Doing Business in China:

- A Best-practice Model for Foreign Invested Small and Medium-sized Enterprises (SMEs)

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Abstract

Title: Doing Business in China
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Background: Foreign invested SMEs have recently become increasingly interested in China. The enterprises are in this report categorized as second wave companies since they follow the footsteps of previous pioneers, of which mostly were larger companies. The ambitions of the SMEs are either to sell products on the ever expanding Chinese market or to utilize the potential of low cost production for global markets. The existing literature is fragmented and solely based on the experience of larger companies. We believe that SMEs are facing new and different challenges, and thus a new generic theoretical frame work is desirable.

Purpose: Our aim is to present companies of the second wave a best practice model on how to do business in China. By using the STAR model they will be better prepared for the upcoming challenges to which they are badly prepared. Furthermore it is our ambition to complement the contemporary literature, which mainly focuses on MNCs, with more specific and targeting recommendations to SMEs with Chinese intentions.

Methodology: The methodology is based upon Glaser and Strauss's grounded theory. By grouping empirical data into categories we have created a best-practice model. The STAR model has 5 perspectives which all contain challenges and opportunities for SMEs doing business in China. Throughout the report we have used an integrated approach to support our theory building logic.

Conclusions: Our comprehensive best-practice model, called the STAR model has five important perspectives. The five perspectives are HR & Culture, Sales & Marketing, Logistics, Development Zones and Investment. The STAR model addresses the challenges and opportunities in all these perspective. By utilizes the model foreign invested SMEs will mitigate the most dominant and common risks faced when doing business in China. The model has been successfully tested on a case company, Emotron, a second wave company in the electronic-mechanical production industry.

Key Words: Doing business, SME, best-practice, model, China, STAR, business, strategy, invest, investment, logistics, HR, culture, development zone, sales, marketing

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题目：　　　　　　在中国经商
　　　　　　　　　　－最佳做法模式为投资中小型企业(中小企)

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背景：

外商投资中小企业最近在中国越来越感兴趣。这份报告反映出第二波投资企业的公司, 自从他们遵循与跟随着先前的倡导者, 其中大多为大型企业，而中小企业的雄心是对于产品销售市场的不断扩大和利用中国廉价的劳动力而面对于全球市场.
对于大公司的现有文献仅是在零散经验的基础上。所以我们认为, 中小企业正面临着全新的和不同的挑战。因此新的理论框架一般是悦人心意的。

目的：

我们的目标是瞄准第二波外商投资的企业在中国如何做生意的最佳实践示范。通过利用最典型的模式来更充分更迫切地准备着即将到来的挑战。而且我们的雄心壮志补充了主要集中与聚焦于跨国公司的当代文献，并针对中小企业与中国人的意图同时给予更精确与详细的建议。

建议方法：

这种方法是建立在格拉泽和史特劳斯的理论基础上的。根据实验数据的分析, 我们创造了最佳的实践与示范。其中包含了各中小企业在中国经商的最典型模式的五个方面的挑战和机遇。在整个报告中, 我们采用综合的方式来支持我们建设性的理论逻辑。

结论：

综合最佳做法模式：称为星模式，其中有五个重要观点，
这五个方面主要为：人力资源，文化，销售和市场，物流，发展区域和投资。在这些观点中集中了所有星模式的挑战和机遇。利用外商投资中小企业的模式，主要减少了　　在中国做生意的风险。已经有一个成功的实例：Emotron公司为第二波外商投资的电子机械工业生产企业。

关键词：

做生意与发展经济，中小型企业，最好的实践与实习，范例，中国，星模式，生意，策略，投资，投资可获利的东西，物流，人力资源，文化，发展地区，销售，市场。

Acknowledgements

This master thesis has been the most interesting and educating project we have conducted during our studies at Lund Institute of Technology and Lund School of Economics and Management. We believe the subject of this paper is very interesting as it is based upon a common and up-to-date issue faced by many SMEs. Our project has been supported by the top management of Emotron AB to whom we hope this report will be of great value. However, the result from this paper will not only benefit Emotron but also other SMEs, which have intentions and strategies to do business in China.

First of all, we would like to thank Emotron AB, and in particular the company's top management team for the opportunity to execute this project. Our supervisors Ola Olsson and Paul Gustavsson have been very encouraging and supporting throughout the thesis. They provided us with necessary data to be able to do a complete investment analysis. Furthermore, the company supported our two month stay in Shanghai, which was imperative for the study. In Shanghai we found the staff of the representative office, Professor Liu, Professor Li and Mr. Chen very helpful and supportive.

We would also like to thank the participants of our benchmarking study. The companies provided us with vital data which our best-practice model is based upon. Also, the Swedish Trade Council, China Supply Chain Council, financial institutions, law firms, and government officials have been supportive and positive to our study.

Finally, our supervisors from Lund Institute of Technology and Lund School of Economics and Management, Fredrik Nilsson and Claes Svensson, have been very helpful, in particular regarding the methodologically work of the study.

Lund, 2006-06-01

Martin Böhm　　　　Hampus Dahlstedt

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1 Introduction

1.1 Background

China has during the last couple of years dominated large portions of the news in the western world. Its current development is quite remarkable as both its history has been and as the future will be. Indeed the country is considered to provide every company with great returns both as an export platform and as a provider of a growing prosperous market. Even though this in many cases might be a sound statement, China’s market conditions and regulations can also become a costly and devastating experience for impulsive actors with insufficient knowledge and preparations.

The fact is that China’s situation is complex. Its goal to create a wealthy nation has always been ambitious but not always turned out as planned. In the beginning of the communist liberalization in 1949 China’s strive to success followed a rather crooked path. Strategies were not of the soviet type of central planning nor of the capitalist market thinking. Instead, self sufficiency was the primary goal which was intended to bring wealth to the Chinese people. Despite of governmental reports showing figures of a 12 percent annual growth since the 1950ies things didn’t really go as planned. In 1978, two years after Mao Zedong’s death, Deng Xiaoping became the new leader of China’s communist party. Shortly after receiving his assignment Deng presented four modernizations that resulted in a fundamental change of the economic policies of the army, agriculture, industry, and foreign trade. The modernizations have proven themselves successful even though Deng’s metaphor of “feeling the stones while crossing the river” has proven itself to be true many times. The introduction of market economy has resulted in a rapid increase in productivity while at the same time creating massive amount of pollution with acid rains in Japan as one of the consequences. The opening up of the Chinese market to the world economy has lead to large foreign investments and technology transfers creating further development but also dependence to the surrounding world. The dependence was further strengthened as China gained access to the world trade organization in 2002 promising to lower its tariffs and create fair and transparent market conditions. Today, the change has gone so far that there will not be a turning back to the days of self sufficiency in a controllable manner.

The Chinese ruling communist party is managing the change in a slow but steady pace. There are several reasons for this. First of all, they have already had bad experiences from previous immense improvement projects made by Mao Zedong that historically have led to severe consequences for its people. Secondly, the examples of the Russian and Polish transformations are not very appealing to a ruling party in charge before such a transition. With no option of going back, an economic growth that eventually will face recession, and an ever increasing influence from the western world the communist party’s right to rule is likely to be questioned. It is also likely that China can not afford more incidents like the one at Tiananmen Square which would, as a consequence, result in democratization as a final step before becoming a full member of the western and developed world. This is however not yet the case, nor is it likely to come in a near future.

Instead, China is currently in the middle of its transition. Several companies have already explored its market, most of them large multinational companies (MNCs) that have learned the hard way of surviving and being successful in market conditions not alike anything else in the world. These belong to the first wave of foreign companies to enter the Chinese market. The second wave comprises the small and medium-sized enterprises (SMEs) that follow the wake of the first wave. Even though larger companies already paved some of the way, SMEs will face challenges quite different from their initial expectations and the experiences of their precursors.

1.2 Issue of Study

In a report published by the Swedish institute for growth policy studies in 2005 Sweden's investments with China were relatively scarce during the 80ties. Until 1992 only eight investments were made. Next decade more than 40 investments were made, accounting for USD 882 million in FDI. In 2004 the total amount of Swedish companies was 93 with a total investment size of USD 2.8 billion which gives an average of USD 30 million per company. Today most Swedish companies with investments in China are MNCs, i.e. companies of the first wave. However, the report concludes that despite undeveloped presence by Swedish SMEs, China is becoming more and more important for SMEs, even though they face particular difficult challenges compared to larger companies. Most opportunities are expected to be found in areas such as technology and services.

Challenges are best faced with proper preparation. Second wave companies are unfortunately not very well prepared for the new challenges they will face in China. SMEs lack resources and are more sensitive towards risks compared to larger companies. They may hire consulting firms to consult them although few SMEs are likely to afford their fees. Furthermore is such consulting likely to be the last resort for SMEs, thus more reparation of the issues than preparation for the challenges.

Neither may the academic world be of help for SMEs doing business in China. When searching on the keyword "China" on different types of search engines several results were found. The same was true for the combination of "China +business". However, when searching on the combination of "China +SME" very few results were found. Most articles that were found were very specific regarding a subject rather than a comprehensive approach to SME specific challenges. In Google Scholar, one of the most powerful search engines, 2600 hits were registered. Despite the large number in quantitative terms, one has to consider that the algorithms of that search engine focuses on all words present in each document while other search engines like ELIN searches on key words. As a consequence we made further combinations on Google Scholar to find more relevant articles. As a result, "*China +SME +challenges +recommendation*" gave 143 results and "*China +SME +"best practice"*" gave 291 results. When investigating the articles found, only a hand full turned out to be connected and/or contributing to our study, most of them commercial articles written by consulting agencies without comprehensive information.

Search engine	Keyword			
	China	China + business	China +SME	“SME” in China articles
ELIN	106331	15932	37	0,03%
Google Scholar	237000	124000	2600	1,10%
Google news	151000	32200	89	0,06%
CNN Business news	17816	6521	0	0,00%
BBCnews.com	4169	2689	1	0,02%

Table 1. Statistics from several search engines based on related topics

As our research for information has shown there is a lack of appropriate literature and information of SMEs in combination with China. Simultaneously, there is a growing need for relevant information as more and more SMEs are entering the Chinese market especially when the challenges they are facing are particular difficult.

Other sources of literature targeting SMEs for other geographical markets are not specific enough to address the challenges SMEs are facing in China. China’s heritage and business practice is too specific to apply under a general frame work. Furthermore, China is one of the few markets to which SMEs both can source from and sell to.

1.3 Purpose of Thesis

In this report our aim is to present companies of the second wave a best practice model on how to do business in China. By using the model they should be better prepared for the upcoming challenges to which they are usually badly prepared. To ensure the quality and the practically usefulness of the model it is our ambition to apply it on a case company. Furthermore, it is our hope to complement the contemporary literature, which mainly focuses on larger MNCs, with more specific and targeting recommendations to SMEs with Chinese intentions.

1.4 Definitions

1.4.1 Company profiles of the second wave

For companies of the second wave there are several ways of doing business in China. In our report we have chosen to define three main ways to do business for second wave companies, illustrated by Table 2. The three alternatives are as follows; production setup, sale setup, and full setup, including both of the prior alternatives.

		Production			
		Domestic		China	
Sales	Domestic	**Status Quo**		**Production Setup**	
				Outsource	**FIE**
	China	**Sale Setup**		**Full Setup FIE**	
		Dist.	**FIE**		

Table 2. Strategies for doing business in China

Many SMEs keep focusing on their domestic market despite increasing competition. These companies need to initiate international production to reduce production costs caused by either high sourcing costs or high labor costs. If not realizing it by themselves, they have likely been abruptly reminded of it by failing or demanding customers. Some have already established facilities in east European countries but need further cost reductions.

Other companies are more opportunistic, they recognize the opportunities of a growing market that contains a sixth of the world's population. Extrapolation can easily turn the smallest margins into large accumulated profits. If not a pioneer, competitors might already be there trying to increase their market shares. When trying to penetrate the Chinese market these companies are either setting up their own sale organization or working close with partners such as distributors.

A full setup involves both sale and production on the Chinese market. However, most SMEs have not the resources to invest in both setups at once.

1.4.2 Industrial Park

An industrial park is an area in which other parks and development zones can be located. Suzhou industrial park for instance includes several parks (IT park, international technology park, life science park, national software park, and SME park) and development zones such as EPZ and ETDZ.

1.4.3 Types of Industries

1.4.3.1 Primary Industry

Primary industry is defined as industries that convert natural resources into primary products. Most products from this sector are considered to be raw materials in other sectors.

1.4.3.2 Secondary Industry

The economic sector which create a finished product. The companies may either be involved in construction or manufacturing. Companies of the secondary industry often use products from the primary industry for their manufacturing/construction.

1.4.3.3 Tertiary Industry

The tertiary industry is commonly known as the service sector. Companies' in this type of industry provide services to other business as well as other companies. In our report "service" also includes transportation and distribution.

1.5 Focus Areas

This report focuses on SMEs that are engaged in some sort of industrial manufacturing and aims to do business with China. Furthermore, the report focuses on SMEs which prefer to setup business in the eastern side of China, close to Shanghai and the Yangtze River delta. The eastern part of China is by the authors, the most likely area for western SMEs to locate their sites. Therefore no regard has been taken to other emerging areas which may be more beneficial for some SMEs.

