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BUSINESS LAWYERS, CORPORATE COUNSEL

**Assessing the China Business Opportunity:**  
**Notes From A Trip to China**

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## **Introduction and Thank You**

I was in China from January 17<sup>th</sup> to January 24<sup>th</sup>, 2005, visiting Shanghai, Beijing and Xiamen with my clients Digital Connexions Corp. From January 19<sup>th</sup> to 23<sup>rd</sup> we were participating in a Canadian trade mission to China led by Prime Minister Paul Martin. The rest of the trip was spent visiting and networking with some of Digital's business connections, customers and suppliers in China.

This memo summarizes some of the things I learned while I was there, so that I can share that information with selected colleagues and clients.

I would like to start by thanking my friends and clients Paul Westhorpe, Barb Westhorpe and John Ching from Digital Connexions Corp., who invited me on this trip, hosted and guided a China rookie with infinite patience, and picked up all of my expenses in return for getting a full week of my time and attention. *Note: will trade time for exotic travel arrangements!*

Digital Connexions is a software company based in Oakville, Ontario with offices in New York and Xiamen. It sells a suite of products that manage and enhance e-commerce for companies communicating with and marketing to their customers using bulk email, including sophisticated campaign management, delivery and analysis tools; data management and analytics; and predictive modeling. John Ching, their CTO, has a Ph.D. from Waterloo in Computer Science. They have many US Fortune 500 clients, especially in the magazine publishing sector. They were recently ranked as #41 out of the 500 fastest growing IT companies by a major US national poll. ([www.dconx.com](http://www.dconx.com)).

What follows is my own synthesis of the information that came my way during my eight days in China. Some information is from official Canadian and China government sources, some from major publications I came across, and some from conversations with a number of local sources with whom we met.

As our focus on this trip was software based, there will be a software bias to some of this report. I apologize to my non-software clients, although the information provided will give a sense of the commitment by the Chinese to developing their IT base – a commitment that extends to every sector of their economy.

Also, much of this memo is in point form. I am far from an “expert” on doing business in China, and am only intending to pass on the little I have learned so far as quickly and efficiently as possible.

## **China: Some Facts and Figures**

- The world's fourth largest country by area, only slightly smaller than Canada and USA.
- 1.3 billion population.
- Labour force of over 744 million people.
- 4.3% unemployment rate in 2003.
- Youngest population in Asia – 93% of them are under 65.
- 50% of China population will be living in an urban environment by 2010.
- 7<sup>th</sup> largest economy and 3<sup>rd</sup> largest market in the world.
- Average 10% GDP growth rate for twenty-five consecutive years.
- 2004 GDP of US\$1.4 trillion, or US\$1,090 per person.
- 35% to 40% savings rate.

- 2<sup>nd</sup> largest economy by purchasing power in the world.
- 2<sup>nd</sup> largest foreign currency reserves in the world - US\$403 billion in 2003, up 40% from year before.
- Strong current account surplus.
- 3<sup>rd</sup> to 4<sup>th</sup> largest trading nation in the world.
- World's 4<sup>th</sup> largest exporter.
- World's 3<sup>rd</sup> largest importer.
- Attracted US\$60 billion in foreign direct investment in 2004 – twice that in contractual commitments.
- Only 33% of Chinese production is for exports – it has voracious domestic demand, which is the real driver of the Chinese economy.
- Large and growing middle class.
  
- World's largest consumer of metals.
- World's largest producer of steel, concrete, coal, fertilizers, household appliances and a wide-range of agricultural products.
- 5<sup>th</sup> largest producer of automobiles.
- World leader in electronics, apparel, textiles and toys.
- Consumes more concrete per year than the rest of the world combined – construction industry is absolutely charging along as 20 million people are expected to move into the cities in the next six years.
- 102 cities with populations in excess of 1 million people, largest has in excess of 30 million.
- Two major stock exchanges.
  
- Over 263 million fixed phone users and growing.
- Over 300 million cell phone users and growing well into the double digits.
- Over 90 million Internet subscribers and growing well into the double digits.
  
- Less than 50% of GDP is now derived from state owned enterprises (SOEs).
- 2.5 million private companies in China today, were none 20 years ago.
- About 100,000 SOEs expected to be sold off in the next few years.
  
- Private property rights enshrined in constitution – Canada and USA cannot say that.
- Investors rights protected in legal system.
- IP protection in legal system and strong government commitment to make improvements in that area in terms of enforcement and culture shift to respect for IP rights.
- Corporate legal infrastructure is in place.
- Since joining WTO in 2001, China has enacted or amended over 2,500 laws to implement compliance, and is still working on it.

