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Peeling the Onion

Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

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China Moves Again to Cool Overheated Property Sector

Status quo of China property market

Housing prices in China have surprised almost everyone by surging since 2000, despite the government's efforts to cool them down, the property developers' expectation for steady growth and the experts' fear of a bubble burst. The nation's investment in real estate increased at an annual rate of more than 20 per cent for five consecutive years starting from 2000. Although the growth rate has dropped in 2005, it was still at 19.8 per cent.

Since the Chinese Government took steps to cool down the Shanghai real-estate market last year, speculators have moved into other cities, creating new property bubbles. In Dalian, prices for new property in the first three months of 2006 have escalated by 14.9% from a year earlier, according to the National Development and Reform Commission. Prices in the southern boomtown of Shenzhen gained 20.6% during the same period while Beijing prices were up by 7.6%.

The above figures may even understate the problem. Other local government agencies, by using different calculations, have given a much higher price increase. In Beijing, for instance, the Beijing Construction Committee has reported that prices of properties sold off the drawing boards have actually increased by 17.3% during the first two months of 2006.

A vivid parable has recently been used in the Chinese media to describe spiraling housing prices: It is like a naughty boy climbing a flagpole, going higher and higher, ignoring his parents' concerns for his safety. The more people look at him, the more excited he becomes, and the higher he climbs.

The situation left ordinary buyers more bewildered. Chinese economists say that owning an apartment is now an unrealistic dream for a large number of urban residents who are falling further behind as home prices surge.

A Beijing computer designer has planned to buy a house for two years, but still remains an armchair strategist. "With all the government's new policies and all the media analysis, I am really afraid the bubble may burst after I bought the house," he said, "However, the price is still getting higher and higher. My money prepared for the initial payment may become inadequate again if I wait for another couple of months."

Zhong Wei, an economist at Beijing Normal University, said the price of the average apartment in Beijing is 13 times the annual average salary. He estimated that 70% of the Chinese capital's population couldn't afford current house prices.

Despite surging prices, the vacant area of China's commercial buildings had surged 18.9% from last year to 122 million square meters by the end of April this year, and the vacant residential buildings amounting to 69.21 million square meters, up by 15.9% as compared to the same period a year earlier. All such suggests a false market, especially given the lack of established second hand markets in most cities in China (all basically except Shanghai and Shenzhen).

Reasons for rising house prices

Under the market economy, the increase in real estate prices is the result of the huge gap between the supply and demand for housing. Middle and low-income earners create huge market demand for low-cost houses while real estate developers are going after houses in the higher price bracket for more profits.

Besides this, another culprit is the profit-making attitude of speculators, who hoarded land and buildings, creating an artificial shortage in the property market. Many treat the housing industry as a "super casino" and are eager to profit from it, and all this crazy gambling and speculation has helped drive up the prices.

Adverse impacts from rising house prices

A report issued by the Chinese Academy of Social Sciences entitled the "Blue Book of Real Estate 2006" predicts that China's house prices will continue to rise over a long period.

Skyrocketing house prices in recent years and weak government control have led to much public debate. If the prediction made by the academy is true, it may spark a series of crises.

To begin with, the continuously rising house prices have caused panic amongst the ordinary buyers who are losing faith in the housing sector. With more and more people shouldering the heavy burden of mortgages, this will further enlarged the gap between the rich and the poor in society.

Secondly, the excessive and rapid growth in property investment is largely responsible for the current investment overheating. Property is a big driver of Chinese economic growth, and runaway investment in the sector has contributed to signs of a broader overheating. The economy grew by a red-hot 10.2% in the first quarter of the year.

Long-standing overheating of housing investment not only harms the real estate market's own development, but it also multiplies financial risks. By the end of last year, bad debts in this industry reached 109.3 billion yuan (US\$13.7 billion). Vacant houses have taken up much of the country's financial resources. The nation's economy and the banks will be most affected if the situation slides into crisis.

In some big cities, the local economic prosperity is too dependent on the growth in real estate sector, and this constitutes a major latent danger.

Take Beijing as an example. Housing input has made up nearly 60% of the total fixed assets investment for a number of years in a row. The figure in Shanghai is in the region of 40%.

The high-speed growth of the country relies heavily on investment. And the level of investment, in turn, depends disproportionately on the real estate sector. This is by no means a blessing because housing construction does little in boosting the country's industrial and high-tech competitive edge. Not to mention that millions of people have not yet benefited from the current real estate boom.