1.6 Target Audience

This report is primarily written for an academic audience of business students at a master level as well as a professional audience consisting of employees at Emotron AB. Secondary audience of the report are other professionals such as employees of other SMEs and professionals with interest of the dynamics of the Chinese market.

1.7 Abbreviations

FCL = Full Container Load
FDI = Foreign Direct Investment
FICE = Foreign Invested Commercial Enterprise
FIE = Foreign Invested Entity
LCL = Less than a Container Load
MNC = Multi National Company
MOFCOM = Ministry of Commerce
PLC = Programmable Logic Controller
RMB = Renimibi (The Chinese currency, also known as Yuan)
SAFE = Secretary of Foreign Exchange
SME = Small and Medium-sized Enterprise (1-499 employees)
SOE = State Owned Enterprise
WFOE = Wholly Owned Enterprise

1.8 Disposition of Thesis

The first chapter of the thesis aims to give the reader a brief introduction to the paper but also to present the purpose, focus areas, target audience, abbreviations, definitions, and disposition of the thesis.

Next chapter, methodology, starts with presenting the hermeneutic approach which is applicable on the ever changing business climate of China. The chapter continues with the grounded theory approach which explains how categories can be found from empirical findings while the integrated approach structures the disposition in a theory building logic.

Chapter three presents which categories, found in the empirical data, which are of main interest for companies of the second wave. The main purpose of the chapter is to show how we have created the best-practice model.

The following five chapters of Human Resources and Culture, Marketing and Sales, Logistics, Development Zones, and Investment are all focusing on each perspective of the best-practice model.

Chapter nine summarizes the conclusions of the previous five chapters and completes the initial model from chapter three.

In chapter ten we are applying the model on our case company, Emotron and their Chinese undertaking.

The results are summarized and discussed in the conclusive chapter. Further research is also recommended.

2 Methodology

2.1 Methodological Approach

2.1.1 Hermeneutic Approach

The business environment for SMEs in China is highly turbulent, ever changing, and repeatedly depending on local actors, i.e. local government. Compared to western standards, doing business in China is far from rational. Consequently, our study is characterized by a hermeneutic approach, which states the need to interpret, experience, and decode information, rather than state primary information as objective facts.[1]

Our study is mainly based upon numerous of qualitative interviews with employees of foreign invested SMEs in China and experts in diverse areas such as logistics, law, and banking. The information we acquired is subjective and applies in a sometimes irrational world. Thus, we have decoded the information according the hermeneutic approach and provided a comprehensive picture.[2]

Figure 1. Hermeneutic approach

Our qualitative interviews were often characterized by an informal set up so that the interview can evolve by the answer of the interviewees'. The information are then to interpreted and often summarized by a case study. As Lundahl & Sköldberg states this working process are closely linked with the hermeneutic approach.[3]

The working process in the hermeneutic approach could either be inductive or abductive, a mixture between an inductive and deductive approach. We have worked using an inductive method, i.e. we have tried to create our own theory from empirical evidence.

2.1.2 The Grounded Theory Approach

As our purpose is to provide a best-practice method for foreign invested SMEs in China, we have used the grounded theory approach to guideline our inductive method. The Grounded theory approach was created by Glaser & Strauss in 1967 and seeks to generate theoretical statements and complex theories based on empirical evidence, although it can be used in different ways and reach various degrees of complexity. The purpose of grounded theory is not to test theories; instead the

[1] Abnor & Bjerke (1994) p. 62-63
[2] Ibid
[3] Lundahl & Sköldberg (1999) p. 44, 101-102

purpose is to create accurate theories from empirical evidence and to make them universal so you can be able to use them in a general context.[4] The grounded theory endorses continuously generating of theories in real-time. Accordingly, when doing empirical studies we have continuously collected, decoded, and analyzed our empirical findings.[5]

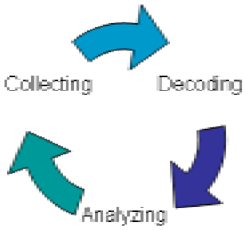


Figure 2. Grounded theory approach

According to the grounded theory approach, the most important issue to begin with, when doing a qualitative analysis, is to get a comprehensive picture of the research field. Once you get an overview of the research field you will be able to focus on specific targeted areas. As Anderson suggest we achieved that by listening to all our interviews and going through our interview notes a second time. Simultaneously we made notes on what type of empirical findings we obtained. By doing so we identified five areas of special interest or *categories*, as Glaser & Strauss defines it; HR & Culture, Sales & Marketing, Logistics, Development Zones and Investment Context. As Andersson states, we subsequently used our notes to separate interview documentation into divide parts. A foundation of the grounded theory is a process called *coding*. This process feeds specific codes to the divided parts, which make synthesis into the different categories possible. Figure 3 illustrates how we generate theories in the logistics area from empirical evidence.[6] The actual process of building the model is discussed in detail in chapter 3.

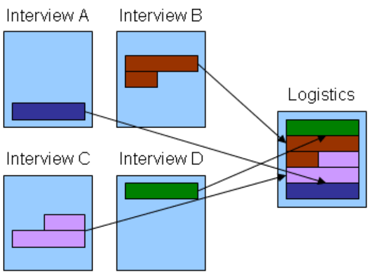


Figure 3. Coding using the grounded theory approach

[4] Strauss (1987)
[5] Holme & Solvang (1997) p. 56-58
[6] Andersen (1998) p. 197-202

2.1.3 Integrated Approach

The traditional way of presenting a master thesis report is to separate theories, empirical findings and analysis into three different chapters. However, as we have used the grounded theory approach, a sound way to present our master thesis is by using an integrated approach. In the integrated approach the sequence of thesis's chapters follows a theory-building logic follows. We believe that the integrated approach makes it easier for the reader to follow our thoughts and analysis.

The parts of the report that are made out of our analysis can always be recognized by absence of references and frequently words such as "Our analyze show" or "We believe".

2.1.4 Theoretical Contribution

Our theoretical contribution is a best-practice model for foreign invested SME in China called the STAR model. The model enlightens and utilizes the challenges faced by SMEs doing business in China. It gives a comprehensive picture of the present investment climate as well as giving a practical guide on how to go implement a china business strategy. We believe that the model could be used not only by companies with no prior experience of doing business in China, but also as a quality assurance tool for experienced foreign invested SMEs in China.

2.2 Research Work Process

Our work process can be divided into three parts; a case study, a benchmarking study of foreign invested SMEs in China, and a field study of the business environment in China. All three parts makes an equal important contribution to our aim to be able to provide a best-practice model for foreign invested SMEs in China. To test the best-practice model we have applied it on our case company. The actual process of building the model from empirical material will be discussed in chapter 3.

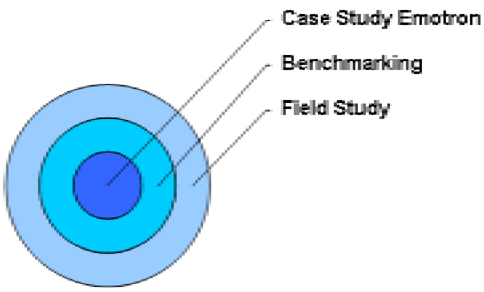


Figure 4. Components of the research

2.2.1 Case Study

The study started with a pre-study of our case company. Initially, we held numerous of qualitative interviews with employees of wide different positions and responsibilities. The purpose of these interviews was to get a fundamental insight of the case company's markets, products and strategies. The interviews were deliberately held without any structured questionnaire forms which made the interviews informal and open. This way the interviewees' answers were not influenced by the interviewer.

Shortly after, we made follow-up specific interviews with key personal at the case company regarding the Chinese market and the current strategies. These interviews were more formal and had a stricter guideline. In China we made similar interviews with key personal at the representative office in Shanghai. We have also visited the case company's distributors to get a comprehensive picture of the Supply Chain from Sweden to the end-customer in China.

2.2.2 Benchmarking

To be able to provide a best-practice model for foreign invested SMEs in China we have used benchmarking as a method to systematically compare with and learn from other companies. We believe that these studies strengthen the validity of the results and added value to the final result.

Our benchmarking method has been carried out by using a 5-step model.

1. Identification of what to be compared
In our search for a best-practice method we identified some key success factor to be compared by. These factors were based upon the time-frame of setting up the business and the costs and benefits of the business.

2. Identification of suitable companies to benchmark
The companies we chosen to benchmark have recently invested in China or are in the process of investing in China. They are also categorized as SME by our definition, have manufacturing site, and have a linkage with Scandinavian countries.

3. Method for collecting data
Our method of collecting data is based upon qualitative interviews with management of China investments or plant management of production sites.

4. Analysis of advantages and disadvantages
Shortly after the visits at the company, the information collected from the interview was analyzed from a critical point of view. Advantages and disadvantages with the companies China investment strategy were discussed and compared to other objects in our benchmark study.

5. Ideas and suggestions to use for the case company
Finally, suggestions were collected and used to further improve our recommendations of future strategies for our case company.

2.2.3 Field Study

To be able to understand the complex and seemingly irrational business environment in China we made qualitative interviews with key intuitions and companies operating in China. Such companies and institutions were banks, law firms, logistics suppliers, custom officials, industrial park officials, trade consuls et cetera. All these actors had one important, but some what subjective piece of the big picture. As the hermeneutic approach sates, we interpret the information and provided a comprehensive picture. The aim of the field study was to obtain additional information of the challenges that foreign invested SMEs faces in China.

2.2.4 Documentation of Interviews

The study is mainly based upon interviews which makes the preserving of empirical findings through documentation vital. All interviews were recorded as it provides a way to preserve the interviews without interpretation. Furthermore, we made separately notes which we after the interview merged into a single document.

2.2.5 Secondary Data Collection

Our search for secondary data started in Sweden by using the ELIN and LOVISA network. Most previous research has been done on multi-national companies (MNC) entering the Chinese market. As previously stated in the introduction chapter, we have not found any comprehensive best-practice method for foreign invested SMEs doing business in China.

2.3 Quality of Research

2.3.1 Validity, Reliability and Objectivity

The concept of reliability show if the result of the study is in somehow connected with the researcher. In quantitative studies the concept is used to measure the ability to replicate the study. However, in qualitative studies the concept is of modest importance due to few statistic data. More attention should be drawn to validity and objectivity to assure high quality of the research. [7]

To assure high validity and objectivity in a qualitative study the need to triangulate different sources of information is vast. When being in China we found it very hard to obtain valid and objective data. When we used the triangulation technique to validate data we often obtained data which were in conflict. To mitigate this issue we did critical analysis of the empirical findings. We asked our self questions such as; *who are giving the information? How do they fit in the big picture? What are their strategies? Who are benefiting from the information?*

We found three China-specific reasons that made it hard to obtain valid and objective data;

Server lack of information transparency in China
Information from the government can not be fully trusted, as they have a tendency to only publish positive news and figures. Also, bureaucratic behavior, generally by the government or local authority, is still a great issue which makes it hard and time consuming to access material.

[7] Holme & Solvang (1997) p. 94-95

The golden shield / the great firewall of China
In 2000 the National People's Congress of the People's Republic of China passed an Internet censorship law in mainland China. By filtering websites and search engines the project aims to censor information for Chinese citizens. Chinese people trying to access information related to Taiwanese and Tibetan independence, the Dalai Lama, Tiananmen Square, opposition political parties, and anti-Communist movements will find themselves out of luck. The implications for our research have been less due to the humble nature of our study. However, some significant sources of references such as Wikipedia - the free encyclopedia and English spoken newspapers, have been blocked or partly censored by the central government.

Languages issues
Finally, still very few Chinese articles, information brochures, and government policies are printed in English. If they have been translated, they are often already obsolete in favor of a new Chinese version.

To mitigate the risk of obtaining obsolete or incorrect data we have tried to triangulate and cross-reference all material. On account of this work, which has been very time consuming, we believe our report has acquired high validity and objectivity.

2.3.2 Methodology Reflections

In the collection of primary data, there are a few biases that are needed to be taken into consideration. The interviews conducted in Sweden and with foreign representatives in China were structured informally and where therefore not influencing the interviewees’ answers. However, some interviews were conducted with Chinese employees. These interviews were more structured and direct due to the difference in languages and cultures. Furthermore, due to the fact that none of us speak Mandarin, we were forced to use translators in some interviews with Chinese employees. However, by providing easy and short questions, we were mitigating the risk of being misunderstood or mistranslated.

China’s business environment is highly unpredictable and changes quickly. This study is done between February 2006 and May 2006. Readers should be aware that facts and government regulations may quickly change.

3 Introduction to the STAR Model

In this chapter we present our best-practice model for SMEs doing business in China. We address the dominant perspectives, how it was constructed and how it should be used.