Note: in areas we traveled infrastructure was mature, modern and reliable, including roads, airports, rail, telecom and IT – and there was lots of it.

### **China Software Industry: Facts and Figures**

- IT industry was 6% of GDP in 2003, for a total of US\$85.4 billion.
- 35 software engineer colleges, teaching in English and Chinese.
- 140,000 software engineering graduates in 2003.
- 172,800 of 700,200 foreign trade software engineers have returned to China.

- Software engineers in China cost 1/6<sup>th</sup> of their US counterparts.
- Increased legal protection for IP and licensed software mirroring Western systems.
- Tax breaks for new foreign software companies – no tax for first two years, 50 % reduction in years 3 to 5.
- Reduced VAT taxes for software companies.
- Reduced employee income taxes on selected software companies.
- Lots of local and national government assistance and encouragement to foreign software companies setting up in China, including many local “software parks”.
- 8,000 software companies in China in 2003.
- Only 25 had more than 1,000 employees.
- Only 23% had sales in excess of US\$1.2 million.
- Industry growing at 30% to 35% per year, including international outsourcing.
- Total of 620,000 software employees nation-wide, targeting 800,000 by 2005.
- Over 100 foreign R&D centres in China.

Other notes:

- IT ranks in top 5 industries Chinese government wants to develop.
- Strong emphasis on developing and supporting local software, which means companies set up in China and employing local Chinese – does not mean disincentive to foreign owned local companies.
- Install base still developing in China – software as competitive advantage not yet well-entrenched – companies rely on other competitive advantages, especially around cost of production.
- Industry not mature, which means lots of opportunity for growth.

### **China-Canada Fast Facts: A Special Relationship**

- From Norman Bethune to Pierre Trudeau, Canada has had a special relationship with China.
- Over 250,000 Canadian citizens live in China.
- Over 1,000,000 people of Chinese heritage live in Canada.
- Over 37,000 Chinese students study in Canada every year.
- Bilateral trade has increased five fold in last 10 years, and expected to double again by 2010.
- Was US\$15.5 billion in 2004.
- China is now Canada’s #2 trading partner.
- Canada is now China’s #10 trading partner.
- 7,000 Canadian companies in China in 2004.
- US\$4.0 billion in direct foreign investment into China by Canadian companies in 2004.

### **Words of Caution**

This all seems pretty exciting, but there are some cautionary observations to be made:

- China is a large country. Economic regional disparities are an important issue.
- This is also a continuing disparity between the middle class and the poor. An average GDP of US\$1,090 shows how far China still has to go to achieve the sort of country-wide standard of

living we have come to expect in the first world. That is an opportunity in the long run, but a potential trip-wire in the short run.

- Issues of “middlemen” and downright bribery are not eliminated in China, especially the further you get from the centres of government.
- Issues of IP theft are still very prevalent. China is the “knock off” capital of the world in part because it is accepted on a cultural basis.
- The local currency (RMB aka Yuan) is pegged to the US dollar (about 8.277 RMB to each US\$1.00). When you do business in China you do business in RMB. Chinese customers will not pay Western prices for your goods and services. They cannot afford to, as they are doing business in China and in RMB. This means that your sales and profits in China will not translate \$1.00 for \$1.00 to your income statement and balance sheet at home. To oversimplify, with US\$1.00 currently equaling about RMB\$8.0, you have to sell eight times the amount you do in China to get the same profit contribution you get from selling US\$1.00 at home.
- China still has a state-managed economy. Interaction with government agencies can be very important to your success. Depending on your industry, issues of government protection or state interference may still have to be reckoned with.
- China is still a communist country, with human rights and political freedoms to wrestle with. Censorship and state control of media content are very real and active issues.
- You will not out-entrepreneur your Chinese competitors. They eat, breath and sleep entrepreneurship, are very smart about it, and are desperate to succeed economically.
- You will never be a local. You will need local assistance to get started, and will need to keep locals involved as long as you are in the market.

### **Opportunities for Canadian SMEs (Small and Medium Enterprises)**

There are two basic ways for Canadian SMEs to benefit from the Chinese opportunity:

- **Cost Reduction:** You can source or outsource goods, services or functions to cheaper Chinese companies or subsidiaries. You can expect to reduce costs by as much as 90% in some categories by switching from North American labour rates to Chinese labour rates.
- **Growth Lever:** You can significantly grow your top line, including adding significant credibility to your organization, by tapping into a Chinese sales base. Anything tied to simple demographics makes sense.

