style="list-style-type: none"> Annual growth rate of 20-30%. By 2015, China will surpass Japan to become the world's second largest purchaser of luxury goods. The luxury market benefits directly from China's consumer boom with the growth of the lower/medium middle-class from 2006 to 2010, and the growth of upper-middle class and the affluent from 2010 to 2020.

Healthcare

Medical Equipment: China's existing healthcare infrastructure does not have sufficient capacity to handle the increasing demand for the medical services its aging population is demanding. Additionally, during the 11th Five-Year Plan, the government set targets to extend medical insurance coverage to 80% of China's rural population, meaning that almost 700 million farmers will join the medical insurance system in the next couple of years. To meet these targets the government is investing heavily in community and rural healthcare infrastructure capacity. Demand for medical equipment, particularly for the low-end and medium market, is growing rapidly.

China has become the 3rd largest market for medical equipment and its market value in 2006 was ~ USD2.7 billion. 75% of this value was in low-end medical equipment, much higher than the global average level (45%). The government has plans to further invest RMB2.5 billion to purchase medical equipment for low-level healthcare institutions such as community hospitals, and town and village healthcare centers in Central and Western China.

As an example of foreign involvement in the sector, GE established strategic collaboration with Shandong Xinhua Medical (a Chinese local medical equipment vendor) to develop and produce medical diagnostic imaging equipment for the medium and low-end market. Both Siemens and Philips have also set up joint ventures in China to penetrate the broad low-end market.

Pharmaceuticals: The rapidly growing Chinese economy and shifts in medical insurance are creating substantial domestic demand for drugs. It is estimated that China will become the world's 3rd largest pharmaceutical market within the next 10 years.

Over recent years, increasingly more global pharmaceutical companies have announced plans to expand their RandD operations in China. These include AstraZeneca, GlaxoSmithKline, Pfizer, Novo Nordisk, and Wyeth. China's huge market potential and the cost advantages of conducting clinical research and drug development in China (at least 70% cost savings for research and 30% cost savings for drug development) will continue to motivate foreign pharmaceutical companies to set up or expand their RandD capacity.

Historically, the major outsourced RandD activity in China was human clinical studies, due to China's relative lack of capital and sufficient expertise in facilitating technical intensive research and pre-clinical work. However, large numbers of returning Chinese scientists and expanded access to capital have resulted in a growing pool of scientific expertise. Increasing numbers of clinical trials are being conducted in China at lower costs than in the United States, Western Europe, and Japan.

Biotechnology: China's biotechnology market is expected to continue to grow at over 10% per year for the next 5 to 10 years. Shanghai, Beijing, Suzhou, and Hangzhou have all made biotechnology a major economic growth initiative. The government's strategic plan focuses on the following priority biotechnology areas:

- Developing genomic drugs and vaccines for disease prevention and cure (particularly cancer and hepatitis).

- Utilizing genomic technology in developing high-grade propagation species to speed up China's agriculture modernization.
- Developing China's protein technology and plant genome technology.
- Encouraging the transfer of intellectual property and purchasing to speed up industrialization and commercialization of biotechnology products.

One of the government's key strategies in developing biotechnology has been the development of biotechnology parks with good infrastructure, environments, and professional and efficient management teams. The parks are incubators for small and medium size biotechnology companies. The most well-known hi-tech parks are Shanghai Zhangjiang Hi-Tech Park, Suzhou New Territory Park, and Wuxi Life Science Park.

Energy and Power

China's energy consumption accounts for 15% of world energy consumption, second only to that of the United States. While participation in the operation of energy infrastructure continues to be liberalized it remains fraught with economic feasibility issues, and should only be considered with a long-term outlook. The best opportunities are, and will continue to be, in supplying advanced equipment to the numerous energy infrastructure projects.

The renewable energy sub-sector presents great opportunities and China has laid out ambitious plans for expansion of renewable energy capacity in its Renewable Energy Law (REL), effective from January 1, 2006. The REL requires that renewable energy sources provide 15% of its electricity consumption by 2020, with a planned investment of more than USD180 billion.

In this regard, China's exploitable hydropower potential is estimated at 300 GW, and China aims to fully capitalize on this potential by 2020, more than doubling of today's capacity. China's total wind power potential has been estimated at 253 GW, and the target is to increase

capacity to 30 GW by 2020, eight times the current level, although in reality this might well be double this target. Within the same timeframe, China is also planning strong growth in biomass power and solar photovoltaic (PV), with biomass power set to increase ten-fold to 20 GW and solar PV twenty-fold to 1.8 GW.