3.1 Building the Model

The greatest difference between SMEs and MNCs lies in their access to resources. SMEs often lack the sufficient knowledge, competence, and financial recourses which forces them in to situations where they are badly equipped for the challenges and at the same time not being able to afford mistakes. Lack of a developed legal system creates challenges like financial issues, patent rights, and pay payment fulfillments. In all of this the transformation of the Chinese economic system provides rapidly changing regulations with low transparency for foreign enterprises. Our empirical findings are based upon the challenges and the opportunities faced by foreign invest SMEs doing business in China.

By using the methodically approach of Glaser and Strauss's we classified our empirical findings into categories of information. We found 5 significant categories of information, which frequently appeared in the empirical findings. In 5 out of 24 interviews, all 5 of these categories were present, and in 12 out of 24 interviews at least 4 of these categories were present. Thus, many foreign invested SMEs stated both challenges and opportunities in many of the presented categories. The 5 categories are as follows;

- Human Resources & Culture
- Sales & Marketing
- Development Zones
- Logistics
- Investment context

As shown by Figure 5 the amount of information in the empirical findings between the 5 categories are around 20 % each, which states the existence of 5 representative categories. However, 9 % of the information could not be categorized into any of these 5 categories. That information was found to be mainly too company specific and would not, according to our opinion, benefit our best-practice model. However, it is also included some classified information that we could not use in our study.

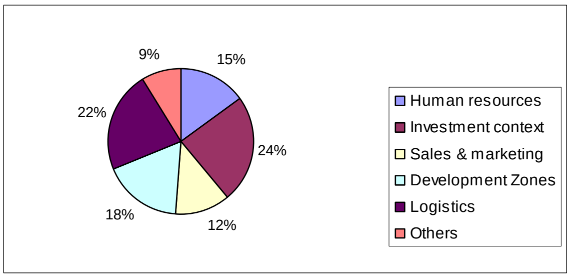


Figure 5. Categories percentage of total empirical findings

Sales & marketing represent a smaller percentage than the other categories. We believe there are two reasons for this. Due to the fact that mainly production businesses were interviewed only four interviews were conducted where the category was present, as shown by Figure 6. Second, Chinese sales strategies are often local and very specific due to product and company specific strategies.

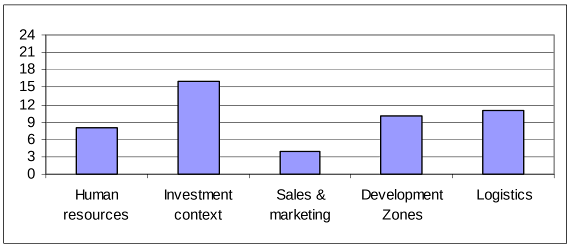


Figure 6. Number of interviews per category

3.2 A Best-practice Model for Foreign Invested SMEs

The STAR model is based upon the five categories we found when analyzing empirical material. Thus, the comprehensive model has five important perspectives. A foreign invested SME needs to consider all these perspectives to be successful. However, some perspective needs more attention than other, depending of the nature of the business conducted by the SME. Naturally, production businesses producing solely for the home market do not need to consider the sales & marketing perspective.

Figure 7. The STAR model for foreign invested SMEs

Challenges in HR & Culture

When analyzing the category of HR & Culture we found some interesting and tough challenges for SMEs. First of all, the ability to find qualified personal and to be able to keep them in the company seemed like a vast challenge for SMEs. Secondly, the culture differences between west and china seemed sometimes immense. Many SME lacked a distinctive HR strategy that took Chinese culture in to consider. Also, SMEs seem to be fairly unprepared for the day-to-day issues appearing when working with Chinese partners and employees.

Challenges in Sales & Marketing

Sales & Marketing are quite different from western markets. SMEs indicate incredibly tough competition from both domestic and foreign actors. Therefore it is a vast challenge for SME is to know which market(s) to target and how to establish and maintain the necessary relations. In addition, many SMEs consider the lack of payment fulfillments from Chinese customers one of their biggest challenges.

Challenges in Logistics

Many SMEs exporting to China report high landed cost in China. As a result their products are not competitive, in terms of pricing, compared to domestic producers or other foreign invested enterprises in China. One big challenge is to locate the drivers of cost when shipping products from / to China. Another challenge is to find the best import and export strategies and to use the most cost effective means to transport products domestically. Other SMEs experience problems with Chinese customs.

Challenges in Development Zones

To be able to benefit from Chinese production many SMEs would like to know how and where to establish a production facility. The first challenges are to recognize the actual needs of the company and to plan a production type that fits the needs. SMEs also report challenges in locating preferable areas and comparing different development zones in those areas.

Challenges in Investment

Many SMEs showed a lack of knowledge about the present legislation and taxations system in China. The investment context is highly flexible and could, if ignored, jeopardize the entire investment of the SME. Challenges exist in issues such as financing and foreign exchange. Also, most SMEs which are going to do business in China need help with choosing business setup and business entity for their foreign invested SME.

4 Human Resources and Culture

In this chapter we address human resources and culture challenges faced by foreign invested SMEs in China. Issues such as employment turnover, raising wages, incentive structures and culture differences are discussed and analyzed from a SME perspective. Also some strategies are discussed to mitigate the risk of being victim to crimes, such as white collar crimes.

4.1 Human resources

4.1.1 Challenges

The majority of the first wave foreign companies established business in China around 1995. At that time foreign companies hired practical any Chinese who could speak English. Hence, mostly graduates with no prior working experience. After a couple of years these persons became middle managers and today they are top managers, e.g. production and sales managers. Consequently, 30-35 years old individuals with around 5 years management experience are having the same positions that would require 15-20 years management experience in Europe. Thus, many Chinese managers are not mature enough to handle that kind of responsibility and therefore under qualified for there positions.[8]

Since there is a huge shortage of experienced personal, under qualified managers will still get top positions with continuously rising salaries. Foreign invested SMEs should expect wages to rise significantly; many positions may double in 4 years. The incentives for managers to change employers are thus very high, as their salaries may raise significant (20%-40%) for every new company they join. This behavior is true for all employees in China, whether blue or white collar. Naturally the consequence is high employment turnover. Recruiting needs to be very fast as good talents are hard to find, experienced managers are frequently headhunted by recruiting firms.[9]

4.1.2 Employment Turnover

As previously discussed, the significant rises in wages are one explanation to the high employment turnover. Thus, the most important incentive for keeping personal is monetary incentives. It is very important to have a monetary incentive structure at all levels in the company. Even blue collar employees need individual incentives to stay. The bonuses should be at least equal to two monthly salaries per year.

One foreign invested SME reports a seasonal shoe factory, which at the beginning of each season loose 50 % of its blue collar employees. Employees just do not show up. One effective way to prevent this is to accumulate employees' bonuses until they worked two or three years at the company, and then release it. However, this solution might be gone due to new employment legislation in the future.

[8] HR Consultant, Communication Consulting
[9] Ibid

Other type of monetary incentives for managers are benefits such as housing, car, and educational. However, recruiting firms do record an increasing interest over other types of incentives such as the ability to develop and good working conditions. Also, as discussed previously, a distinctive company culture and internal company training also mitigates high employment turnover.

4.1.3 Wages

First of all it is important to differ, in terms of cost for the company, expatriates and Chinese employees. Hiring expatriate managers are very expensive compared to Chinese managers. Expatriates do not only have higher salaries but brings also other expenses, such as housing, schools et cetera. However, most companies prefer to have foreign employees for management purpose, in particular in the beginning of an investment. Approximately 10 % western employees in the work force would secure and embed the company visions, goals, and culture in the FIE.[10]

The social standards and the living cost in China differs vast depending on which province to be examined. As a result the spread of wages are immense. A general rule is that wages will continuously decrease the further west you go in the country. Also, difference exists depending on diverse “economies”. For example, SOE are not enough flexible to respond to local supply and demand of the work force. A finance manager in a SOE may have a salary of 4 000 Renimibi (RMB) / month while the same position in a foreign invested enterprise may receive 25 000 RMB / month.

Table 3 presents updated (2006 February) average wage statistics from Shanghai. Blue collar labors in development zones outside Shanghai differ from 1000-2000 RMB / month, depending on the distance to Shanghai and naturally local supply and demand of the work force.

	Experience	Qualifications	Salary / month
Assistant Engineer	**0-2 years**	**Associate Degree**	**1700- 3500**
Receptionist / Clerk	**0-2 years**	**Bachelor Degree**	**2200-3500**
Sales Representative	**1-2 years**	**Associate Degree**	**3400-6800**
Import / Export Op.	**2-3 years**	**Bachelor Degree**	**3500-5000**
HR Recruiter	**3+ years**	**Bachelor Degree HR**	**5100-9500**
Marketing Manager	**5+ years**	**Bachelor Degree**	**6500-17000**
Accountant	**5-6 years**	**Bachelor Degree**	**7600-14000**
Purchasing Manager	**6+ years**	**Technical Degree / MBA**	**10500-12000**
Logistics Manager	**7+ years**	**Bachelor Degree / MBA**	**10000-21000**
HR Manager	**6 years**	**Bachelor Degree HR**	**12000-17000**
Finance Manager	**8+ years**	**Bachelor Degree / MBA**	**12000-27000**
Operation Manager	**10+ years**	**Bachelor Degree / MBA**	**29000-36000**

[10] Supply Manager, ABB Robotics Waigaoqiao

General Manager	**15+ years**	**Bachelor Degree / MBA**	**49000-85000**

Table 3. Salary statistics (Source: Spot Check Paper of Shanghai Salaries 2006, Sunshine Consulting)

4.2 Culture

4.2.1 Confucianism

Confucianism was created by Confucius (K'ung Fu-Tzu) around 600 B.C. during the Chou Dynasty, and have since then been the root of Chinese culture for more than 2500 years. Though not a religion, it has significantly been affected by Buddhism and Taoism. The concept was based upon the love of harmony and humanity, as a moral goal in life. As the Confucian ideal firmly rooted in the value of the family, values such as virtue and sincerity developed. A virtuous person is characterized by righteousness, humanity, propriety, and wisdom. The definition of a sincere person is absolutely truthful in all mater, and never pretending to be something that he was not.[11]

Confucianism is both hierarchical and classless, thus a seeming paradox occurred. It was hierarchical because the love of humanity required harmony and that one had to accept one's role in society. Hence, the loyalty to leaders is very strong. It was classless as reward in term of educational and professional opportunities was to be based on merit, not heritage. One important concept of Confucianism was the so-called Five Cardinal Relations. The relations consisted of the affection between parent and child, righteousness between ruler and subordinate, responsibility between husband and wife, order and respect between elder and younger, and faithfulness among friends.[12]

During the Republican Era (1911-1948) Confucianism flourished, but were faced by several attempts to be fully replaced by the communist doctrine during the Communist Consolidation Era (1949-1965). But, Confucianism was not completely destroyed at the ten year Cultural Revolution. Instead, after the revolution an ideology vacuum was created, which was in time once again filled by Confucianism. By eventually supporting Confucianism the Chinese government gained the favor of the Chinese public, many of whom preferred traditional Chinese culture to communism.[13] [14]

Confucianism is still after 2500 years very rooted into the minds of Chinese people. But the forward movement toward the universal love and harmony proposed by Confucius could be by questionable. Hierarchical structure in the society have created social inequality and the strong focus on family core values have exclude non-family

[11] Wong et. al. (1998)
[12] Ibid
[13] Ibid
[14] Ralston et. al. (1999)

such as foreign investor to do business in China. The need of guanxi for doing business is still vast in China.[15]

4.2.2 Guanxi

The concept of *Guanxi* is the art of building relationship with a network of people through which influence and resources is brokered. In business, *Guanxi* may be described as mutual obligations and trust, and is thus alternative to contracts and legal rights. One foundation is Confucianism which, as chapter 4.2.1 describes, highlights harmony, hierarchy, and moral. *Guanxi* have made several business prosper by the ability to be flexible and adapt through quick reaction within networks based on trust and promise of reciprocity. [16]

Guanxi is the building of a relationship, which may start with two individuals who wants to do business. The goal is to become an "insider", which can be achieved by using concepts such as *mianzi* (face) and *renquing* (exchange of favors). *Mianzi* is an individual's public image, gained by performing one or more specific social roles that are well recognized by others. *Mianzi* could as easily be gained as well as lost. The status of an "insider" implies a state of harmony, when both parties respect and honor each other. In business, *Guanxi* means that the partners honor their words and no formal contracts are needed for future business. The process of transforming a business partner into an "insider" are more rapid if the two parties are introduced to each other by an individual who they mutual regard an "insider". [17]

To be able to form a partnership, such as a joint-venture with a Chinese company, the need of excellent *Guanxi* is vast. It is utterly important that the two partners consider each other as "insider", and thus know the other party's intention and goals with the partnership. If the foreign partner neglects *Guanxi* there is a vast risk of being lured in to business or be victim of a crime.

