LEHMANBROWN
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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 Expo 2005

LehmanBrown at the China Expo

We will be attending the China Expo, 27 June 2005, Earls Court Exhibition Centre, London.
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feature article

M&As in China: Opportunity or Hornet's Nest?

The Chinese mergers and acquisitions market

The strategic use of merger and acquisition in the People's Republic of China has only begun to proliferate in recent years, mainly due to the easing of legal restrictions which had previously acted as a significant roadblock.

Until the beginning of the 1990s, Chinese law did not readily permit foreign investors to invest in other China-based companies, even if they had existing PRC operations in the form of a Foreign Invested Enterprise (FIE). This served to stifle M&A activity and led to foreign investment in China being relatively inefficient. However, during the last decade significant progress has been made and major M&A deals are now commonplace.

The impact of WTO accession has been particularly notable in allowing M&A activity to flourish. The current environment is one where the framework supporting M&As is gradually improving, although certain lingering restrictions do still exist.

M&As have surged in recent years, particularly following the adoption of several new regulations in 2003 that have helped boost their appeal. M&A deals in China - including both cross-border and domestic deals - were worth US$23 billion in the first half of 2004, which was already 65% of the previous year's total.

The evolving Chinese legal and regulatory environment has had a major impact on M&A activity, particularly in terms of the way merger deals are conducted. The availability of target companies has increased significantly as changes in M&A legislation have provided much clearer guidance and since April 2003 FIEs have been able to acquire both private domestic companies and non-listed state-owned enterprises, with the reform of the latter being seen as a key challenge to China's ongoing economic development.

There are three main methods of merger or acquisition:

1. Equity purchase
2. Asset acquisition
3. Statutory merger

The first two methods are governed by the M&A law officially known as the "Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (effective since 12th April 2003), whilst the latter is regulated by the "Provisions on the Merger and Division of Enterprises with Foreign Investment" (effective from 1st October 1999).

1. Equity purchase

Purchasing equity in the target firm can be done by foreign investors through indirect or direct equity acquisition, if those investors currently do not have an existing PRC presence (e.g. an operational FIE).

Indirect equity acquisition can occur through purchasing a foreign investor's stake in a FIE which is already held by an offshore vehicle. Such vehicles are not subject to the same levels of regulatory interference in terms of gaining approvals and are an efficient way of structuring Mainland projects in terms of equity transfers. Equity in the offshore vehicle can simply be bought or sold as a means of transfering ownership of the Mainland enterprise.

Direct equity acquisitions both of FIEs and of domestic PRC companies are legal, and indeed are a common way to invest in state-owned enterprises. In the case of the former, regulatory intervention is discretionary but nevertheless a real possibility. In the latter, the legal status of the firm combined with the rules that apply to it may change.

If the proportion of foreign investment in the target is below 25%, it is classed as a minority foreign investment, otherwise the company must go through the process of conversion into a FIE. These factors need to be taken into consideration when planning the deal to improve the overall chances of success.

For foreign investors maintaining an existing FIE, other PRC enterprises can be acquired if the corporate structure allows such activity under prevailing regulations. This can occur if the acquiring company is classed as being either a limited liability company or as a holding company (which tend to be rare due to the large capital requirements).

However, there are restrictions on the total proportion of group assets that can be deployed in subsidiaries of limited liability companies, with a limit of no more than 50%. Consequently, acquisitions by this method are restricted to relatively small target companies.

On the whole, purchasing equity is generally the quickest and cheapest method currently available, as the legal status of the company usually remains unchanged, with only the share of ownership of the target entity changing.

2. Asset acquisition

As foreign companies by law cannot directly operate PRC-domiciled assets, the purchase of assets is generally performed by creating a vehicle to operate the assets at the same time that they are purchased. The main benefit of this approach is that it allows the acquiring firm to cherry-pick the best assets of the target and spin off the unwanted portions of the company.