Foreign companies with differentiated technologies and services that do not have prohibitive upfront costs should consider testing the market in China.

However, there are some renewable technologies in which Chinese companies are starting to become globally competitive, such as photovoltaic cells, presenting an opportunity for foreign companies to source from China and save costs.

The development of the industry will depend on future coordination between central and local government agencies. In the near-term, the lack of cohesion means policy and regulatory uncertainty, in particular as it relates to pricing policy.

InterChina believes that top leaders eventually will force opposing agencies to work together, driven by the imperative to find new energy sources

and reduce pollution. A fundamental facilitator will be the narrowing of the pricing gap, as scale production and technology breakthroughs drive the costs of renewable energy downwards, and environmental concerns and supply shortages drive the costs of traditional energy upwards.

China presents a variety of opportunities for foreign players prepared to enter the market during this developmental period.

Indeed, given the expected expansion of the various renewable energy sectors in China, and the potential impact of Chinese competitors on other markets, many foreign players will conclude that they simply have to participate. However, given the level of government intervention and the lack of coherent policy, foreign companies should tread carefully.

Automotive

China is the world's largest producer of commercial vehicles, the second largest automotive market, and the third largest producer of passenger cars. Following a year of rapid growth in 2007 (18% year-on-year), China's automotive industry faced a much more challenging year in 2008. Nevertheless, China will still produce close to 9.5 million units in 2008 (likely between 9-9.5 million), just as InterChina forecasted back in 2007, up around 8.5% year-on-year. This is impressive, especially considering the negative growth in many mature markets.

Competition in the passenger car sector has become even fiercer, and market shares are continuously changing. European and Japanese carmakers lead the way (based on sales in the first 11 months of the year), with FAW VW and Shanghai VW taking the No. 1 and 2 positions, followed by FAW Toyota, Dongfeng Nissan and Guangzhou Toyota in the No. 4, 5 and 7 positions. General Motors dropped back to No. 3 in 2008 from its No.1 position in 2007. Chinese carmakers struggled in 2008, but managed to maintain their aggregate market share.

The slowdown in sales growth has been due to a range of factors. In addition to several one-off events that disrupted sales during the course of the year (e.g. winter snowstorms, the Sichuan earthquake, the Beijing Olympics), there has been a recent drop in consumer confidence (resulting from the global financial crisis and the impact on the Chinese economy) that has caused discretionary spending on big ticket items like cars to be postponed. We believe that this is causing pent-up demand, which will drive sales growth once the economy starts to recover its growth momentum and consumer confidence returns.

The government is also stepping in, looking to support the automotive industry to help boost the overall economy, both with incentives for consumers and supportive policies for carmakers. It is likely that taxes will be revised to reduce car purchasing costs by 5-10%, especially for small-engine cars that are more environment-friendly. In addition, carmakers will likely receive investment financing and bank loans (already being considered for Beijing Auto and Chery), such that China could be one of the few car markets in the world building new production capacity in 2009.

InterChina remains confident that demand will continue to grow at 9-12% over the next 5 years, although 2009 will be a relatively slow year, with growth standing at only 5-10%.

For automotive component manufacturers, the pressure to produce in China is increasing. As multinational carmakers implement global sourcing structures, component suppliers without production in China will not be considered as suppliers for new models. While many of the structural problems of the auto components sector, such as fragmentation, protectionism and entrenchment continue to exist, the trend is towards a more consolidated, structured and competitive auto component supply base. Although foreign component manufacturers entering the China market might still need to consider having a Chinese partner in order to gain market access, it is becoming increasingly difficult to find available partners with sizeable market share. Furthermore, these partners also want to acquire advanced technologies that they lack, and will be expecting contributions in this area from the foreign component manufacturer.

The recent push for energy savings and pollution emission reductions present good business opportunities in the medium-term. The government has shown support for new energy cars and buses, with about 500 alternative energy vehicles put into use during the Beijing Olympic Games, and Warren Buffett recently invested USD230 million in BYD (a major electric car developer in China). There are also a plethora of after-market opportunities. Car repair and maintenance services are poor in China, and while the carmakers continue to expand their dealer networks, a market leader has yet to establish itself as a multi-brand player. Other opportunities exist in auto refit, auto clubs and roadside assistance services, which are all in their early stages of development.