Guanxi is often said to be a possible source of sustained competitive advantage for foreign enterprises doing business in China. However, there is little theoretical basis for this view. In the contrary, *Guanxi* may become worthless or even turn into a liability once the partner loses power. For example, the former party secretary of Beijing City, Chen Xitong, was convicted of corruption charges in 1995. As a consequence, any individual or company that had outstanding *Guanxi* with Chen lost their investments. Thus, when creating and maintain Guanxi, foreign investor needs to be careful.[18]

4.2.3 Globalization's Effects on Chinese Culture

As globalization continues, several Chinese scholars have directed their critique of globalization's impact on China's culture. Historically, nationalism has been very strong in China. But deepen economic reforms and more extensive cultural market

[15] Wong et. al. (1998)
[16] Buttery & Wong (1999)
[17] Ibid
[18] Tsang (1998)

makes new generations more interested of absorbing and manifesting the lifestyle characteristic of Western capitalist nations. Some researchers even say Chinese citizens already show traits of more commitment to capital market economy ethos than people in Europe.[19]

The consequences have been dramatic. Especially Chinese youth have turned from idealism to pragmatism and from collective ethos to individualism. Increasing supports of individualism have created materialism prevalent amongst Chinese people, which constitute a challenge to socialist idealism. Another challenge for the Chinese government is a change in people's orientation from politics to economics. Consequently, the Central Government faces a dilemma: globalization is required to maintain GDP growth rate, but are also driving unwanted Culture change. [20]

The impact can be showed by the new type of Chinese managers available for foreign invested SMEs. Many of these managers have experience of western beliefs by working abroad. Research show that Chinese managers now acts more independently and take higher risks in the pursuit of profits, even when these actions are in conflict with traditional ways. Higher level of individualism and opportunism are reported and the biggest incentive for doing business is personal wealth. These new behaviors appear to decrease the influence of Confucianism values. The new managers are also more flexible which may support higher employment turnover.[21]

4.2.4 Culture Challenges

Despite globalization's influence, there are still many culture differences in China, compared to Western societies. In general, Chinese employees take their work more serious than western employees. One reason is that work express status at much higher extent than in Europe. Swede's beliefs demonstrate a complete contradiction, as high status is showed by spare time, flexibility at work, and the ability to travel. These concepts do not yet fully exist in China. Chinese employees are also proved to be more hard working and ambitious about their work. However, in general they are less loyal to their company compared to European employees.[22]

Additional, Chinese management style differs vast compared to European leaders. In China, managers are micro-manage all decisions at a higher extent.[23] As a heritage from Confucianism, the hierarchical structure of Chinese companies is strict and Chinese employees are used to get firm orders. They are mostly more loyal to their leaders than to their company. Moreover, Chinese employees may lack creativity and practical ability, as these skills are not promoted in Chinese schools and universities. Thus, foreign invested SMEs need to consider sending foreign managers used to micro-manage decisions rather than having a decentralized approach to management.

[19] Knight (2006)
[20] Ibid
[21] Ralston et. al. (1999)
[22] General Manger, Fagerhult China
[23] Ibid

Also the ability to follow up decisions is a key factor of succeed for mangers in China.[24]
Several foreign invested SMEs experience a perceived lack of rational thinking from Chinese employees. This western rational thinking strives from continuously development and creativity. The western world has been taking many small steps to develop the products and technology we have today. The last century's development in Europe takes place now in China in 10 years. Thus, many development steps are leapfrogged. Chinese mobile phone users who do not know there is a device called a telephone, exemplifies the speed of the development. Another reason why Chinese employees may lack rational and critical thinking is the suppression from the Chinese government, which limits freedom of speech and strain objective thinking.

Another issues foreign invested SME need to focus on is training of Chinese staff. Training takes a longer time but is definite worth investing in. Specific company training will benefit the company culture and lower the employment turnover. The foreign invested SMEs culture should be dominated by its parent's culture but also be influenced by Chinese culture. It is very important to work active against the feeling of "us" versus "them", when thinking about the parent and the FIE.

The concept of quality is not yet as developed in China, as in western countries. Thus, foreign investor should never assume that western standards apply on quality. For example, a general Chinese supplier does not have a minimum limit for quality. The supplier may lower the price of their products as long as it takes to finally get the order, without consider the quality of the product. As a result, all specifications must be stated in detail, even specifications considered standard by the western world.[25]

Despite thousands of state-owned enterprises (SOE) have been privatized in the recent 10 years, foreign invested SMEs will be confronted with customers and suppliers that are still state-owned. When doing business with SOEs some special attention is needed. Political agendas and business issue are naturally strongly linked in SOEs. It is important that the SME show its intention to follow the political agenda of the SOE. Moreover, the lack of transparency in SOE's power structure is severe. The power structure is complex and often based upon a concern of companies with cross ownership. Thus, it is very hard to actually get in contact with top management, especially for SMEs. Compared to private enterprises in China, SOEs are expected to have a strong hierarchically organizational structure and lack customer focus. [26]

4.2.5 Guanxi with Local Government

It may be important to establish Guanxi with the local government. If a good relationship exists officials may be very cooperative and give superior incentives when setting up a FIE in a development zone. To create *Guanxi* with local government SMEs should have two or three individuals focusing on relationship with three officials. Having only one or two contact person(s), may risk loosing the *Guanxi*

[24] Production Manager, Besam China
[25] Supply Manager, ABB Robotics Waigaoqiao
[26] Ibid

if the officials quits or change employers. Two or three relationships mitigate that risk, but having too many relationships might be too expensive and time consuming to maintain for a SME.

The relationship should be based upon informal and social meetings. But there are some formal objectives to keep in mind. First of all the SME should emphasize its long term commitment in its business. It is important to show that the parent is willing to invest in the business and to be part in the society. For example, the SME may show this by sponsoring a school in the society or install an advanced environmental protection in their production facility. The SME should also stress the importance of having a good personal policy. Finally, it is naturally very important to follow the rules and laws, have all documents in place, and pay taxes in time.[27]

However it is not always necessary for SMEs to establish Guanxi with local government. The process of establish really good Guanxi may be long, time consuming, and expensive. In addition, in some industrial parks it is fairly easy to setup a business, and thus minimal contact with local authorities is required. Many SMEs consider the lesser time spent with local officials, the better.[28]

[27] General Manager, Fagerhult China
[28] Production Manager, Besam China

4.2.6 CASE - Lighting China

Fagerhult is Swedish company producing light fittings and luminaries. Today, the Group is in a leading position in Sweden and the export market is developing positively.

In 2005, the company set up a production enterprise in Suzhou. The primary goal of the investment was to lower production cost. Starting sales in China was just a bonus. By renting a facility in a development zone they were operational in just 3 months. When setting up the production facility, Fagerhult used the same production layout as the factories in Sweden. The layout was based upon flexible benches for one person to assembly an entire product. However, when Chinese employees started to work, they instantly formed a traditional production line with three persons at each “flexible” bench, performing only one activity each. The heritage from Culture makes Chinese blue collar employees prefer old style production lines to flexible and modern production.

Chinese conditions may have other implications on production layout and investment costs. Because of the low cost of manpower, many activates that normally are conducted by machines may be conducted by cheaper manpower. Fagerhult noticed it is more cost effective to have employees physically carry parts from one machine to the other, instead of investing in conveyor belts. Thus, investment size in terms of equipment is seemed to decrease compared to similar facilities in Europe.

The general manger of Fagerhult China, Mats Johansson, has become aware of some culture differences. In general, Chinese people take work more serious and work definitely creates status, he says. As a consequence, Chinese employees have higher ambition and motivation in work. However, I need to micro-manage my employees on a much higher degree than I’m used to, he says. As he continues, he states that too much research focuses on the differences; there are a lot of similarities too.

Soon after the setup of the facility, Fagerhult noticed the issue of high employment turnover. To mitigate the risk of losing experienced personal they setup incentives structure mainly based upon individual monetary bonuses. These incentives applied for every employee, whether blue or white collar. Fagerhult believes that the relatively small cost to give all employees incentives are well invested money, since they can keep experienced personal and decrease the cost of training new personal. Chinese culture is often blamed for the opportunism of Chinese employees, but one has to consider the employees position. If their salary is 1000 RMB / month and they are offered 1200 RMB by another employer, the raise is 20 %. Consider an average salary in Europe of 3000 Euro. A 20 % raise will give you 600 Euros more a month – an amount not easy to neglect. Thus the high employment turnover can not solely be explained by Chinese individualism and opportunism.

Source: General Manager, Fagerhult China

4.3 Risk of Crimes

Ever since the boarders of China opened in 1979, foreign companies have entered through the Chinese borders, bringing western standards and beliefs. The integration has been far from smooth and there are several issues still present. White-collar crime still is and will be a common issue that needs to be resolved. Chinese managers may be blinded by great opportunities. However, also cultural blindness, linguistic blindness, and lack of local presence creates the soil in which crimes like counterfeit, fraud, theft, and corruption grows.[29]

Crimes are usually a consequence of either acting to fast when establishing business in China or enter partnerships with Chinese companies, which have bad intentions.[30] Ready, fire, aim, is a common way of doing business in the rapid growing Chinese market.

4.3.1 Counterfeit – a Heritage from Culture?

In general Chinese people are excellent entrepreneurs; they love to do business and are frequently profitable. However, when combining this trait with too much opportunism and large personal wealth incentives, Chinese people may be lured into illegal business. As China still is a development country many business are built upon imitating more developed countries' businesses and making them more cost efficient. This behavior is natural for any developing country, including China. However, when Chinese companies use patents, trademarks, or complete productions process from western companies, the businesses becomes illegal.

Today western companies are complaining on the vast amount of counterfeited products flooded from Chinese production businesses. A famous statement illustrates the problem:

"If your product is profitable in China, it is already copied"

In the mind of most Chinese people, counterfeit a brand, product or a complete business model is not a serious crime, it is just a good way to do profitable business. There are adequate laws which control patents and brands in China. The difficulty lies on a local level. As the ties between political and economics still are very close, local authorities may take a dislike to shut down production businesses, which are illegal. These Chinese businesses may contribute largely to its province in terms of tax revenue and employment opportunities. Hence, local courts and authorities commonly act in a protectionism manner, favoring the local business.

The pressure from the international community is great, as counterfeit products are flooded into the rest of the world. As a consequence, the central government have

[29] Humphrey (2006)
[30] Branch Manager, SEB Shanghai Branch

been taking serious action against production business as well as closing down famous “fake markets”. However, the illegal business still grows in absolute terms.[31]

A Swedish company operating in Shanghai demonstrates a good example. They recently discovered that their Chinese manager was corrupt. After further investigation they found that all personnel in that office also were in collusion with the manager. Together they had started a shadow-company, coping products, production process, and the complete business model. The Swedish top management was forced to take actions which resulted in that the entire unit was fired and new personnel had to be recruited.[32]

4.3.2 Strategies to Mitigate Risks

Foreign invested SME have different strategies to approach the problem of having its products counterfeited. Some choose to register patents and trademarks in China. This way the foreign investor assures its legal rights of the production in China. Also it gives the opportunity to be able to use the power of the legislation in the future, when the outcome should be more beneficial. On the other hand, many foreign investors do not care to register its patents and trademarks, because they believe it does not matter. They simply admit coping as a fact, and try to live with that. A good strategy is to assure to be in the frontier of product development, thus always be in front of competitors with continuously new products. Other strategies include building smart solutions that are hard and expensive to copy and remain core competencies at the parent company. We recommend a mixture of these strategies depending on the attributes of the company’s products.

In absence of own local knowledge western companies may be forced to use the *Guanxi* of their Chinese managers to do business in China. This puts western companies in dangerous positions especially in the startup phase of the investment. [33] By using best practice, FIEs may learn to identify, manage and mitigate the risks.[34]

Reference checks is one of the most effective tools in an environment where trust is scarce. Reference checks should be made on recruitment of employees and managers, on customers, and suppliers. Also, employee screening is necessary when recruiting new personnel. References alone isn’t good enough, employers need to know who the person really is, the reasons he/she left the last position and if the background history is accurate. Moreover, hiring restrictions should prevent managers to hire and conduct business with relatives. Collusions with friends and relatives are the most common recurring factors of fraud in China.[35]

[31] Humphery (2006)
[32] Branch Manager, SEB Shanghai Branch
[33] Supply Manager, ABB Robotic
[34] Humphery (2006)
[35] Humphery (2006)

The FIE should also use Code of Ethics (COE) to communicates the intentions of the parent company to the employees, suppliers, distributors, and JV partners. At the same time it forces the involved parties to commit to the regulations with their signature on a contract. Even though prosecutions in China are far from effective as they are in western countries they still have a deterrent effect.[36]

4.4 Conclusions

4.4.1 HR Strategies

We believe a high-quality Chinese Human Resources strategy are based upon; the company culture, the HR environment & Risks, and the Chinese culture. In previous chapters we have discussed these areas thoroughly. This chapter will summarize the most important findings and analysis with a model showed by Figure 8.