The world’s multinationals are in China, and many of them in a big way. Many industries are mature, and no more accessible to our Canadian SMEs than those same industries are at home. However, there are still lots of opportunities for Canadian SMEs.

It should also be noted that your current size is irrelevant depending on what industry you are in. In China the opportunity is there for Canadian SMEs to compete quite successfully with their larger counterparts from the rest of the world. As you will see below, success in China is a combination of

right strategy, right local relationships, preparation, solid and committed financing, and perseverance. In the still maturing markets of China, being big at home means nothing. In fact, it might be a detriment if your size has blunted your entrepreneurial abilities or you are too focused on this quarter's results.

There is even a ricochet opportunity, where your credibility as a player in China can lead to better credibility in your existing North American markets or further foreign opportunities.

The Chinese economy is growing in every conceivable category. The following lists are things I ran across. However, just because your business type is not listed here does not mean that it is not an opportunity for you:

- Information and communication technology of any type.
- Education.
- Anything environmentally related, especially if it helps battle pollution.
- Anything selling to Telco's.
- Tourism, especially domestic tourism
- Agriculture.
- Energy saving.
- Transportation and communications.
- Manufacturing processes and logistics.

### **Doing Business In China: Strategic and Localized**

Certain messages were repeated over and over when it came to doing business in China. My summary is as follows:

- 1 Be patient – set realistic expectations – patience, perseverance and staying power are key.
- 2 Do your research – be thorough and strategic – strategic thinking is a science in China.
- 3 Identify and concentrate on one most promising market, and then move on to other opportunities.
- 4 Hire Chinese-speaking staff internal to be part of the project, and make sure you have enough in-house Chinese resources in Canada or in China.
- 5 Localize your business cards, marketing materials, PowerPoints, and maybe even your website into Chinese.
- 6 Learn from success and failure of others – network with other Canadian companies and Canadians working in China.
- 7 China is a big country with a huge population – select the region you want to do business on as your first step.
- 8 Visit in person – attend local trade fairs.
- 9 Study local business culture and etiquette and adapt accordingly – respect hierarchy – respect others and build trust –save “face”, build “face”.

- 10 Visit and form relationships with local businesses and potential partners.
- 11 Visit and form relationships with local officials.
- 12 Form partnerships or joint ventures with local companies, but do not be too hasty about it – network with many potential partners and complete due diligence before legalizing a relationship.
- 13 Test your strategy before throwing huge resources behind it.
- 14 Be prepared to mount a sustained effort including human and financial resources.
- 15 Be prepared to move quickly as your Chinese competitors will be swift to react.
- 16 Rely on your local managers – if you have selected them wisely they should be trusted – they do not have to be English speaking as long as you have a Chinese-speaking employee on your team.
- 17 Use local professional advisors.
- 18 Liaise with local Canadian trade commission.
- 19 Join and consult with the Canada Chinese Business Council.
- 20 You will need a Chinese speaking point person who will be accepted locally – should be bilingual and ethnically Chinese who has lived in both Canada and China – if you find a good one in China bring him or her to Canada for a while – if you find one in Canada you may need to send him or her to China for a while – you need someone on the ground you can trust.

### **Deal-Making in China: The Art of the Relationship, *Not* The Art of the Deal**

There was also some good information on deal making in China. While on the surface it may seem different than how we see things here, the relationship focus on China is very comfortable to me, as I have been coaching my own clients to recognize and foster the relationship element underlying all successful business deals. What I have been able to put together so far is very basic:

- 1 Build a relationship and friendship first and then try to do a deal – do not try to do a deal and then form a friendship – relationships are the single most important part about doing business in China – opportunity follows trust and friendship.
- 2 Chinese companies want to know how you can make money together – once convinced of that they will want to see your products or services – pitch the opportunity for them, and then the product or service.
- 3 Respect “face” – reach consensus without conflict – do not criticize – do not “tease” – a smile does not mean they found it funny – a “yes” does not mean agreement – must be win/win or will get nowhere – business is *not* business in China, it *is* personal.
- 4 Strategic thinking is a formal discipline in China – they think we are naïve in negotiations – be tough – once you make a deal, stick to it.

- 5 Lots of approvals may be required – make sure your local partner has the right ones - be patient with the bureaucracy – remember that one civil servant will be attracting investment while another one will be required to impose standards and requirements for approvals.
- 6 Exhibit patience, perseverance and staying power.

### **Financing Your China Strategy**

We only had a basic introduction to financing in China. We did learn that there is a lot of Canadian and Chinese government moral and practical support for Canadian companies who want to invest in China, especially in areas targeted by the Chinese government.