Environmental Infrastructure

Rapid economic growth and increasing urbanization have made environmental infrastructure one of the fastest growing construction sectors in China. In 2006 total investment in environmental infrastructure topped RMB20 billion, a 10.5% increase from the previous year. Government forecasts predict that by 2010, over 50 new cities will be built, 125 cities will have populations over one million, and China's urban population will swell to nearly 630 million. Population migration will put tremendous pressure on the country's environmental infrastructure. Opportunities for foreign investors exist in three key sectors.

Water treatment: In January 2005, China's Ministry of Water Resources reported that over 53% of the water in China's major rivers was undrinkable and that a further 30% was unsafe for use in industrial production. Water shortages exist in over 400 of China's 600 cities and in 110 of those cities the water supply is in critical condition. Opportunities for foreign investors to address this worsening situation exist in two categories:

- **Primary water market:** to increase volume, hundreds of new water treatment plants will have to be

established, especially in medium-size cities and China western regions.

- **Secondary water market:** water supply systems in most cities have low efficiency or are currently under construction. Leakages and contamination will necessitate system upgrading over the next few years.

Most large international players, such as Veolia and Suez, already have a strong China presence, especially in the primary market; however, many un-explored opportunities, such as small/middle scale water purification plants construction and piping system design and supply, continue to exist.

Sewage Treatment: A major reason for China's water shortages is the lack of viable sewage treatment systems. Nearly half of China's cities lack relevant facilities and those that do are operating below capacity. The average sewage treatment rate in large cities is around 43.8%, while in small cities it can be as low as 13.63%. China currently consumes three times more water than developed countries to produce the same amount of industrial products. Population growth and the booming economy have increased the amount of sewage dramatically and the government has identified sewage treatment as a pressing need. In the 11th

Five-Year Plan (2006-2010), the central government set a target of 1,000 new sewage treatment plants and a sewage treatment rate in large cities of 60% by 2010. Over RMB10 billion has been earmarked to finance these projects and the government is keen to attract foreign capital, technology, and expertise.

Attractive opportunities lie in:

- New sewage treatment plant installation, especially in the medium sized cities;
- Existing sewage treatment plant utilization and pipeline system modification;
- Industry sewage treatment (e.g. chemical, metal, and pulp/paper manufacturing);
- Equipment and technology sales.

Solid waste treatment: China produces more waste than any country in the world. The country's 350 million urban residents consume an average of 1.5 kg of garbage per person per day; a number that has grown by 8% to 10% every year since 2002. Total industrial solid waste reached 1.52 billion tons at end of 2006, a five year YOY increase of 10%. In solid waste treatment China lags far behind the rest of the world.

By the end of 2006, only 772 garbage treatment plants existed in the entire country and over 50 million tons of garbage remained untreated. As a key factor in the government's efforts to balance economic growth and environment protection ambitious goals have been established.

However many impediments to their successful attainment exist including:

1) Landfills, China's most commonly used method for garbage disposal, are limited by a shortage of available land and stricter pollution controls 2) A lack of an efficient garbage collection and sorting system and high operational costs means garbage power generation has limited profitability 3) China currently lacks advanced and cost effective technology for industrial solid waste treatment.

Foreign companies can help overcome these impediments by providing:

- Advanced garbage treatment collection, sorting, and treatment systems.
- Specialized industrial (cement, metal and paper making etc.) waste treatment solutions.

Food and Beverage

Consumption habits have changed dramatically over the past few years. Rising incomes have increased demand for more expensive items, such as meat and higher-grade alcoholic drinks; dairy products have seen demand soar with the process of greater urbanization; and consumers have increasingly adopted western-style eating and drinking habits.

Although the Food and Beverage market in China is already very competitive, opportunities will continue to exist primarily due to booming spending among China's emerging middle class and changing consumer tastes.

Besides, the Chinese FandB industry is involved in the greatest shift in its history. This shift has been sparked by massive food quality scandals throughout 2008. The largest scandal was the use of melamine in milk by at least 21 local producers in China, which caused deaths of babies, and several thousand babies hospitalized. This scandal, which broke out just after the Olympic Games in August, has shaken the country, both on the consumer as well as on the regulatory side. The concerns for food quality have spread beyond milk categories but to

literally all other processed and non-processed food and drinks categories.

The reasons for quality compromises are normally found within the complex and fragmented supply chains of food producers. As such, together with governmental help, such supply chains are now in the process of being streamlined to keep quality high and uncompromised. As such, the Chinese FandB industry and market creates opportunities with high quality and technology advantages.