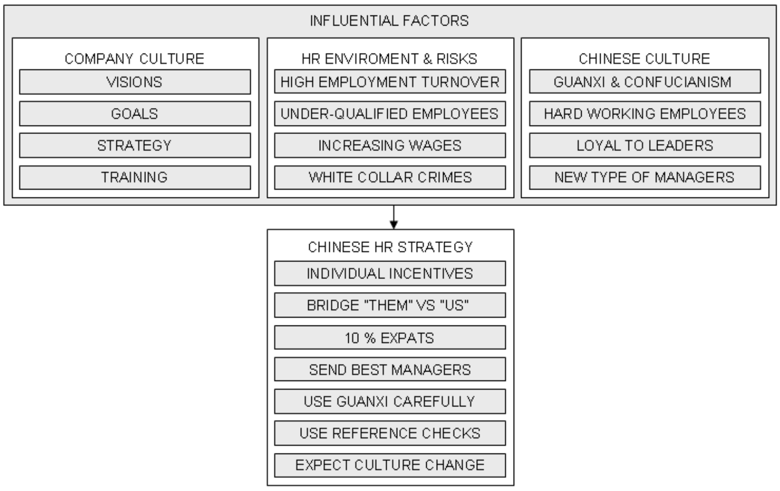


Figure 8. Building a Chinese HR Strategy

Most foreign invested SMEs in China report difficulties of finding qualified employees and retain them in the company. By highly reward trustworthy and experienced Chinese employees SMEs will mitigate this issue. SMEs may calculate the cost of incentive programs and relate them to recruiting and training costs. In almost all cases the SME will find it is better to have an individual incentive program at all levels of the company to mitigate employment turnover. Other reasons to have individual incentives programs are that Chinese people are used to it and like to be measured and rewarded individually.

To further decrease employment turnover SMEs may want to use a lockup strategy by releasing bonuses after a period of maximum three years employment. This strategy may also be good when sending Chinese employees on courses, training, MBAs et cetera. However, legislation will most likely soon change to the benefit of employees, which may obsolete this strategy.

[36] Humphery (2006)

Investing large in company training and having a strong company culture are also important ingredients of a first-class HR strategy in China. The aim should be to communicate the parent's core visions, goals, and strategies, and thus make the SME's strategy coherent worldwide. Despite the higher cost, we recommend having around 10 % expatriates in the FE to further strengthen the company worldwide strategies, at least in the startup phase. Send HQ's best people, but consider especially managers who are social, comfortable of micro-managing, and following up decisions.

The company culture must be adapted to Chinese culture. Culture differences exist and it is very important to give up the "us" versus "them" philosophy. However, expatriates in China should expect seemingly "irrational" behavior and time consuming day-to-day issues. The Chinese culture will change in time as globalization shift their beliefs into more western style.

SMEs must be aware of the power of relationships in China. We recommend maintaining *Guanxi* carefully and hedge risks by having more than one key relationship. Also, expect more complicated relationships when dealing with local government and SOEs. Use *Guanxi* where needed but do not make up a business case solely on relationships in China as *Guanxi* is very flexible.

The server problem of counterfeit are derived from a combination of vast market opportunities, personal wealth incentives, and traits from Chinese and western culture. To mitigate the risk of being victim to counterfeit and other crimes we recommend applying for IP protection. In the future it will probably be a very effective means of fighting the war against counterfeit. We also not recommend SMEs to move their core competence in production business to China yet as it may still be tough to protect. Depending on what products are produced, these strategies may differ vast. However, it is always important to do reference check on all partners and employees to mitigate any risks.

5 Marketing and Sales

This chapter aims to provide SMEs with the appropriate marketing and sales recommendations for handling an ever increasing market. Another vast challenge for SMEs discussed in this chapter is accounts receivable and payment fulfillments.

During the last couple of years China has become the world's sixth largest economy in terms of purchasing power, the third largest trade nation and the number one nation as a recipient of foreign direct investments (FDI). The development of China has been rapid and sets pattern in its statistics. Chinas GDP has grown at a remarkable rate and its markets along with it (See Figure 9).

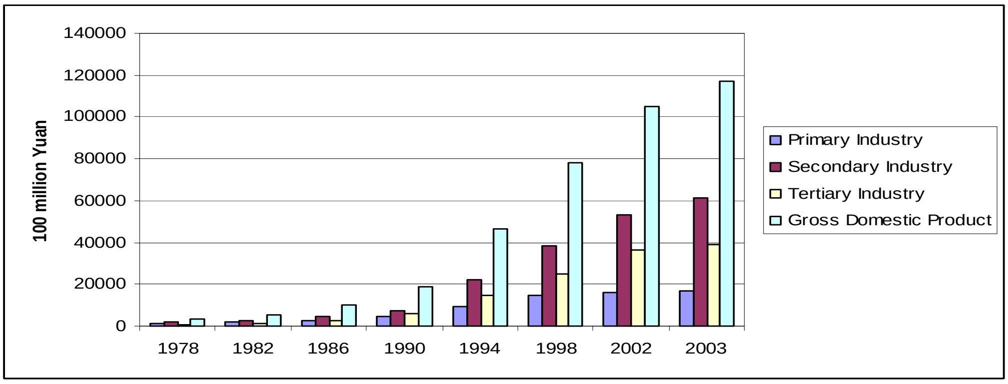


Figure 9. Gross industry type products and GDP (Source: China Statistical Yearbook 2004)

As shown in Figure 10 household consumption of urban and rural conditions are compared. Rapid development of the national highway system makes rural provinces logistically available for inter-provincial distribution chains thereby increasing market volumes further. As a consequence, business is further stimulated.

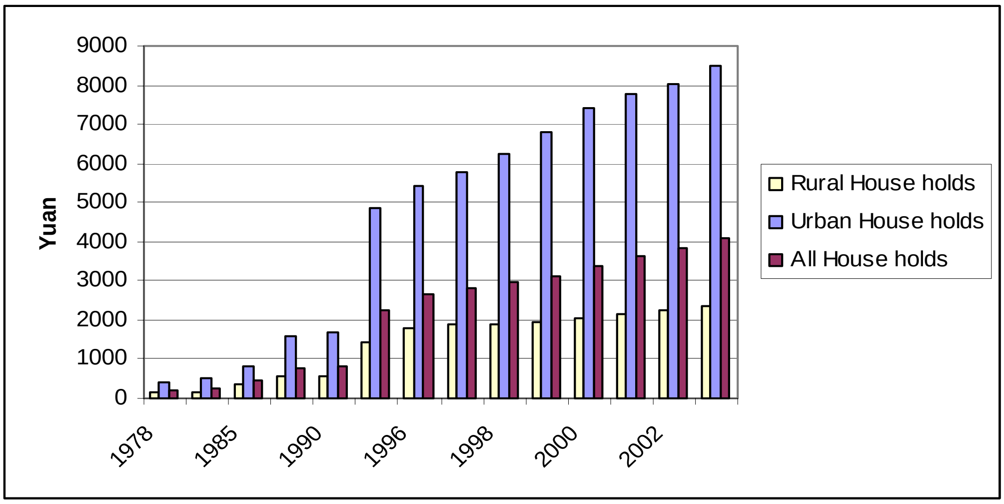


Figure 10. Average house hold consumption in China (Source: China Statistical Yearbook 2004)

5.1 Competitive Environment

Despite the appealing market sizes, competition is going to be tough for foreign SMEs entering the Chinese market. Most industries are highly fragmented without major players even though mergers and acquisitions are becoming increasingly common.[37] China is full of opportunistic entrepreneurs trying to find profitable solutions in every niche. To be successful it is therefore important to be competitive on a local level. SMEs are the backbone of the Chinese economy and accounts for 60 % of the total industrial output and employ about 75 % of the work force. Most of the SMEs are privatized companies and have great local market knowledge thereby superior initial advantages compared to foreign invested SMEs.[38] Many Chinese SMEs are also starting to learn and practice marketing actively and are thus increasingly becoming more market- and customer driven. For western companies it is therefore of importance to work closely with locals to get to know local costumers and markets.[39]

5.2 Creating a Sense for Quality

Due to the fierce competition, prices are low, extremely low. But as China is steadily emerging as a developed country, other factors than price becomes important. For instance, several high end consumer companies are establishing stores in China's major cities. Their focus is on the increasing middle class which today holds strong purchasing power. Despite competitions from low cost counterfeit-markets many of these companies still find their niches to be profitable. High end companies have the potential to be a part of defining the word "luxury" thereby also defending more expensive price tags in the future.[40] The industry market is not as trend sensitive but the development is also slowly moving to become more quality minded. A foreign invested enterprise producing fast industry printers has successfully been able to educate its costumers of the importance to have access to a high quality service network to reduce costly production stops.[41]

5.3 Relationship Marketing

Even though the concept of relationship marketing has its roots in North America and European culture it is applicable on the Chinese market. In China, there are several reasons for having good personal relationships. However, there are some differences to consider. As earlier discussed, relationships or guanxi are almost crucial for doing business in China. Relationship marketing takes time and effort but in China it can not be used ad hoc. Instead, guanxi should more be seen as an investment that might pay off in the future. In comparison to the western way of building transactions before relationships, the Chinese norm is to fist build long-term relationships, and if

[37] Woetzel (2003)
[38] www.usembassy-china.org.cn, 2006-03-18
[39] Liu & Siu (2005)
[40] Woetzel (2003)
[41] General manager, Domino China

successful, transactions will follow. Working with relationship in China should therefore be considered as building a bridge before crossing a river. Four dimensions are important when building a holistic relationship in China; bonding, empathy, trust, and Reciprocity. As can be seen in Table 4 each dimension is seen differently by Chinese and westerns and can easily lead to cultural misunderstandings when doing business.[42]

	Westerners	Chinese
Bonding	**- Between consumer and supplier - For desired goal**	**- Blood basis and social basis - For social control and business behavior**
Reciprocity	**- Expect value to be returned in short-term - With specific intention - Converged value**	**- Value returned at time both giver and recipients will benefit - No specific intention - Increased value**
Trust	**- People with promised integrity - Build transaction first, relationship will follow - Based more on the system**	**- Kinship or in-group members - Build trust first, transaction may follow - Based more on personal contacts**
Empathy	**- Sender-centered communication**	**- Receiver-centered communication**

Table 4. The four dimensions of Relationship Marketing in West versus China (Source: Liu&Siu (2005))

The four dimensions are all important for the product mix and can be used to get specific advantages compared to competitors. Product reputation for instance, which is an important factor of success for every market, can be gained in rather different ways depending on culture. In the western world product reputation can be reached by having a history of high quality, in China it can be done in seconds by having the right persons or government officials endorsing it.[43]

Relationship needs constant stimulation to maintain or grow. In China there are several ways to improve guanxi. Social meetings are important for build trust. By attending to dinners and giving social support, personal recognition relationships can be enhanced and lead to future sales opportunities. A more private approach is to have informal discussions in which businessmen may let people in confidence know about personal flaws and feelings thereby showing sincerity and frankness. Gifts are also a way of creating closer bond. However, it is important not to give gifts in situations when they could be considered as bribes. It is of importance to know at which occasions it is appropriate to give gifts, such as the Chinese New Year and anniversaries. Another way of reciprocity is to do non-business favors. This is

[42] Chow et al. (2000)
[43] Chow et al. (2000)

particular common within an organization when a manager is helping his staff in difficulties and in return receives their loyalty.[44]

For all companies doing business in China it is preferable to stimulate and cultivate relations with key individuals. Such relationships should be considered long term and may have great impact to a company's performance. One example is reliable sources of information. The Chinese market lacks transparency and in such an environment news is far more trustworthy and up to date if it has been passed through a reliable source than other official lines.[45]

5.4 Initiating the First Sales

As newcomers in China, many SMEs will find out that initiating sales may be their greatest challenge. Foreign companies will experience that their international recognized brand is not at all recognized in China. Without previous references or business relationships it is even more difficult to motivate why Chinese customers should invest in a new product. Furthermore is the Chinese market structure and demography highly differentiated for each province. [46]

Therefore, as a first step, market intelligence is advised to be conducted. This can be done by hiring a marketing agency or use the competence of local employees. In a survey made by Siu & Liu in 2005 it is revealed that higher performing SMEs exhibit distinct marketing behaviors. The survey also concludes that organizational pyramid structure and the encouragement of perceptive decisions in the marketing function also are related to success.

Distribution can be accomplished by either using distributors or creating an own sales force. Naturally distributors will add a margin on the products but they also have already local knowledge and personal networks that will be superior to the producing firm especially towards customers in distant provinces. However, as relations are built up and sales increase it is more common for companies to build up their own sales channels.

5.5 Payment Issues

Many foreign invested SMEs reports challenge of getting paid in time or even at all from Chinese customers and distributors. The concept of paying on time is not a cultural convention in China. However, the main reason for this server payment issue is a capital market which is not yet properly developed. In the absence of adequate long-term debt and securities that may hedge temporarily demand and supply curves, companies do not have funds to pay for its liabilities. Moreover, there are no factoring companies and it is impossible to use accounts receivable as collateral for debt. As a result cash management is hard.

[44] Chow et al. (2000)
[45] Chow et al. (2000)
[46] Chairman, Beijing Chapter, Swedish Chamber

5.5.1 Terms

It is very important for SMEs to state beneficial terms when signing sales contracts. Most favorable is naturally ex-works payment in advance. However, business practice in many industries is 50 % up front. If the customer and the supplier do not know trust each other, we recommend using letter of credits. On behalf of the buyer the Chinese bank issues a letter of credits. Usually, a foreign bank will control the validity of the letter of credits. The Chinese bank trust the Chinese customer as the foreign bank trusts the foreign investor. The Chinese bank commits to pay the seller when the terms of the letter of credit are fulfilled.

