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Investment in China – Choosing the Appropriate Form of Investment

Given China's market size and high economic growth rate, there has been no lack of attractiveness for foreign investors. However, with the unification of the income tax for domestic and foreign companies and with the change in foreign investment policy from the pursuit of "quantity" to "quality", foreign investors are experiencing the transition from "super-national treatment" to "national treatment".

However, at the recently concluded Fifth Plenary Session of the 17th Central Committee of the Communist Party of China (CPC), it raised a change in the development approach, which is "from national wealth to people's wealth". The writer's perspective is that this change suggested that the government will put more emphasis and protection to private interests. We can foresee that enterprises and investors, including foreign investors, as the carriers for private interest and medium for creating people's wealth, will be benefited by more fundamental legal protection and growth opportunities.

As investors, we must have bold investment strategies, but also require careful planning and execution. Once determined to enter the Chinese market, as investors, an important consideration is to decide on the form of investment.

1. Available Forms of Investment

In the existing legal framework, direct investment by foreign investors in China can be roughly categorized into two basic forms; greenfield investment and mergers and acquisitions.

In addition to direct investment, foreign investors and domestic investors can achieve economic alliance and benefit-sharing in a more loose way, mainly through contractual relationships.

Greenfield Investment

Greenfield investments refer to foreign investors' enterprises who are entitled full rights to some or all of the assets setup by the foreign investors, in accordance to Chinese laws.

Wholly Owned Enterprise

Wholly owned foreign enterprises are wholly owned enterprises generally established in the form of limited liability companies and regulated under the "Wholly Foreign-owned Enterprise Law of the People's Republic of China".

In addition, two or more foreign enterprises and individuals can establish partnership enterprises

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within the territory of China under the "Administrative Provisions on Registration of Foreign-invested Partnership Enterprises". Among the parties, the partners (except limited partners) need to assume unlimited liability over the debts of the partnership enterprise.

Joint Venture

Joint venture refers to a joint investment formed by a foreign investor and domestic investor. The specific legal form can be a Sino-foreign equity joint venture as stipulated in the "Sino-foreign Equity Joint Venture Law" or a foreign-invested joint stock company as stipulated in the "Tentative Provisions of the Ministry of Foreign Trade and Economic Cooperation on Certain Issues Concerning the Establishment of Foreign-Invested Joint Stock Companies"

The nature of the former is a limited liability company and the latter is a stock corporation.

Sino-Foreign Co-operative Joint Venture

This takes the form of a Sino-Foreign Co-operative Joint Venture as stipulated in the "Sino-Foreign Co-operative Joint Venture Law of the People's Republic of China", requiring the approval of the Chinese Government and formal business registration, and often treated as an independent tax liable entity

Mergers and Acquisitions

Mergers and acquisitions, according to "the Rules on Merger and Acquisition of Domestic Enterprises by Foreign Investors", refer to a foreign investor purchases the stock right of a shareholder of a non-foreign-invested enterprise in China ("domestic company") or capital increase of a domestic company so as to convert and re-establish a domestic company as a foreign-invested enterprise; or, a foreign investor establishes a foreign-invested enterprise and purchases and operates the assets of a domestic enterprise by the agreement of that enterprise, or, a foreign investor purchases the assets of a domestic enterprise by agreement and uses this asset investment to establish a foreign-invested enterprise and operate the assets.

The substance of mergers and acquisitions is the consideration required to acquire a domestic enterprise's full or partial control. From legal's perspective, mergers and acquisitions can be either in the form of equity acquisition or asset acquisition.

2. Comparison of the Different Forms

Relatively speaking, the benefit of a greenfield investment, especially a wholly owned setup, is that the foreign investor has greater autonomy, and have greater control over project's riskiness. Moreover, investors can better protect their proprietary technology and manage their know-how.

On the other hand, the establishment of a greenfield investment needs a longer period, and requires

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higher level of international investment and operating experience of the investors.

With mergers and acquisitions, investors can benefit from quicker penetration into the targeted market and obtain market share. However, the determination of the target price for the acquisition is the real obstacle in the negotiation between the parties. In addition, integration issues need to be dealt with following the completion of acquisition. Mishandling the integration issues will defeat the purpose of the mergers and acquisitions.

Co-operation in a loose way could provide benefits such as time saving and more flexible funding adjustment according to riskiness, but enjoy a lesser extent of economic benefits. Furthermore, because there is no direct investment relationship but only reliance on contractual relationship, this form lacks stability and binding power on the partners.

3. The Suitable Choice for You

For each investor, the form of investment that is more favorable depends on its current position and its goal setup.

For multinational corporations, they often possess a set of proven business models and methods that have demonstrated success in other countries and regions. Hence, they are more suitable to greenfield investments (mainly through setup of wholly owned enterprises). Their primary concern is in operations management. For those who seek for greater market share where time is the essence or those who seek for supply chain integrations, mergers and acquisitions is the more effective form.

However, with regional companies, such as Hong Kong domestic companies, due to their lack of experience and unfamiliarity of foreign investment business models, it is more suitable to form joint venture with Chinese domestic enterprises to reduce the risk of investment failure. Here is the benefit:

They can ride on the success of the domestic partners' operation experience in the local market and utilize existing funds and established relationship with the local government. This not only reduces the initial capital funding, but also allows penetration into the market quicker. On the basis of same interests for both sides and with the co-operation of the domestic partner's management team, the formed enterprise will be easier to succeed.

Besides direct investment, for testing the water in China, investor may begin with the loose way of co-operation. Meanwhile, investor may obtain better understand of the Chinese market and partnerships in China. By then, investor may opt for co-operation through equity or directly establish a wholly owned enterprise.

Without a doubt, selection of partners is crucial shall investor decide to form co-operation relationship or joint venture. In a broad sense, the criteria to be considered include: relevance of business nature, previous operation results, legitimate needs for co-operation, the integrity of the management and so

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on.

With clear strategic goals and prudent investment strategies, complemented by the assistance of professional organizations, investors will be able to participate in China's economic growth and gain share of relevant interests.

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