On the beverage side, many of the product segments that have attracted attention from foreign players over the past few years, including beer, wine, mineral water, etc. Many of the players are now overpopulating a saturated sector which is now in the process of consolidating. The demand for fruit juice and juice beverages is on the rise, and with per capita consumption still less than 2 liters per annum (much lower than typical per capita consumption of over 40 liters in developed markets), and there is still plenty of room to grow. Foreign capital and expertise is needed to support the development of Chinese brands, expand and upgrade production capacity, integrate sales channels and supply chains, and accelerate research and development.

Demand for fast and convenient food, particularly ready-made-meals is another noticeable trend. Existing offerings, available primarily in convenience stores, are of limited range and use relatively low quality ingredients and packaging. As Chinese consumers (especially in first tier cities) become increasingly sensitive to what they eat and develop the purchasing power to pay premiums the sector is expected to take off. However, impediments such as the inability of China's logistics infrastructure to ensure the cold chain (distribution and transport of temperature-sensitive products) will have to be overcome first.

China's FandB market is highly fragmented, with over 95% of the estimated 10,000 market players SMEs. To gain market share (in consideration of local protectionism and competition), foreign companies have increasingly used MandA to access the market. Chinese companies have been relatively receptive as they often lack the capital and experience necessary to expand. Many FandB players who may have opted for rising capital through an IPO in the domestic stock exchange markets are now more receptive towards investment from foreign parties as the local stock market fell significantly through 2008.

Machinery

2009 is likely to bring the best and worst for machinery makers. In certain sectors (especially textile machinery and automotive, and potentially construction equipment), 2009 will be a difficult year for new machinery orders because of looming or clearly present production overcapacities. Other sectors, such as aviation, environmentally infrastructure-related industries, and mining, will continue their strong demand.

China's total machinery output in 2008 is likely to be around USD230-250 billion (statistics and categorizations vary). The localization of international machinery producers' factories in China has advanced so much that they now make up around one third of China's total machinery output.

Governmental incentives on industrial equipment and machinery purchases will be a crucial stimulator in early 2009. We believe that many of the favorable policies the Chinese government is implementing are applying to machines made in China (by both Chinese-owned or foreign-invested factories) rather than for imports.

We have seen a rising trend of foreign companies localizing their machinery

production in China in 2008, and we believe that foreign companies will continue on this road in 2009. In various machinery sectors, foreign companies are looking for ways to tap medium quality customer segments, and are specifically designing machines for this segment. This trend can be observed in construction machinery, production equipment, print/packaging equipment, and textile machines for example. As such, foreign players are aiming at lowering import sales to China and supplying the local demand with machines made (or at least assembled) in their China factories.

China is exporting now around USD100 – 120 billion worth of machinery – doubling the export of 2005. There are vital signs that China is about to establish itself as a player in worldwide machinery markets. Compared to leading machinery export nations Germany, USA, and Japan, which jointly assume 45% of all machinery value internationally traded, whilst China achieves only around 5-6%. But in certain sectors, such as scales, woodworking machinery, precision instruments, fittings, garment and leather technology, and mining machinery and welding technology, China is already in the higher ranks of export volumes. Much of the export power currently demonstrated by China can also be ascribed to foreign-

invested production capacities in China, which make up around 60% of China's total machinery export value. Nevertheless,

Chinese machines in all categories are recognized in various markets as new and aggressive competitors.