5.5.2 Accounts Receivable

In China accounts receivable are used as tool to balance companies' cash management. Basically, when companies lack cash to pay its liabilities companies choose not to pay. The problem is not that big for MNCs because the have the benefit of a known brand and often full-size bargain power on customers and suppliers, which makes them in control of sales terms. SMEs on the other hand, may have to accept bad terms with accounts receivable as a consequence, to be able to get any business at all.

Consequently, many foreign enterprises have entire departments just to collect debt claims. Some companies consider an adequate bad debt percentage as high as 5% of the total revenue.[47] Most cases are just written of as bad debt due to small chances to retrieve debt. If the case ends up in court, the foreign company will most definitely win. However, the main problem lies in debt collecting. After the conviction, it is up to the foreign company to find some one to collect the debt, which may be very hard because the debtor is commonly lost or bankrupt. If the foreign investor doesn't find the debtor they are forced to pay all juridical expenses. Consequently, foreign investors choose not to file charges against bad debtors.

5.6 Conclusions

In order for SMEs to create an efficient marketing and sales strategy for the Chinese market we believe there are four main components (Figure 11) that need to be emphasized; Understanding market conditions, developing relationship marketing, initiating sales, strategy for payment and debt issues.

Figure 11. Sales and marketing model

[47] General manger, Domino China

The Chinese market provides great possibilities for almost any foreign company. However, the market is fiercely competitive, particularly on a local level. Therefore understanding the market is crucial. Most markets are also highly fragmented with few dominant players which give SMEs vast opportunities to enter the market successful. Another recurring factor is the focus on low prices. Despite a growing sense for quality both in the consumer market and the industrial market, we advise companies to take the risk of lower market shares than expected when calculating on a business plan for high-end products. In China, even well known global brands have to start from the beginning when building market reputations. It is also advisable to take the market size in consideration when creating a budget. In terms of population, China is 144 times greater than Sweden. If a Swedish company has one sales representative for the Swedish market, China should thus require 144 sales representatives to become equally successful.

Relationship marketing is widely used in China but differ from western norms. Companies have to decide to what extent they should use guanxi for business purposes. There are several advantages but they could also turn out to liabilities. Further more can relationships be harder to oversee compared to formal business contracts that the western world is used to. As a consequence, we recommend that companies should embrace the potential of guanxi while at the same time hedge for it. A customer relationship management system in which employees report their contacts and relationships made could be used as a facilitator for upholding relationships on a personal level and as a tool for control and management on a firm level.

To initiating sales can be extremely tough for new entrants. It is important to do market analyses and to build up a portfolio of references. We also recommend that companies conduct sales with a business case approach to better defend price and quality. Companies without any relationships can be supported from either a development zone or distributors. Government officials working in developing zones are using the leverage from the zone to facilitate the procedures for companies to get into contacts with suitable suppliers. Distributors often have good local knowledge and customer relationships.

Just as important it is for a company to sell its products, getting paid is equally important. Many foreign invested SMEs report a vast challenge in getting paid for their products. SMEs have lesser leverage to deal preferential terms especially when they lack references and connections. It is still strongly advisable to receive at least 50 percent down payment before shipping product to customers. However it is hard trade off for SMEs, as the customer base may easily double if customers are allowed to purchase on credit. Claiming accounts receivable can be costly and even though the results turn out favorably, debts are far from certain to be collected. SMEs should expect a percentage of their sales to not be paid for. Therefore a two folded strategy should be developed to reduce accounts receivable and at the same time not loose customer due to too strict sales terms.

6 Logistics

This chapter aims to give an initial understanding for the infrastructural and logistic development of China. Furthermore are different alternatives of international freight, import/export procedures, and domestic freight discussed.

The importance of Chinese trade with western states became highlighted during the two opium wars of the 19th century. During the period of self sufficiency, the trade balance was at a minimum even though some trade occurred between China and other Communist-ruled countries. In the 60ties trade for grain started with countries such as Canada and Australia.[48] However, it was not until Deng Xiaoping's four modernizations that there was a significant increase in trade. In Figure 12 China's export and import development after 1978 is illustrated. As we have discussed in earlier chapters trade has been one of the fundamental factors for growth in China. Today goods are shipped more then ever and the export import rates of China are increasing for every year. Even though China does not yet qualify on the top ten list of Sweden's trade partners, China has still become its largest trade partner in Asia with a trade volume of 5.7 billion US dollars.[49] For the Chinese government tariffs and taxation of trade, has become an increasingly important source of revenue. For companies, trade is not just a matter of transporting goods but also financial penalties and complicated procedures when importing and exporting.

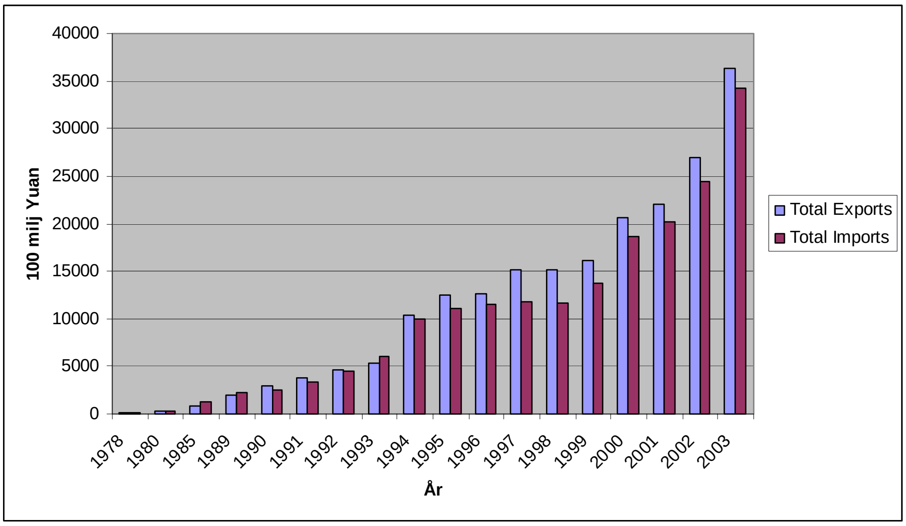


Figure 12. Total value of Chinese Import and Export. (Source China statistical Yearbook 2004)

[48] China: the race to market
[49] China, Sweden's largest trade partner in Asia, Business in Asia, www.china.com, 2006-04-06

6.1 International Logistic

Along with China's escalating trade volume the international logistic companies have taken part in the ever increasing business. For companies who are establishing trade flows there are currently three options of transporting the goods between Europe and China; by sea, air, or rail. Even though sea and air are dominating the rail option might be a stronger option in the future.

6.1.1 Shipping

The Chinese east coast contains several large port cities such as Dalian, Qingdao, Shanghai, Ningbo, and Tianjin. The largest of these, Shanghai, is currently the worlds largest in terms of cargo. In 2005 443 million tons of cargo was handled which is more than a 100% increase in a half decade.[50] In terms of container handling capacity, Shanghai is still the second largest port with a capacity of 18.09 million TEUs (20-feet equivalent units) in 2005 after Singapore which in same year handled 21.2 million TEUs. [51] However, in order to handle the 50 percent increase during the next five years in cargo demand, the Chinese government has decided to build the Yanshan deep water port. The port has a depth of 15.5 meters (more than two times the maximum depth of the Yanshan river estuary) and is able to handle up to the eight generation of container ships (ships that can carry more than 8000 TEUs). Even though the port is just partially in operation, the handling capacity is estimated to be more than 25 million TEUs in 2020.[52]

[50] Shanghai, now the worlds largest cargo port, www.atimes.com, 2006-01-07
[51] Mattison (2005)
[52] Mattison (2005)

Figure 13. Yanshan deep water port

Shipping products from or to Europe to China takes about five weeks. When custom procedures are included the total transport time is usually six weeks. Price depends on the weight of goods and the ability of filling up entire containers. [53] Even though the ocean freight industry is fragmented there are still a few dominant players.

Ocean freight company	Market share
Kühne & Nagel	**7.3 %**
DHL Danzas Air & Ocean	**5.5 %**
Schenker	**4.1 %**
Panalpina	**4.0 %**
Exel	**2.9 %**

Table 5. International market shares of ocean freight companies (Source: Deutsche Post World Net - Investors' Fact Book No. 3 (June 2005))

6.1.2 Air Freight

Air freight is a far faster alternative of shipping products to and from China. Instead of the estimated sex weeks of transportation time for sea freight most cargo by plane can be shipped within a week to end costumer. The business has an annual growth of 6.4 percent and in a report Boeing Co. predicts that Asia will account for 52 percent of the world's air cargo by 2019 compared to 41 percent in 1999. International airports are being more common in China even though they are concentrated in the eastern regions. Major international airports are currently Beijing airport, Shanghai Pudong airport, Shanghai Hong Qiao airport, and Hong Kong airport.[54]

[53] Trade Line Manager DHL China
[54] China's airports, http://www.business-in-asia.com, 2006-04-12

Figure 14. International airports of China (Source: www.mapsoftheworld.com, 2006-04-26)

The trade imbalance in international air freight to China is still five to one. However the breaking-point of capacity is in sight and airfreight companies are increasingly finding other Asian airports as springboards to the Chinese market. Another issue is the lack of cargo plane to handle the increasing volumes, which reduces trade growth temporarily.[55] The international air freight market is even more fragmented than the one for international sea freight, but dominated by DHL who recently acquisitioned Excel.

Air freight company	Market share
DHL Danzas Air & Ocean	**6,4 %**
Nippon Express	**5,3 %**
Exel	**4,7 %**
Kühne & Nagel	**3,5 %**
Schenker	**3,2 %**
Bax Global	**3,1 %**
Kintetsu	**2,9 %**
Panalpina (excl. ASB)	**2,7 %**

Table 6. International market shares of air freight companies (Source: Firoz Nadeem & Murray (2003))

[55] Thuermer (2002)

6.1.3 Rail

Currently there is only one possible option for transporting goods on rail between Europe and China. The rail goes along the trans-Siberian railway and connects to Yishuan, China. Transport on train is not yet an option for most companies. Even though the estimated transportation time is three weeks, the alternative is associated with high risk and high costs. First of all is it preferable to ship batches of two FCL to prevent tedious breaks while waiting for available wagons to load on. Second, all former members of the Soviet Union have broad-gauge rail as a standard which further complicate transports and increase transportation times. Third, there is a lack of control systems to keep track of lost goods.[56]

However, Kazakhstan has initiated an ambitious project of building a 3083 km railway across the country. The aim is to create the first standard-gauge railway between China and Europe reaching from the Chinese border across Kazakhstan and Turkmenistan and finally connecting with Iran's standard-gauge network which leads to Europe. Even though the current volumes of goods transported through Kazakhstan is only about 800,000 tones annually the new railway is predicted to reach a capacity of 30 million tones. Despite the grand project it is far from certain that it becomes a success. The political environment in several of the countries is rather unstable and there are technical challenges involved, such as restrictions on train lengths on the ferry link across Lake Van.[57]

6.2 Import and Export Procedures

6.2.1 Customs Clearance Procedure

Since the membership of WTO in 2001 the customs clearance procedure in China has becoming more and more transparent and standardized towards other countries processes. However, local and regional difference in the procedure still may exist. The key success factor for a successful import procedure is to fully comply with Chinese laws and provide all documents required by local officials.[58]

Customs clearance is usually done directly by the airport/port when the goods have arrived. However, the Chinese government has granted a significant amount of bonded zones and bonded warehouses which basically are treated as foreign soil. By using bonded trucks from airports/ports goods can be shipped to any of these bonded areas without being obligated to import tariffs and import VAT. Naturally, as soon as the goods are transported out from the zones the general customs clearance procedure will occur, shown by Figure 15.

[56] Supply Manager, ABB Robotics Waigaoqiao
[57] Briginshaw (2004)
[58] Trade Line Manager DHL China

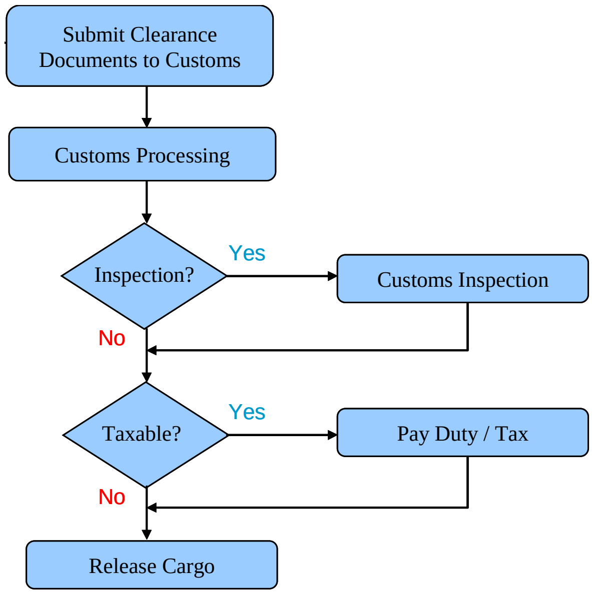


Figure 15. Customs Clearance Procedure

When using airfreight the customs clearance procedure takes approximately 1-2 days. At ports the time for the process differs greatly from FCL to LCL. Ocean FCL may only take a day when LCL takes up to 5-6 days. Thus, the process for LCL is the most ineffective due to the need to re-pack the goods before going through customs. Naturally, without the proper documents filled in, import will take much longer time. [59]

6.2.2 Licenses

To be able to import goods into China a license is required. Companies which lack this license basically have three alternatives for importing goods, use: a local import agent, a distributor with trading licenses or one of the few international 3PLs which has the required licenses. As of December 2004 Wholly Foreign Owned Enterprise, are allowed to obtain this license in two ways. First they can apply to extend their business scope to include trading rights. Secondly, they can start up a new business entity according to the FICE regulations, which automatically include trading rights. However, still many SMEs find it either to expensive or to bureaucratic to mange the import process and document handling.