Although this may prove to be time-consuming, it is particularly desirable given the lack of information available on the hidden liabilities of many target entities. The target's legal status does not change after such a transaction, although it may be liquidated after a major asset sale to return money to its shareholders.

There are also significant issues in terms of receiving government approvals and rearranging labor requirements with respect to the new configuration of assets. The latter point is particularly significant given the weighty procedural impediments to laying-off Chinese workers, which may notably impact upon the overall process.

3. Statutory merger

A statutory merger is a transaction where the acquiring entity assumes all of the assets and liabilities of the target. However, the legal framework pertaining to this method is relatively basic and needs further development before this method can be best optimized.

Theoretically, under this method the target can be merged into an existing company or a new vehicle can absorb both organizations.

However this process requires multi-stage approval from various regulatory bodies and thus can be quite time-consuming. As an example, if there are suspicions that market competition will be impaired, regulatory investigations can take twice as long (180 days) to rule on the matter, relative to equity purchases or asset acquisitions (90 days).

Overall the legal uncertainty in this area makes other acquisition methods much more attractive, given that risk reduction is such an important factor in any acquisition process.

Is it worth the risk?

The prevailing regulations help to create an environment where mergers and acquisitions in China can present a positive opportunity, but only for the careful investor.

There are many potential pitfalls during the process that are very much China-specific. As examples, the valuation of target entities can be a real problem due to a lack of reliable information sources, public information about companies is often unavailable, and the target's accounts may not be up to the rigorous standards required in many developed economies.

Where possible, double- and triple-checking of data sources is desirable, as information accuracy can vary widely. In addition, the existing Chinese regulatory bodies act not only in an antitrust role but also in a much wider approval role in terms of whether or not the deal will benefit the Chinese economy.

Common to all transactions are the two stages of obtaining approval by the Ministry of Commerce and approval of the new entity's business license, whilst added levels of complication may be encountered depending on the particular industry sector involved. An example of this is that investment is still guided by the government's industry catalogue which restricts foreign involvement in a variety of sensitive sectors.

Furthermore, in the event that the overall process goes awry, liquidating the China operation can be a lengthy and troublesome affair. Informing the relevant government bodies and dealing with the ensuing paperwork can take up much of a company's time to legally extract themselves from the venture.

Despite these problems, firms can successfully employ an M&A strategy to forge a presence in the PRC. Problems with information can be minimized with effective due diligence to weed out any nasty surprises lurking amongst the potential targets.

If the company is to effectively harness the opportunities that China offers, the cost of proper due diligence far outweighs the mess that can occur should one of China?¡¥s numerous dysfunctional companies be acquired.

So as to avoid the potential need to liquidate a company in China, firms looking to engage in M&A activity often choose to structure their ventures through offshore holding companies. Although many companies use such vehicles for their various commercial and tax benefits, they can also help in planning an effective exit strategy.

Should the worst happen, sale of shares from an offshore entity does not require the approval of the local partner or the mainland authorities. Many global jurisdictions are available for creating such offshore vehicles, though the most practical for PRC ventures is Hong Kong. With its advanced business support network, closeness to the mainland, and availability of bilingual business documentation, it serves as the most efficient centre for conducting offshore business transactions.

Conclusion

Although mergers and acquisitions in China have the potential to be either an opportunity or a hornet's nest, the likelihood of being stung bv a Chinese venture can be greatly reduced by having a clear strategy and an awareness of the risks. An increasing number of successful M&As gives further encouragement to foreign companies seeking to forge a significant presence in the bright economic future of the People's Republic of China.

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economy

Strict economic controls to reign in overheating industry sectors

The interest rate on property loans has been upped in an attempt to tackle the ongoing problem of soaring house prices. The central bank raised the interest rates on property loans of more than five years to 5.51% from 5.31% on 16th March 2005, continuing a trend that has seen rates adjusted in an upward direction. To further dampen activity in this area, the down-payment requirements for home loans have gone up to 30% from 20%. The need for action in this area was exemplified by figures from the National Bureau of Statistics showing investment in property was some 27% higher in the first two months of 2005 compared with the same figures for the previous year. Analysts believe the move is a key part of the country's macro-control policies and is aimed at tempering the rapid increase of property prices.