Opportunity	Product Examples	Demand Drivers
High-end machine tools	5-axis machines High-accuracy machine tools	The aviation and military industry is one of the major drivers behind the growing demand for high-end machine tools, as domestic producers' machines will not be sufficient in quality and performance. As China builds a large number of aircrafts, we believe that the production capacity build-up will continue through 2009.
	High-end CNC machining centers (lower accuracy requirements, but higher automation requirements)	As Chinese producers continue to upgrade their quality in 2009, there will be a chance for high-quality (possibly imported, but especially locally assembled). At the same time, labor cost will be – for the first time – an issue factory managers will need to consider, and factories will test steps for higher degrees of automation. However, in many Chinese regions, favorable conditions (e.g., import tax refunds etc.) for customers importing machine tools have been (mostly) abolished, and customers turn to international qualities made in China – hence to machine tool makers who already assemble or produce in China.
Machinery used in Environmental Protection Projects	Engines and gearboxes for windmills	Both local and foreign players are aiming at further localizing their supply chains to meet local content requirements and to reduce production costs. Increased machining demand for larger and more efficient wind turbines will bring chances for imported machinery in high-end and high-speed applications.
	Equipment for hydropower stations	China intends to increase the share of hydropower in its energy mix. In addition to mega projects, small hydropower stations are encouraged in China. Chongqing, for example will build 470 small hydropower stations (installed capacity below 25,000 KW) by 2010.
	Wastewater treatment equipment	Sewage has become one of biggest threats to China's marine environment, with more than half of wastewater pumped untreated into the sea. China has promised to treat about 70% of its urban wastewater in the coming years and decrease pollutants by 10%. In coastal areas alone, there are around 145 wastewater treatment plants under construction.
Construction	Construction machinery and equipment (excavators, etc.)	Despite short-term financing bottlenecks at the end of 2008 and also in 2009, the construction boom in China will continue – and it will take place especially in smaller cities and inland provinces. Whilst some residential development in larger cities may be stalled, further investment into infrastructure will compensate for this decrease and the need for construction equipment will continue. Although at higher prices than domestic equipment, foreign importers will find a market through leasing offerings. At the same time, control instruments/units will be mostly imported, whereas the rest of the equipment will be produced locally. Domestic construction companies require imported special equipment for ambitious large projects (e.g. tunnel construction, infrastructure projects).
Mining	Special / high-tech mining equipment	Chinese mines are pursuing mechanization of mining processes and implementing control and safety systems to increase safety and avoid catastrophic and tragic disasters. At the same time, market consolidation will continue as smaller mines are closed and larger mines become more productive and internationally competitive. This is also driven by governmental initiatives. The opportunities for foreign producers are in the provision of special / high-tech equipment, whereas standard systems and equipment will be supplied by domestic producers.

Chemicals

2009 might be a difficult year for chemical companies in China. The market has already experienced slowing demand from major downstream industries such as steel, auto, real estate etc. In addition, the slow-down of exports (e.g. toys and cloth) also decreased the demand for chemicals in these segments. To make things worse, the start-up of crackers in the Middle East in the next few years will put pressure on the players globally with an obvious cost advantage in crude oil.

However, the slow-down doesn't mean that the chemical sector will stagnate. Future growth will be driven partly by relatively strong economic development (compared with other countries that might suffer seriously in next few years) and relatively strong industrial growth. In addition, customer requirements on product quality, technical service, and/or joint product development are favorable to foreign companies with leading technologies and high-level customer service.

The major concerns in this sector are pollution controls and raw materials supply. Chemical producers and downstream industries that use polluting chemicals came under increasing scrutiny from SEPA (State Environmental

Protection Administration of China) in 2008. SEPA's increased muscle has lent more weight to enforcement of existing standards and regulations. Environmental due diligence will become more important when building new plants and conducting acquisitions of local chemical producers. Raw material feed is another concern, especially in cases where these materials are difficult to transport, are in short supply in China, and/or are too expensive to import. The big Chinese producers are increasingly using their control over raw material feed to control downstream investment and production activities.

In this promising industry, the major opportunities will be in two areas: niche specialty chemicals, and high-performance bulk intermediate petrochemicals. In addition, stagnating economic prospects might lead more companies to sell, either proactively (seek a chance to exit) or passively (experience short-term operation problems). This presents a good opportunity for chemical players with long-term mentality for sustainable development to acquire companies with better potential synergy at a lower price.

Opportunity	Product Examples	Demand Drivers
High-performance chemicals	Pollution Treatment Materials (and Technology and Equipments)	Good opportunities and high growth forecast. China's central and local governments are emphasizing environmental protection and pollution treatment in line with the policy of "energy-saving technology and pollution emission reductions". Therefore, new business sectors are opening up e.g. water treatment chemicals.
Industry-Oriented Intermediate Petrochemicals	Industry-Oriented Resins and Rubbers	Stagnating economic conditions might slow down the growth of purchases in consumer goods (e.g., automobiles and construction materials). However, from the medium-term perspective, China is still on the fast growth track in these consumer goods sectors. The current shortage in the industry-oriented intermediates (resins and rubbers with better quality and new materials to replace traditional materials) will continue to attract investment from large-scale MNCs in 2009 and onwards.

Luxury Goods

China's consumer boom has finally started. It is being driven initially by the explosive growth of the lower-middle to middle classes. By 2010, consumer demand will get a further boost from the growth of the upper middle class and the more affluent. The lower/medium middle class will grow from 100 million people in 2007 to about 500-600 million by 2020, while the upper middle class and the affluent will expand from about 10 million now to 70-100 million by 2020, the size of a country like Germany.

The luxury market has benefited from the boom with an annual growth rate of 20-30%. Chinese consumers bought USD6 billion worth of luxury goods a year in 2006, more than 12% of total worldwide sales. By 2015, China will surpass Japan to become the world's second largest purchaser of luxury goods, accounting for nearly 1/3 of the world's luxury sales.