6.2.3 Trade Agents

Swedish companies use different strategies, a lot of them are selling or buying through trade agents in China, historically via Hong Kong due to its beneficial trade agreements. The trade agents are specialized in finding tariff-numbers that are advantageous when moving the goods into the mainland. The incredibly fierce competition among the trade agents has led to somewhat “innovative” ways to import goods which not always are considered legal. The trade agents’ commission fees have

[59] Trade Line Manager, DHL China

since 2004 decreased from 2-3 % to about 1 % of the value of the imported or exported goods.[60] When importing the product, the import agent formally purchases the product, and is therefore the legal owner of it. The consequences are thus companies which import goods to China get little information of its import agent's business. On the other hand they are not legally responsible for a product that they are not the legal owner of which make it more to a moral issue when choosing trade agents. For companies who do not want to support these kinds of alternatives a different more transparent way is to demand transparency, handle the import and by themselves, using one of their distributors licenses, or use a 3PL. [61]

6.2.4 CCC-Standard

In May 2002 the Chinese government implemented a unified safety license requirement for all manufactures that sells covered products to the Chinese market. The certification, known as the CCC-standard, has strong resemblance with its European correspondent, the CE standard. The CCC-standard is the result of another consolidating process after the entrance into the WTO in which the two former CCIB safety mark and CCEE "Great Wall" mark were combined. The items comprised by the CCC-standard are published in a CCC-catalogue which is issued by the Chinese Certification and Accreditation Agency (CNCA). Importation of products that lack a required CCC-certification may be held at the boarder and feed by Chinese Customs. Due to restrictions of self- or third-party registrations the application process conducted by the, of CNCA designated, China Quality Certification Centre may take 60 to 90 days or even longer and cost several thousands of dollars. The certification requires numerous technical documents and a product sample to be sent to accredited laboratories in China for testing. Furthermore are factory inspections required which are conducted every twelve to eighteen months on the applicants expanse.[62]

6.2.5 HS-Code

Harmonized System code is a standardized and international used system for categorizing goods. The HS code consists of a 6 numbers, the first 4 digits are to categorize the product group, and the last 2 consists of detailed information about the product.[63]

Based upon the HS code different goods are applied to different tariffs. Governments controls the amount imported goods by stating different tariffs for different HS codes. For instance, in China, computer circuit boards are obliged with zero custom tariffs and so are generally spare parts. Some products could be categorized by two or more different HS codes and thus obliged with different tariffs. Companies strive to re-categorize their product into other HS codes by all kind of means. Import agents are often specialized of finding the most favorable HS codes. [64]

[60] Trade agent, Hangzhou
[61] Chairman, Beijing Chapter, Swedish Chamber
[62] www.ccc-mark.com, 2006-03-11
[63] http://mkaccdb.eu.int, 2006-02-05
[64] http://mkaccdb.eu.int, 2006-02-05

6.2.6 Inspections

In China local custom officials tend to have a great deal of decision power in the customs clearance procedure. Thus, depending on which port and province the goods are imported to, differences in import terms exists. Basically importing in China has historically comes down to actual guanxi with local officials. In general, customs is said to be less strict in the south of China. As the Chinese government strives to stop corruption by local officials the differences in the customs clearance procedure ought to decrease even though there still is a long way to go. When interviewing one of the inspectors at Waigaoqiao harbor, following answer was given:

“During the last couple of months the government has been allocating troops from the People Liberations Army (PLA) to supervise the inspectors, thereby decreasing theft. But still, thievery is quite common. Of all products that are not recognized, the inspectors are in title to confiscate samples for further inspection. These samples are rarely returned.”

The custom officials are usually interested in two issues: categorization of goods and valuation of goods. As previously discussed under heading 6.2.5 the custom officials need to know that the imported goods have been declared using the right HS Code and that no illegal goods are being moved into mainland.

The second issue of interest is valuation of goods. The officials do benchmarking against comparable products and companies from similar exporting origins to figure out if the products are declared at an accurate value. A difference of less than 10 % is usually acceptable. However, custom may not recognize specialized products from SMEs since they don’t have any suitable companies to benchmark against. In that case SMEs could have an advantage in terms of being able to import products at lower value. Many companies use a trial and error method, importing a very small amount of goods at different values, to find an actual valuation that custom will accept. [65]

However, government officials have recently announced a more strict policy regarding these questionable strategies for importing. Companies that violate the custom rules are bound to pay high fines and could ultimately loose their business license or even go to jail as recently have been the case for some manager in a big FIE.

6.2.7 Bonded Warehouses, Centers, and Zones

In China there are bonded warehouses which are especially beneficial to companies engaged in export. Such areas are considered to be outside of China in a tax perspective therefore imported goods in such warehouses are not exposed either to tariffs or VAT. However, if the goods are sold to the Chinese market, that will be exposed to tariffs and VAT.

[65] Import agent, Hangzhou

A new alternative to the existing bonded warehouses, bonded logistic centers (BLC) in bonded logistic zones (BLZ) has been introduced in Waigaoqiao. In such a facility there are more liberating rules (Table 7). There are currently plans to develop the concept in remaining14 bonded zones.

Existing Bonded Warehouses	Bonded Logistics Warehouses
Must segregate outbound and inbound goods	**May commingle outbound and inbound goods**
Moving goods into warehouse – export for customs purpose only	**Export for tax and customs purposes**
Storage **Simple processing**	**Storage** **Value added logistics services** **Import and export of bonded goods** **Global procurement and distribution**
Physical supervision by customs	**Video supervision** **Spot checks**
Minimum registered capital: RMB3M	**Minimum registered capital: RMB 30M-50M**
Minimum size: 2000 sqm.	**Minimum size: 2000-10000 sqm**

Table 7. Existing bonded warehouses vs. bonded logistic warehouses (Source: Eugene Lim, Baker McKenzie, 2006)

Even though BLCs/BLZs require a high level of registered capital it might be of interest for some SMEs. Hopefully, there will become other alternatives available that requires less registered capital. The functions are of BLCs/BLZs are illustrated in Figure 16.

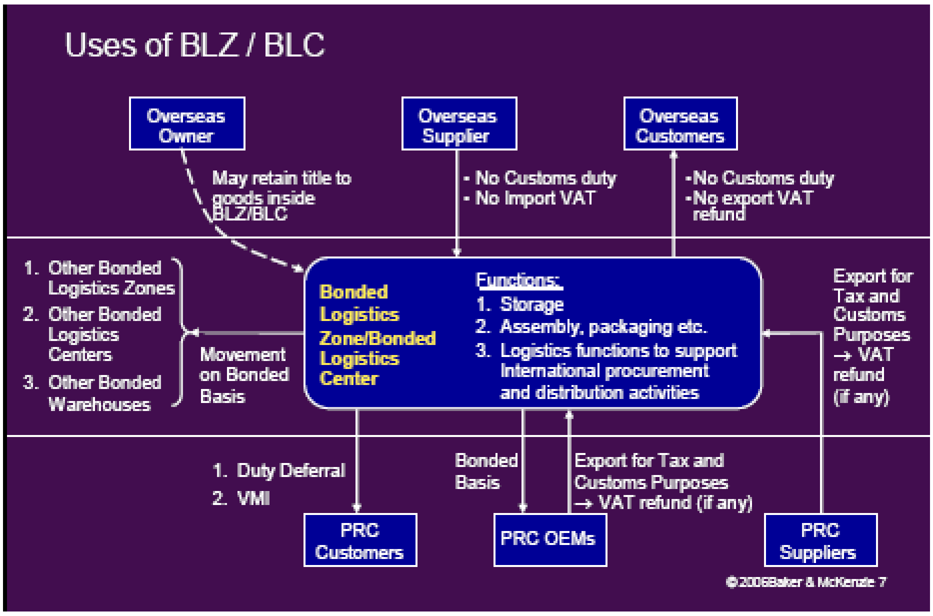


Figure 16. Uses of BLZ/BLC (Source: Eugene Lim, Baker McKenzie, 2006)

6.3 Domestic Logistics in China

Until the beginning of China's WTO era the evolvement of domestic logistic services staggered due to two restricting factors; the dominance of state owned enterprises and the predominance of cellular economies with limited, local distribution areas. This contributed to a concentration of logistic operations around the major ports leaving the western parts of China completely out of improvement.[66] To boost the logistics sector the Chinese government has initiated, and to some extent finished, large projects to upgrade its infrastructure during the decade. Today, there is also an increasing privatization of the logistic market which will lead to improved services and lowered costs.

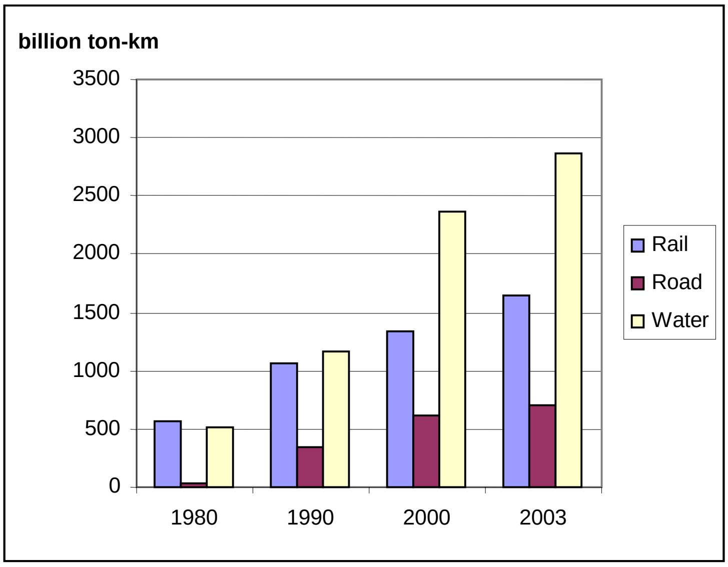


Table 8. National transport in China (Source China data: Ports and Shipping, The China Business Review Jul/Aug 2005)

6.3.1 Rail

The Chinese railway system faces several challenges before becoming a competitive way of transport for SMEs. Currently 90 percent of its capacity is used for bulk materials such as coal, mineral, and grains leaving other customers without long lasting contracts and with smaller volumes often unattended.[67] As the usage of rail decreases compared with other means of transport the Chinese government has decided to invest $30 billion into the railway net.[68] Today, process has been made to improve inland container handling capabilities. In late 2007 it is expected to be a significant development in rail transports as the market of rail companies is deregulated.[69] However, despite the efforts, the challenges for railway system such as

[66] Hertzell (2001)
[67] Hertzell (2001)
[68] Kerr (2005)
[69] Kerr (2005)

lack of modern rail sidings, damaged goods rates 200-300 percent higher than trucking, and long lead times for LCL, will still provide issues for the future.[70]

6.3.2 Air Freight

China's Domestic air cargo industry is expected to increase more than 10 percent annually during the next 15 years.[71] China is also expected to become the world's largest market for aviation by 2020. Still the country has just 196 certified airports for transport aircrafts compared to the US which has 14,807 airports. The business is geographically uneven distributed and mostly located in the eastern region, 39 of China's largest airports accounts for 93,5 percent of the traffic. Since the 1990ies the Chinese government has invested $30 billion to upgrade landing strips and to build 47 new airports. Several airports has also either been turn over to local governments or privatized to increase their efficiency. Future challenges are to handle the lack of an effective supporting ground-based network and the recruitment of trained personnel.[72]

Figure 17. Total departing seats by province 2004 (Source: Airclaims international Transport & Tourism Consultancy)

6.3.3 Trucking

Chinas highway net is being developed rapidly. The Chinese government's emphasis on highway development is not mistakable considering its injection of $120 billion into road developments. In 1989 there was 168 miles of expressways. In 2003 there was 18,500 miles and in 2008 there will be 51,000 miles. This can be compared with the American highway net of 46,500 miles of interstate highways. Roads are being

[70] China's evolving logistic (2001)
[71] Kerr (2005)
[72] Chinas runway challenge

laid so quickly that China is using 40 percent of the world's total concrete.[73] The broader network gives access to second and third tier cities which increase the size of the potential market even more.[74]

Trucking is becoming an increasingly common way of transporting goods within China. However, unofficial boarder tolls by local governments that consider it important to protect their local economies are restricting trade flows.[75] Four levels of licenses are required for trucks that transport goods between two cities located in different provinces: national truck operating license, provincial operating license, local truck license, and local truck operation license. Max Henry, executive director of the China Supply Chain Council argues that it is important to hire trucking companies located in the regions of destinations. A rule of thumb is to let each company in the supply chain take care of organizing the transports heading to their operations thereby decreasing the impacts of protectionism.