All the major Canadian and international banks have presences in China.

China itself has a mature and accessible banking system.

The Canadian government has departments which help with trading in China, especially the Export Development Corporation (all kinds of financing assistance), and the Canadian Commercial Corporation (supports Canadians to do deals with foreign government procurement agencies, including negotiating deals and providing government guarantees).

There are VC opportunities out of Hong Kong and Japan, as well as local VCs within China itself, specifically focused on the Chinese marketplace.

As you would expect, the goal of most local Chinese entrepreneurs is to build a company they can take public or sell to a multi-national.

NASDAQ is the target for Chinese IT companies, many of which are listed there already.

Canadian companies are expected to bring cash to the table, not just expertise. Do not come without cash and the commitment to use it. Chinese partners are often short of cash but long on energy and connections, and Canadian and US dollars buy huge leverage in China (people, goods and services cost 1/6<sup>th</sup> to 1/10<sup>th</sup> what they cost at “home”). At the SME level, most local Chinese associates are not expecting to contribute money to the deal. A commitment by you of US\$150,000 to US\$250,000 is probably the minimum required to start something at the SME level in China, *after* you have paid for your research, developed the right strategy, localized your product and business model, and formed up with key local resources. However, keep in mind that those funds should buy you five to ten times as much localized resource in China than the same amount of money would buy you in North America.

### **Next Steps**

If you have an interest in China from a business perspective, either as a cost-reduction model, to find Chinese products or services to bring to North America, or to take your products or services to China:

- 1 Begin by researching a Chinese strategy for your company, hopefully using a Chinese research assistant. A co-op or other student from a local university or community college is one potential

resource. Identify Chinese based sources of information and publications. Buy them even if they are in Chinese and use your Chinese-Canadian research assistant to summarize them for you. Spend some time on this. It is all about strategy.

- 2 Network with other Canadian companies doing business in China.
- 3 Contact the Canadian Trade Commissioner's office and determine what they can do for you, including the local offices located in major Chinese cities. Their job is to help facilitate trade opportunities for Canadian companies.
- 4 Network with the Canada Chinese Business Council, and join and participate if it seems the right thing for you.
- 5 Outline a basic China business strategy, including your key reasons for wanting to be there – lower your costs by buying local production capability, or increasing your sales by tapping into the Chinese market. Be sure to have given some thought to how you will localize, finance and test your business thesis.
- 6 Plan a trip to China. Determine what regions you want to visit. See if there are trade shows or similar opportunities to attend or participate in. Consider making arrangements to visit the local Canadian Trade Commission office, local Chinese officials, local professional advisors, and potential suppliers, customers or partners – not to make commitments, but just to assess the strategic potential and to lay the groundwork for a profitable and enjoyable relationship.
- 7 Localize your marketing and presentation materials before you go. The best combination seems to run both English and Chinese together (e.g. fronts and backs of business cards, top and bottom bullets in PowerPoint presentations, etc.).
- 8 Take a Chinese-Canadian partner or assistant with you, or hire someone for the trip, to guide you through the China travel experience. Make sure they will also be a good and trusted representative for you and your company.
- 9 Get on a plane and go. Unless you see it for yourself, you will never know if it is the right thing for you to do or not.

### **Some Closing Thoughts**

At the end of our trip Barb Westhorpe asked me what I was taking away with me. Now that I am home, I think the main things I have learned from this trip are as follows:

- 1 China is open for business! This is like Japan or Taiwan in the 1950's, with much bigger potential because of the huge population base and the massive infrastructure investment already made by the Chinese government. This is not a temporary development. This is part of a long-term and long-developing strategy by the Chinese government to "open" China economically and culturally for the benefit of the Chinese people. The opportunity is huge; the impact on the world economy and your current market may be even bigger.
- 2 Canadian SMEs can take advantage of the China opportunity, and even out-manuever both larger and local competitors, if they develop and implement a well-researched and thought out localized

strategy, with the right people on the ground in China, and with sufficient funding to back up a sustained effort.

- 3 However, while you may be able to succeed fairly well as a Canadian SME flying by the seat of your pants at home, you will not succeed flying by the seat of your pants in China. The business community in China is sophisticated, modern, educated, experienced, Westernized and backed by both thousands of years of entrepreneurial heritage and the support of a centralized government committed to the success of its local population. If you are not prepared to implement and apply solid business practices, then stay home.

Would I go back to China? In a heartbeat.

Would I be afraid to do business there? Absolutely not.

I hope this memo is of some interest to you. Please let me know if I can be of any further help.

Phil

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