However, winning in such a market, especially for 2nd and 3rd-tier brands, has proved to be extremely difficult. China's steep import duties and value-added taxes, IPR issues, and rising operating costs have all added put downward pressure on profits. So far, only a handful of luxury brands, including LVMH and Prada, have reported significant returns from

the Mainland Chinese market. Tackling China's elusive consumer group still remains a challenge.

Chinese consumers are a unique and rapidly changing population. They might be influenced by the West, but they are certainly not western clones: Chinese consumers are relatively young (between 25 to 40) and not particularly brand savvy. They view luxury brands as a way to demonstrate their status and success. At the same time, they are price conscious and tend to show no loyalty to any particular brand.

In such an environment, the key success factors are an understanding of the consumer's mindset, correct product positioning, extensive marketing, and wide retail and distribution channels.

As far as product positioning is concerned, some second and third-tier brands have learned the hard way that simply shifting their usual product positioning to China will not suffice—the market is still just beginning to take off and is unique in many ways. Companies need to do their homework (investigate the market, identifying target segments and unfilled niches) in order to set the right product positioning to match their core strengths to market needs. Marketing strategies should focus more on building and

nurturing brand loyalty, on promoting a lifestyle concept and culture, than of selling the products themselves. Distribution in China has always been complex and resource intensive given the country's weak infrastructure. Companies often have to make major investments in distribution in order to control China's fragmented distribution systems.

Summing up, China's luxury market is expected to grow immensely in the coming years. There are tremendous opportunities but even greater competition and challenges. The market is still in its infancy, though, and visionary strategic planning is required. Luxury companies will need to look beyond short-term gains to secure market position for the long term.

Industry Case Study

By InterChina Consulting

Energy and Power Case

Study: Entry Point Strategy

For those Western companies that are vertically integrated or have a wide product and service portfolio, determining which business to bring to China is often the core issue in the development of their market entry strategy for China. In this case, our Client needed to decide which point of the value chain to enter.

1.1 The Objective

Our client was a leading energy player focused mainly on the natural gas value chain, with activities ranging from upstream exploration and production, through mid-stream transportation and LNG terminals, to downstream residential distribution and gas-fired power plants. Following a history of successful expansion into other markets, and the emerging opportunities in China's energy sector, our client decided to proceed with the development of a market entry strategy for China. Given the complex and opaque nature of the sector, our client worked with InterChina to identify the strongest opportunities and determine how best to capitalize on them.

1.2 The Approach

InterChina and the client established a joint project team, comprising of consultants with strong experience in China's energy sector and Client representation with expertise in the natural gas business.

The project team was able to draw upon existing experience and expertise, including an understanding of the regulatory regime as well as the client's core competencies, to focus the project on five points in the natural gas value chain that presented higher potential for the client. This focus was necessary, as an assessment of each point in the value chain required a modeling of the financial return, and this modeling would be dependent on very detailed data in order to capture characteristics specific to China and strengthen any assumptions made.

While secondary data existed, it was largely macro in nature, and inadequate for the financial modeling. Moreover, due to the heavy government involvement in the sector, and the consequent distortions in free market dynamics, there was little existing insight into the real workings of the sector. InterChina

therefore relied heavily on primary research. Our consultants conducted over 130 discussion-based interviews in person, focusing on key players within the industry. Interviewees included, for example, officials from government energy bodies, managers of energy related enterprises, as well as specific energy experts. Due to the widespread nature of the industry, these interviews took place in 21 of China's 31 provinces, autonomous regions and municipalities, including 40 individual cities.

As the project team's insight into the real workings of the sector developed, the high degree of interdependency between different points in the value chain became apparent. This was important, as the interdependency created severe risk for players that were specialists in one point only. The implications for the client's entry point strategy was that multiple entry points would be necessary, leveraging a presence in one point to create strategic advantage in another point.

Meanwhile, as the effort to collect and crosscheck the detailed data started to result in a more refined financial model, the understanding of each point in the value chain deepened. Not only was the Project Team able to determine which point presented the better financial return,

but by analyzing the real profit drivers for typical projects, also ideal project profiles for each point in the value chain. The results of the financial modeling thereby formed the basis for the detailed entry strategies for the prioritized points in the value chain.

1.3 The Outcome

InterChina recommended one 'primary point' in the value chain that had the most attractive mixture of significant growth, financial return and manageable risk. It was also a point in the value chain where the client would have a differentiated value proposition, a proposition which would be deemed valuable by relevant government bodies from whom support would be needed going forward.