Thirdly, rising house prices cumber China's urbanization process.

Industrialization and modernization in China goes hand in hand with urbanization. But there will be no urbanization with higher housing prices.

Excessively high housing prices keep farmers who want to seek employment in cities at bay and make it hard for college graduates of rural origins to establish themselves in urban areas. In this scenario, the urbanization process is hampered rather than facilitated. This results in the rural population, which makes up the vast majority of the nation's populace, being kept out of the cities.

Finally, overgrowth of the real estate industry could easily lead to so-called "economic bubbles".

The skyrocketing housing prices are in the interests of the investors, developers, and speculators, and in many cases, local governments.

It is considered that the higher the house prices, the more buyers there will be, as everyone is afraid of having to pay for higher house prices in the future. This looks very much like a stock-market craze. But one thing goes unheeded: The bubbles will likely burst someday when reverse elements happen to all be there.

New measures to curb rising house prices

In order to moderate overheated investment in the property sector, the central government has taken some actions to curb the rising house prices. At the end of May 2006, The State Council issued a statement with detailing measures in its attempts to curb the rising house prices, using a combination of tax, credit and land policies to ensure the healthy development of the real estate industry.

- *Land and housing supply*

The State Council's paper has asked the local governments to make 70 per cent of its annual land supply available for the development of low-cost housing from June 1.

In any new residential housing projects, houses smaller than 90 square meters must be accounted for at least 70 percent of the total floor space built.

By doing so, the central government has demonstrated its desire to change the structure of housing supply, one that has been excessively tilted against low and middle income households.

- *Land hoarding*

A policy has also been issued requiring that the developers of land designated for development be charged a high "idle land fee" if it remains unused for more than a year, while rights to the land will be revoked if it remains unused for 2 years.

It explicitly forbids "land hoarding," a step forward from last year's rather vague banning of "land speculation." This indicates that making the best use of land and increasing the housing supply have become an important means to control real estate prices.

- *Tax*

A transaction tax (business tax) will be imposed on people attempting to resell their properties within five years of purchase. The existing period is two years. The tax rate stays unchanged at 5.5 per cent of the sales value. This move is to prevent speculative and investment-oriented house buyers from entering the property market.

But some respondents voiced their concerns that the policies could lead to further price hikes on the second-hand property market in Beijing. The sellers will definitely shift the tax burden to the buyers.

Many experts say the immovable property tax, which is imposed on owners of properties, is more effective than the transaction tax to restrain property speculation.

The immovable property tax is an indispensable instrument to get rid of excessive housing demand resulting from speculation and investment purposes, because the immovable property tax would increase the costs for investors and would make many think twice before investing capital in property.

- *Credit policy*

According to the statement, the minimum down payment for a new apartment larger than 90 square meters will be raised from 20 per cent to 30 per cent, whilst the ratio for an apartment smaller than 90 square meters remains unchanged at 20 per cent, to cater to the needs of middle- and low-income groups.

This move would deter those investors who wish to finance the purchase of their properties by renting out to others. However, for higher income earners, especially the speculators, the increase in down payment may not served as a major deterrent.

The statement also introduce tougher criteria for lending to property developers, requiring them to finance at least 35% of their projects from their own capital.

This new requirement may make life difficult for the less competitive and smaller developers, but it will have little impact on the strong and competitive ones.

The statement also forces the domestic banks to reduce their exposure to housing loans. In response to the overheating, China's Central Bank on 28 April 2006 raised the interest rate for the first time in 18 months when it increased the one-year benchmark lending rate by 27 basis points to 5.85%. The China Banking Regulatory Commission also proposed stricter controls over new loans, curbing financing to property developers and stemming the grant of credit lines to local governments.

- *Information disclosures*

Loud public complaints about the lack of credible statistics on the housing market has become one of the most eye-catching phenomena so far this year.

Property developers are not the only ones who disagree with government officials on whether the market is short of supply, even national statisticians cannot agree with their local colleagues on the actual pace of housing price growth in some major cities.

Domestic homebuyers are fully justified in demanding immediate government efforts to bring an end to such information chaos.

Inconsistent local and national statistics have left them totally confused, and misleading sales information provided by developers makes them even more so. To put a stop on the increasing house prices, having the correct information is absolutely necessary for both policy-makers and consumers.

The measure concerning information disclosure is a new one that marks a swift response to emerging problems in the property market. Disclosure of real estate statistics should be more timely, accurate and transparent to facilitate decision-making.