Further controls were also announced in April to restrict investment in steel factories and to control the surging price of iron ore, both of which are thought to be dangerous areas in which there is a risk of the economy overheating. The State Council plans to restrict investment in steel production and strictly control steel exports by eliminating tax rebates for exporters. It was also noted that the government will act on the iron ore problem by strengthening the co-ordination of imports in relation to existing iron ore operations, which should improve the overall efficiency of the industry. If allowed to go unchecked, the development of several overheated sections of the economy would cause serious problems for China's continuing economic growth.

Timeline set for withdrawal of funding for ailing SOEs

The Chinese government will stop bailing out bankrupt state-owned enterprises (SOE) within four years to force them to operate according to market rules, an official with the State-owned Assets Supervision and Administration Commission announced on 26th March. Following the plan to stop propping up SOEs, these companies will face added pressure to follow market rules and apply for bankruptcy according to the same laws and regulations as foreign and domestic private companies.

The plan was made public earlier this year, but no timetable was given at that time. In order to help the badly performing SOEs to retreat from the market smoothly, the Chinese government has drafted favourable bankruptcy policies on employee's rights, asset management and bad loans.

By April 2004, 3,377 insolvent SOEs have been closed through administrative intervention and 6.2 million employees have already been resettled. In this process, the government had allocated RMB 49.3 billion as SOE bankruptcy subsidies and allowed state-owned banks to write off a total of RMB 223.8 billion of bad loans caused by SOEs bankruptcies. According to the four-year plan, the government is willing to allow a "last batch" of 1,800 companies to go bankrupt when government funding is removed. *Source: China Daily*

Improvements to the Foreign Exchange market

China is taking concrete steps to construct a more mature foreign exchange market, as part of efforts to improve its exchange rate forming mechanism.

The China Foreign Exchange Trade System (CFETS) said it will soon select a further eight banks to act as market makers for the new products it plans to launch in May, after it signed up Bank of China as the first market maker earlier this week.

The new products in the pipeline are eight types of transactions between foreign currencies, including trading between the euro and US dollar and between the euro and Japanese yen. Currently, only transactions between the Chinese currency, the renminbi, and four overseas currencies - US dollar, euro, the Hong Kong dollar and Japanese yen - are permitted in China's foreign exchange market.

The other eight prospective market makers reportedly include one Chinese bank and seven foreign banks, including HSBC and Deutsche Bank. Market makers are responsible for a continuation in trading, by simultaneously offering buying and selling opportunities to market participants.

While the new types of transactions and their market maker system will help activate trading in the domestic forex market and meet domestic companies' trading needs, analysts say what is also significant is that the moves will pave the way for the launch of a market maker system for trading between the renminbi and the US dollar, which the local currency is pegged to. *Adapted from China Daily*

Green GDP

The National Bureau of Statistics intends to enforce a pilot "Green GDP" accounting system in ten provinces and the municipalities Beijing, Tianjin and Hebei. This would be a milestone for China in evaluating the cost of environmental pollution in the course of its economic progress. "Green GDP" is calculated as the balance after environmental cost and environmental resource protection expenditure is deducted from GDP.

The test results are expected to be released early next year, and will lay a foundation for the nationwide implementation of the new method of calculating the "Green GDP." Due to the problems with pollution in China, the "Green GDP" growth rates are expected to be significantly lower than corresponding GDP growth rates produced under the existing calculation methodology. However, the resultant figures will be much more accurate when the environmental damage linked to economic growth is properly taken into account. *Adapted from China Daily*

Economic Indicators

In January, China's Consumer Price Index (CPI) rose only 1.9 percent year-on-year as the inflation of consumer prices cooled from the high of 5.3 percent seen in the middle of last year and after 2.8 percent in December. However, the CPI rose 3.9 percent in February when compared with statistics from the same month last year, picking up far more sharply than expected after January's slowdown. According to the State Development and Reform Commission CPI was expected to grow about four percent in 2005. China's CPI rose 3.9 percent in 2004. *Source: Shenzhen Daily*