At the same time, InterChina Consulting recommended several "secondary points" in the value chain. These points were not the most attractive in their own right, as their economic viability remained uncertain. However, a presence would be needed in these secondary points in order to best capitalize on the current opportunities and minimize exposure to future threats in the recommended primary point.

Following the conclusion of the project and presentations to the client's international development team, the client proceeded to

implement InterChina’s recommendations, starting with an acquisition approach to one of the existing players in the primary point, and partnership discussions with major energy players relevant to the secondary points.

Machinery Case Study: Total China Strategy

More and more Western companies are factoring China into their global strategy planning process. Issues that need to be addressed range from China as a cost competitive sourcing base, China as a market opportunity, and China as an export threat to home markets. In this case, our client needed to address all three issues.

1.1 The Objective

Our client was a European machine builder, one of the top ten players in their sector, focused on sales into the European construction market. Their international competitors had already established production plants in China to ride the domestic construction boom, a boom that appeared to have good momentum. In addition, despite the technology barriers, Chinese players were also starting to become competitive in certain product segments, even starting to export components and kits to Europe. Given this context, our client decided to

include China in their strategy planning process. They worked with InterChina to understand the potential impact of China on their business, and develop a “total china strategy” in response.

1.2 The Approach

The breadth of issues to be addressed required the development of a strong framework at the project outset to focus the data gathering, analytical thinking and strategy development. InterChina worked with the client to determine the decisions to be made and how to make those decisions based upon the nature and drivers of their business. For example, with regard to the market opportunity:

- Whether the demand growth created enough market space for a new market entrant.
- Whether there was potential demand for the Client’s product proposition.
- Whether product sales could be complemented by installation and maintenance services.

As with many industries in China, there was an absence of reliable secondary information, with the industry reports published by the relevant industry association being basic, incomplete and inconsistent. InterChina’s primary

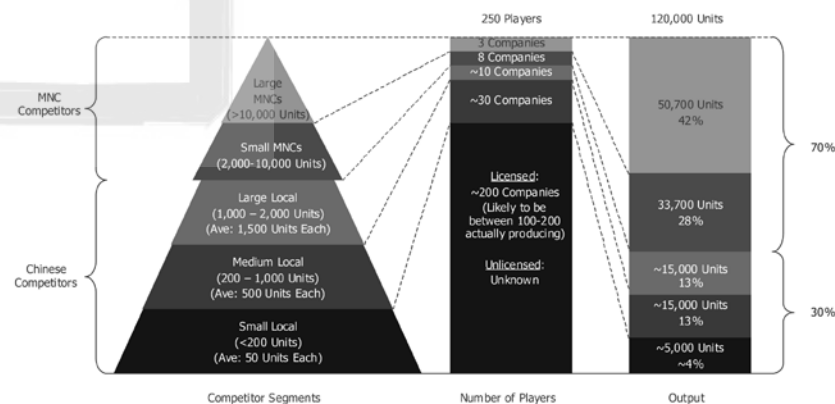
research, with our consultants conducting over 120 discussion-based interviews in person, focused on key players within the industry. Interviewees included, for example, property developers and construction contractors, international and Chinese machine builders and component suppliers, installation and maintenance providers, government regulators, as well as specialist research institutes.

InterChina transferred the findings to and received feedback from the client on an ongoing basis, supplementing regular conference calls with several client visits to participate in a selection of interviews. As the understanding deepened, the focus of the data gathering drilled down on the key drivers, including those that were unique to China, those that were opaque,

complex or unpredictable in nature, or those that were deemed most relevant to decision making. For example, with regard to the export threat:

- Whether international competitors would continue to transplant production facilities from the United States and Europe, leaving little production capacity left in the West, and thereby turning China into a global production base.
- Whether the buildup of production capacity in China, combined with the general downwards pressure on prices, would lead to cost oriented production process improvements that would set new global standards.

Competition Structure



- Whether the RandD centers of the international competitors in China, which had thus far only been conducting product localization for the domestic market, would start making an effort towards real product innovation.

As the evidence strengthened that China would have an increasing impact on the client going forward, the fundamentals of the strategy started to take shape. For example, with regard to cost competitive sourcing, Chinese suppliers were an attractive source of strategic components (converters, motors and controls) that would improve the client's cost competitiveness in its home markets. InterChina built out the strategy by short-listing the strongest independent players, evaluating their long-term partnership potential, and testing their interest in certain forms of cooperation.