Perspective on new measures

The measures taken by the central government to ensure a healthy development of the real estate industry are by and large similar to those taken by the policy-makers a year ago, but laid out more specifically this time round.

A year ago they first launched a campaign to deal with the skyrocketing housing prices, especially in a number of large cities like Shanghai and Beijing. One year later, unfortunately, double-digit growth of housing prices in some major cities has only made many potential house buyers regretful.

By focusing on making adjustments to the structure of the housing supply and increasing government input for construction

of economically affordable or low-rent houses, the central government seemed to have come up with a feasible solution for the problem. The only problem is that local governments did not implement the measures as they were supposed to do. Local governments benefit from real estate development through land transactions. So further efforts are needed to ensure that the policies established by the central government are faithfully carried out.

To a certain extent, the measures are ones of "psychological shock" that will slow home sales and dampen price escalation for several months. In the long term however it is skeptical whether they can cool speculative fever.

The measures have failed to address the underlying problem for property speculation -- investors have too few options for growing their personal wealth. The speculators are motivated to plow yuan into the property market, given that rental yields in major cities are 4% to 6%, while bank deposit rates are almost zero once taking into consideration inflation and tax.

It will slow things down for the next six to twelve months, and then people will start investing again. This is because the bond and equity markets are still underdeveloped; Chinese have very few investment alternatives.

In some experts' view, half of the measures are aiming at providing affordable apartments for the low-income group, which should not affect prices but increase construction activities, and the other half are targeted at speculative activities, which may stop for a while, but are most likely to persist until monetary conditions are normalized.

The new measures are moderate in the public's eyes. They may not be sufficient, but the Central Government isn't willing to jump in the deep end quite yet. The way they operate in China is to do it step by step, and try to engineer a soft landing. These measures leave room for further tightening if need be. If there is no significant reaction from the property market or slowing down in house prices, there's always the possibility that the Central Government will take further measures to address this issue.

It also must be noted that the closure procedures in the second hand market in most cities are over inflated slow and cumbersome, to the extent that the time between paying a deposit and closing the deal with mortgage monies transferred can be up to nine months. As such, this taken into account with the new regulations provides no liquidity, and new properties are over inflated, which could very easily end in tears.

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Scope of Tax Rebates on Re-investment by Foreign Investor

The "reinvestment tax refund policy" is a well-known tax incentive granted to foreign investors in China where foreign investors may enjoy up to 100% corporate income tax refund on its direct re-investment in other foreign invested enterprises (FIEs) made with the profits realized from their existing investments in China. Such policy was firstly launched in 1993 with the obvious intention in encouraging foreign direct investment (FDI) into China.

During the course of implementations, the scope of tax rebates has been clarified further and further in order to make the said incentive to better serve its policy purpose in stimulating the FDI while balancing the concessions in tax revenue collection.

On defining direct re-investment, the "direct re-investment in other FIEs" refers to direct re-investment in both newly established and existing FIEs with the funds forming part of the registered capital of the FIEs concerned.

Hence, if the foreign investor re-invests with his profits from an FIE into another FIE through equity acquisition where no increase in registered capital or working capital are resulted, the re-investment will not be eligible for tax rebate.

Regarding the reinvestment amount, when a foreign investor re-invests with the after-tax profit generated by an FIE in a given year, a cap is imposed on the cumulative re-investment amount that will be eligible for the tax refund. Such limit is determined by the following formula.

Re-investment cap = (taxable income of the FIE in the year where the after-tax profit is re-invested -- corporate income tax actually paid by the FIE for that year) x proportion of shares of the FIE attributable to the foreign investor during that year.

With this provision, where the re-investment amount falls within the above-mentioned limit, tax rebate will be calculated based on the actual amount of re-investment. If the re-investment exceeds the cap, the excess portion will not be counted for tax refund.

In regards to the timing for claiming the tax rebate, the foreign investor will only be eligible for a tax refund for the reinvestment if the reinvested profits have been realized at the time that the relevant authorities approve the reinvestment plan (regardless of whether the reinvestment is made in a lump sum or in installments). The foreign investor cannot enjoy a tax refund for the reinvestment if part of or all the profits for reinvestment have not been realized upon the approval of the reinvestment plan.

Foreign investors who are contemplating to capitalize on this incentive need to have a clear understanding on the tax rebate scope in order tax planning purposes.