According to statistics released by the Ministry of Commerce, China approved the establishment of 5,444 new foreign-funded enterprises in the first two months of 2005, down 9.02% on a year-on-year basis. By the end of Feb. 2005, a total of 514,385 foreign-funded enterprises had gained government approval to establish operations in China. Source: MOFCOM
China's industrial firms reported RMB 165.3 billion in profit in the first two months of 2005, up 17.4 percent from a year earlier. *Source: National Bureau of Statistics*

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legal

Capital requirements reduced for foreign investment in leasing

New regulations have come into force to increase foreign involvement in the Leasing sector to meet China's WTO commitments. Promulgated by the Ministry of Commerce, the "Measures on the Administration of Foreign Investment in Leasing Business" were issued on February 3rd and have been effective from March 5th, 2005. The first significant change is that Wholly Foreign Owned Enterprises (WFOE) and joint stock limited companies are now allowed to be used as investment vehicles for leasing operations in China. Previous regulations only allowed foreign involvement through an equity or contractual joint venture and thus the flexibility of investment options available to the foreign investor was a limiting factor.

The second main change is that for the two types of leasing business permitted by the new regulation - general leasing and finance leasing - and the finance leasing company, market entry thresholds in terms of total assets and industry experience requirements have been greatly reduced. FIEs engaged in non-financial leasing had to have total assets of USD 50 million and a 3 year track record in the industry while total assets of an FIE engaged in financial leasing had to exceed USD 400 million and a 5 year track record under the old regulations. Based on the new regulations, the leasing business requirement has been abolished and the minimum capital requirement of foreign investors has been reduced to USD 5 million for both types. Also, the minimum registered capital was reduced from USD 20 million to USD 10 million for finance leasing companies. These changes should greatly enhance foreign involvement in this sector and expose the current relatively protected industry to increased levels of competition.

Upcoming reform of China's securities law

Small investors' interests are high on the agenda in the revision of China's 1999 "Securities' Law of the PRC", which will be deliberated by China's legislature later this year. The draft is expected to be submitted to National People Congress Standing Committee at its meeting in April. The main aims of the Securities law are to "standardize the issuing and trading of securities, protect the lawful rights and interests of investors, safeguard the economic order and public interests of society and promote the development of the socialist market economy" China's legal system needs to be improved in this area to enable investors to make full use of the Securities Law, including taking steps like "collective action" against listed companies that act in a fraudulent manner.

This comes at a time when investor confidence in the markets is particularly low and the two Chinese stock markets are amongst the worst performing in the world. The existing Securities Law and its 2003 adjustments have been criticized due to the fact that they have many provisions to allow investors to sue fraudulent companies of which very few are enforceable. In addition, although the current laws also set out the ability to file collective suits against companies, punishment of deviant companies is not yet consistent enough and to date only one case has ever reached a final verdict. *Adapted from China Daily*

Scope of consumption tax to expand

According to the State Administration of Taxation (SAT), China will adjust the scope of consumption tax (CT) in 2005. Consumption tax is turnover tax, which is generally levied on manufacturers and importers of specific luxury goods, including tobacco, liquor and cosmetics. CT can have a major impact as the tax rates range from 3% to 45% of the sales value. CT issues are governed by the "Provisional Regulations of the People's Republic of China on Consumption Tax", which have been effective since 1994.

The scope of this law will likely be expanded to cover items such as spending at golf courses, top fashion outlets and nightclubs. With wealth inequalities being a serious problem in China, the taxation of wealthier individuals will serve to act on this issue as well as bring in additional tax revenue. However, for those industries that now fall under the amended scope there will be an uneasy wait to find out to what extent their profits will be affected which results from the large range of possible tax rates. In addition, several outdated tax items will be adjusted to fit the new legal framework including removing the tax on gasoline once the upcoming Fuel Tax is introduced.