1.3 The Outcome

Due to China accounting for a significant share of global consumption and production in the Client's sector, the Client considered their improved understanding of the scale, structure and dynamics of the sector in China to be critical to their future. Moreover, the scenario forecasts revealed the range and degree of potential impact of China on their business, and it was only by

being actively involved in the project that the nature of the potential impact was properly understood.

As a result of the project, the Client had a China strategy in place that covered the breadth of issues. Some issues were prioritized, with the deployment of significant resources to take advantage of the opportunities presented by China, or prepare for the threats that would soon emerge. Other issues remained dependent on the development direction of the sector, and this required putting a structure in place for ongoing monitoring in China. For the remaining issues, an informed decision was taken not to make a move, saving the Client from risking resources on opportunities where their weak competitive advantage would have led to a poor return on investment.

Following the project and presentations to the client's board of directors in Europe, the client decided to move forward with the implementation plan.

Food and Beverage Case Study: Negotiation Support

Why do the majority of MandA projects in China end up in failure? More often than not, the negotiation process is the critical success factor in getting deals closed. However, many negotiations between Western and Chinese companies breakdown where bridging or workaround solutions could have kept talks on track. In this case, our client needed both experienced and creative negotiation support.

1.1 The Objective

Our client was a leading food brand and a top three player in a number of product categories. With demand for its products in China growing quickly, our client established a wholly owned subsidiary in China to produce for the domestic market. However, our client soon discovered that over 70% of product sales were distributed through traditional channels, such as 'mom and pop shops' and 'wet markets', where our client had no presence. In response, our client decided to acquire a Chinese competitor that had access to the traditional distribution channels it was lacking. InterChina was engaged to assist throughout the acquisition process, including target

search, due diligence, company valuation and negotiation support.

1.2 The Approach

Following a systematic search and screening process, InterChina and the client reduced a long list of potential acquisition targets down to a number of high potentials, and selected one with which to begin negotiations. However, despite strong commitment from both sides, the attractiveness of the target and a reasonable valuation, several difficulties soon emerged.

As is often the case in China, the managers of the target company had very little understanding of Western corporate governance and business practices. The target company's CEO was used to making rapid decisions in response to market developments without the typical constraints of a board of directors. InterChina forewarned our client about the potential for frustration on the target company's side, and was able to keep the client's communication and decisions within an agreed timeframe to avoid the target company withdrawing from the negotiations.

Cultural differences such as these are common, and normally require concessions from both sides during the negotiation process. Having gained the trust of the target company's CEO, InterChina probed for irregular operations, and duly uncovered a long history of financial transactions that had been excluded from the official financial statements. These included off-the-book sales, fraudulent VAT operation and hidden profits.

While such transactions are common for private companies in China, the target company's shareholder structure had been devised to facilitate and conceal these transactions, and the target company's CEO was worried that the takeover would expose all and risk government reprisals (he was a former government official himself). As this company was the most attractive of the high potential targets by some margin, finding a solution and

building trust between the two parties became critical for the subsequent negotiations.

1.3 The Outcome

Following 9 months of negotiations, InterChina led our client and the target company to a mutually beneficial solution. The target company agreed to undergo a restructuring process, moving towards "regular" operations in preparation for a future acquisition. In the meantime, the two companies agreed to a sourcing and production alliance, granting our client access to the target company's distribution channels. The deal safeguarded the interests of our client, finding a path forward without prolonging negotiations further, and providing a transitional period for building trust and understanding ready for the eventual integration of the two companies.



U.S. Commercial Service

The United States Commercial Service is the trade promotion arm of the International Trade Administration within the United States Department of Commerce.

The U.S. Commercial Service consists of a network of International Trade Specialists in U.S. Export Assistance Centers in more than 100 locations throughout the U.S. Overseas, our Commercial Officers, Specialists, and other staff are located in U.S. Embassies and Consulates in more than 150 cities in 80 countries.

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InterChina Consulting

InterChina Consulting is a boutique management consultancy specialized in strategy, Corporate MandA and human resource services for companies doing business in China. Since being founded in 1994, InterChina has emerged as one of the leading consultancies in China. As testament to client satisfaction, over half its project volume is accounted for by returning clients, international companies with demanding consulting needs. InterChina has developed expertise across sectors to further its delivery of pioneering, practical solutions. InterChina has three offices in China; Beijing, Shanghai and Shenzhen, supported by liaison offices in Europe, in Madrid and Milan, and North America, in Washington D.C.

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