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Understanding M&A in China

In the last several years China's business climate has warmed up to foreign investment thus making the market for Mergers and Acquisitions in China significantly more attractive. From inward investment of Domestic Chinese Enterprises to cross-border investment of foreign companies, M&A is poised to increase. In a study by McKinsey and Co., in 2004, roughly US\$60 billion was spent by multinationals on newly acquired businesses and joint ventures with Chinese enterprises. During the first ten months of 2005, investment in the banking sector in China exceeded US\$10 Billion alone. This was more than five times the largest amount that foreign enterprises have invested in the banking sector in the last few years. According to the American Chamber of Commerce (AMCHAM) 2005 Business Survey, 17% of AMCHAM affiliated companies are "likely" to acquire a local Chinese company and 11% are "highly likely" to acquire a local Chinese company.

While M&A activity in China has gone up substantially, the percentage of failed deals is about 70%. If such poor success rates exist, then how and why can private and institutional investors still profitably acquire and merge with Chinese companies? The answer lies in the ever-evolving process of due-diligence in China.

In most developed investment environments, investors rely mostly on traditional valuations techniques surrounding financial and legal due-diligence. Unfortunately, most Chinese companies have questionable financial statements and occasionally two to three accounting books. In these cases, expensive financial modeling for can be futile and therefore one must concentrate heavily on a more comprehensive due-diligence process.

Implementing several different techniques in valuing Chinese companies is essential in determining an accurate price of the company. Many times, foreign investors, will over-value or under-value a Chinese company due to projected instability in the market or industry. Chinese market volatility disallows for accurate discounted cash flow methodologies and projecting cash flows outside of five years are unreliable. Unfortunately, 85% of the 1397 listed companies in China are State Owned Enterprises (SOEs) and only a small percentage of those are tradable, thus making it difficult to use a multiple-based valuation such as using a company's P/E ratio. In the same respect, a market value approach can be just as imprecise. Because of the imperfections in valuing a Chinese company in such a complicated market an investor must hedge their risk against over and under valuation by using a range of different valuation scenarios. It is not uncommon for an accounting firm to use the income approach (NPV), cost approach, and the market approach in order to calculate a true and acceptable range of value for the company. Varying one's valuation techniques is especially necessary when the Chinese company is in research and development stages.

Many buyers often use a form of statutory valuation where the buyer will value the company's assets at book value. This unfortunately does not consider the company's cash flow statements of their assets. In addition to this, it is difficult to locate the owner of a company's assets due to the lack of transparency in the relationship between many Chinese companies and the state. Many of the larger SOE's are still owned by the State-Owned Asset Supervision and Administration Commission (SASAC) and scores of domestic enterprises still deal with the government through asset management companies or other industry bureaus. It is important to investigate and confirm the company's asset ownership and the relationships it has with related government agencies and partnering companies.

Similarly, locating the ownership of the land rights is comparably complicated due to the fact that land use rights are given to businesses and individuals by the government. It is not uncommon to perform due diligence on a company's property and uncover a string of false mortgages. Hurdling the breadth of government bureaucracy and opaqueness of a company's accounting books can be successfully done through the use of knowledgeable due diligence teams with local experience.

The acquiring company should hire an outside due diligence team. Aside from the valuation and investigation of asset ownership, the project team must acutely inquire about government licenses and approvals. Hiring practiced legal or consulting teams who have strong relationships with the necessary government and industry agencies can minimize the complexity and time required to gain government approval. A traditional "courting" process still exists in China's business environment especially when acquiring a state owned enterprise. The project team must also have experience in navigating the myriad of evolving rules and regulations concerning acquisitions in China. Awareness of the government approval process is just as important during post-acquisition period as it is during the acquisition itself.

While risk is associated with the majority of the due diligence process, understanding one's tax situation can be beneficial during the acquisition process. Foreign enterprises that acquire 25% or more of the Chinese company will be privileged to preferential tax treatments. Unfortunately, the tax situation of most domestic Chinese enterprises is complicated and the acquirer could be subject to the liabilities of the acquired company's income tax and value-added tax requirements. Many Chinese companies keep a set of management accounts and tax accounts thus potentially exposing the acquirer to hidden risks that are not on the company's balance sheet.

China's mergers and acquisitions market is getting easier as China's business climate adapts to international business standards. A successful acquisition of a Chinese enterprise can happen by working with veteran due diligence teams that are not only experienced in China but externally as well.

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