New regulations on the issuance of Renminbi-denominated bonds

Chinese authorities issued tentative rules on the 1st March to allow international development agencies to issue renminbi bonds in the domestic market, which are retroactively effective from 18th February 2005. These are termed the Interim Procedures for the Management of Renminbi Bond Issues by International Development Organizations issued jointly by the People's Bank of China, Ministry of Finance, State Development and Reform Commission and China Securities Regulatory Commission.

Those international development institutions that meet the new requirements, namely having more than US$1 billion in loans and equity investment in China and an AA upward Renminbi bond credit rating, will be able to issue the new bonds. Promulgation of the rules is part of a major effort by the authorities to usher in international financial institutions such as International Finance Corp. (a subdivision of the World Bank) to help develop local bond markets. *Adapted from China Daily*

Asset securitization gains approval

Asset securitization - a landmark initiative in China's financial markets - has been finally accepted by the country's authorities. The People's Bank of China, the central bank, announced on 21st March that the China Development Bank (CDB) and China Construction Bank (CCB) will be pilot institutions for the plan.

Asset securitization is the transformation of non-liquid assets into securities; for example, into an instrument that can be traded in a capital market. Securitization, which originated in the United States in the 1970s, has become a major financial instrument in modern finance. It bridges the currency and capital markets. It also translates, eventually, assets into a cash flow, which is of vital importance to investors and the financial market. However, some analysts remain skeptical, pointing out that China does not have a specific securitization-related law which will hinder development of the industry. *Adapted from Xinhua*

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LehmanBrown International Accountants Named 1st China-Wide ACCA Platinum Employer

Ms. Yao Zhiyun, Chief Represntative ACCA China
Mr. Dickson Leung, Senior Partner, LehmanBrown

LehmanBrown International Accountants has become the first company to receive China-wide, Platinum Employer status from the Association of Chartered Certified Accountants. Platinum status is the highest status granted by the ACCA.

LehmanBrown support WWF

WWF for a living planet

LehmanBrown is pleased to announce its support to WWF (World Wide Fund for nature) at the occasion of their 25th anniversary. In supporting them, we wish to make a difference in the long battle to preserve and save China's remarkable natural environment.

We are interested in receiving your feedback on our articles and any suggestions as to future topics are more than welcome at newsletter@lehmanbrown.com.

LEHMANBROWN
雷 博 國 際 會 計

"Providing an Alternative in China"

Beijing Office:

6/F, Dongwai Diplomatic Building
23 Dongzhimenwai Dajie
Beijing 100600
Tel: +86 10 8532 1720
Fax: +86 10 6532 3270
E-mail: beijing@lehmanbrown.com

Shanghai Office:

Room 902, Shanghai Universal Mansion, Tower A
172 Yu Yuan Lu
Shanghai 200040
Tel: +86 21 6249 0055
Fax: +86 21 6288 1636
E-mail: shanghai@lehmanbrown.com

Shenzhen Office:

Room 3206, News Building
2 Shennan Middle Road
Shenzhen 518027
Tel: +86 755 8209 1244
Fax: +86 755 8209 0672
E-mail: shenzhen@lehmanbrown.com

Tianjin Office:

Room 610, North Technology Exchange
Market No. 248 Baidi Road
Tianjin 300192
Tel: +86 22 8789 0247
Fax: +86 22 8789 3254
E-mail: tianjin@lehmanbrown.com

Hong Kong Office:

Room 801-802, Lansing House
47 Queen's Road
Central, Hong Kong
Tel: +852 2537 5425
Fax: +852 2537 5649
E-mail: hongkong@lehmanbrown.com

Mongolia Office:

3rd Floor, Dalaivan Building
Bayangol District
Amarsanaa Street
Ulaanbaatar-44, Mongolia
Tel: +976 11 305 271
Fax: +976 11 329 050
E-mail: mongolia@lehmanbrown.com

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