Routes	Hours needed 2004	Hours needed before
Beijing - Hong Kong	**25**	**55**
Chengdu - Chongqing	**4**	**9**
Chongqing- Shanghai	**17**	**37**
Shanghai - Beijing	**14**	**31**
Shenyang - Beijing	**7**	**16**
Dalian - Shanghai	**25**	**55**

Table 9. Improved highways (Source China's silk roads get's paved)

In china there are currently some 510,000 companies that offer trucking services. Most of them are regional actors covering a city to a few provinces, while none has a complete national coverage or a market share above two percent. Limited professionalism and trade imbalances between east and west are common problems. Estimates shows up to 50 percent higher transportation costs compared to developed countries, derived from high local road tolls and other hefty transportation fees. As a consequence logistic costs can be up to 20 percent of the companies' revenues, corresponding to 2-3 times the costs in developed countries. However, as the market emerges, more consolidations will occur which will lead to larger companies, higher satisfaction rates, and economies of scale.[76]

6.3.4 Shipping

In comparison to the other logistic sectors China has been proactive in terms of constructing ports to meet a future demand. However, some new ports are still needed to be built along the Yangtze River. Even though there are container ships of first generation that can transport goods almost 2000 miles up the Yangtze River there are several issues involved. To ship goods between Chongquin and Shanghai (900 miles)

[73] Meredith (2004)
[74] Woetzel (2003)
[75] Kerr (2005)
[76] Liu, W. China Supply Chain Council Conference

takes almost as long time as shipping the same goods from Shanghai to Los Angeles. (7,400 miles)[77] Domestic shipping is also mainly suited for commodities, rarely a suitable way of transport for finished goods. The main reasons are low frequency and flexibility.[78] As a result, trucking is mostly used instead. [79]

6.4 Case: How Much Does it Costs to Import Goods to China?

Most SMEs tempted to import goods to the Chinese market will face the challenge of how to lower their landed cost. In this section we will create a fictive case of importing goods to the Chinese market based on geographic locations.

Company X is a Swedish company located close to shipping point and produces a product P1 for an ex work cost of RMB 1,000. Their aim is to initiate sales on the Chinese market. Facing strong competition on price from local Chinese competitors they are keen to investigate the cost structure of their landed cost. The company's internal rate of interest is 10%.

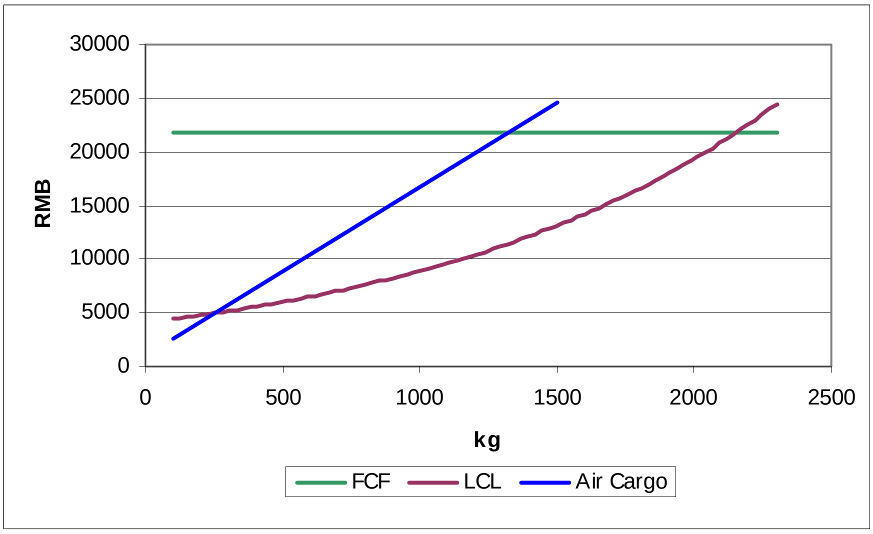


Figure 18. Price variations per kg by transport alternatives

As we have discussed earlier is there only two feasible options of transporting goods from Europe to China; shipping and air freight. Both alternatives have their own advantages. Air cargo is fast (one week) but expensive for larger volumes and heavy cargo. Shipping is slower (six weeks) but can be more profitable at larger volumes, especially if the volume is large enough to cover the expense for FCL. A container carries at least 13 pallets but if they can be put on top of each other, the maximum amount is 26. When comparing the different alternatives breaking points can be found to ensure which alternative that is superior to the others. In Figure 18 the alternatives are illustrated with regard to the increased capital cost of the tedious shipping route.

[77] Gelb (2005)
[78] Hertzell (2001)
[79] Kerr (2005)

The optimal shipping prices are dependent on how much the product weights and how large batches being sent. The weight of the P1 is 100 kg and each batch contains 10 P1, the alternative for a transport of 1000 kg stands between LCL shipping (RMB 8000) or air freight (RMB 17000). A trade off has to be made between price and lead-time. If volume of shipped goods exceeds a ratio set by freight companies, prices will become somewhat more expensive. This is however not the case for company X.
Import procedures are a challenge for SMEs. Since most variable costs of importing are relatively small commissions for trade companies (about one percent) is a fair estimate of the cost for small volumes. Some agencies also add an exchange fee corresponding to the commission charge. VAT of 17 percent (for most goods) is added on the selling price and domestic transportation cost varies dependent on distance. Furthermore is the product P1 exposed to 12 percent import tariff. In the cost of different domestic trucking costs are compared. In this example we'll estimate the domestic transportation distance to 500 kilometers. This gives a domestic transportation cost of 50 km x (0,002 RMB / (kg x km)) x 2000 kg = RMB 2000

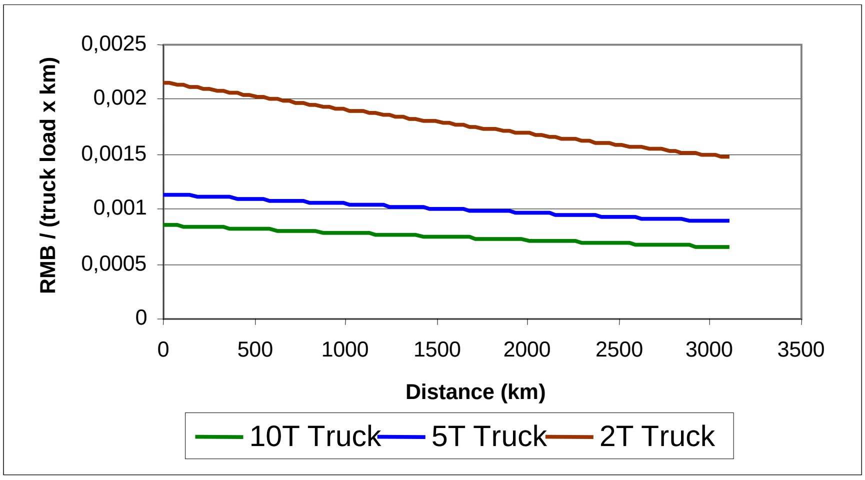


Figure 19. Domestic trucking costs

In Figure 20 the total impact of import is shown. The shipment of air cargo results in this example of a 50 percent increase in price while shipping accounts for a 41 percent increase. However, if the purchase price of the Chinese customer is the same thereby increasing the selling price of the European producer when shipping, those profits will also face VAT and tariffs.

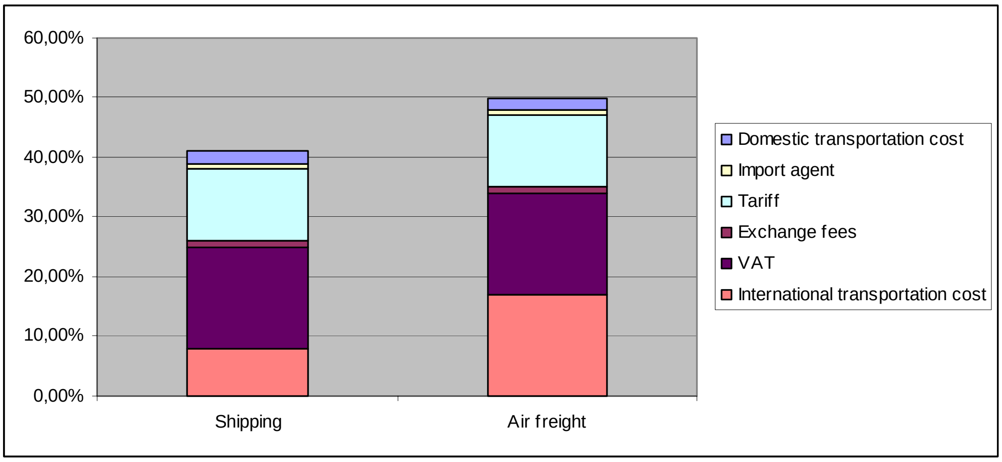


Figure 20. Total impact of import on landed cost

6.5 Conclusions

Cost reductions, and to a slightly lesser extent consumer satisfaction, are vital components for a company's success. Logistic issues therefore needs to be solved as smooth as possible. By knowing China's history and current status of development SMEs will be better prepared for handling the changes and apparent irrationality of the turbulent market. As a consequence, our conclusions are focused on price reductions.

The market for international freight is mature which has lead to competition mostly based on price. For SMEs it is therefore of interest to benchmark different freight companies and 3PLs in order to get as beneficial deals as possible.

Importing goods can be complicated. It is therefore recommended to use an import agent. This way, risks of having goods stopped at custom clearance due to non-standard pallets etc. can be avoided. There is also a great variety of import agents ranging from small specialized companies to large SOEs. The small companies will have better knowledge of specific products and are therefore likely to be better of determine which HS-number your product should carry while the SOEs are likely to have better connections with custom officials. Best way of reducing costs is to benchmark import agents for better deals and consolidate volumes. An alternative way of reducing costs is to change import/export strategy. For example, a product can be shipped as components or pre-assembled alternatively partly shipped and partly sourced at destination.

Local transportation costs are more expensive in China than in western countries. It is therefore common to benchmark different suppliers on their price offers and choose a more profitable one. Our recommendation is first of all only to hire 3PLs if they ship within or to your own province. In other cases it is preferable to have the other party take care of the transports. Secondly should benchmark analyses of logistic service providers be based on several parameters including price. It is important to find out whether the provider has a possibility to track the goods, how well the products will be stored, rate of damaged goods, history of overloaded trucks, and history of accidents due to unacceptable drive schedules of truck drivers. Best way of finding true values on the parameters is to as for and check up on references.

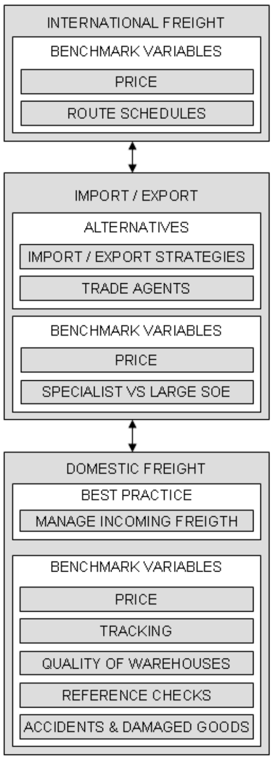


Figure 21. Overview of logistic conclusions

7 Development Zones

This chapter provides an explanation of export processing zones, the emergence of China's development zones, what they provide, and conclusions that can be drawn for SMEs in a pre-investment phase. In order to give an in depth view of how zones differ and where they are located a closer study has been made on the Yangtze river delta even though areas such as Shenzhen and more central areas such as Sichuan also are potential sites for SMEs.

7.1 Export Processing Zones

In the early 17th century free ports, with intentions to encourage trade, started to emerge in European cities like Venice, Marseilles, and Hamburg. Despite their early emergence it lasted almost three and a half centuries until systematic research were made on the topic. In the 1970s, several countries started to develop the concept of Economic Processing Zones (EPZ) for areas with special benefits striving to attain greater economic openness.[80]

The overall aim of EPZs is to increase FDI by providing tax relieves, custom duties exemptions, preferential tax rates, and lower corporate taxes.[81] Further incentives such as providing proper infrastructure and necessary laws are also provided by the hosting government in hope to stimulate its domestic industry. An export processing zone can thus be defined as a relatively small, geographically spread area within a country, the purpose of which is to attract export-oriented industries, by offering them especially favorable investment and trade conditions as compared with the remainder of the host country. In particular, EPZs allow the importation of goods to be used in the production of exports on a duty free basis.[82]

EPZs have historically been controversial. Questions have arisen whether they actually solve their intentions such as if they mitigate socio-economic problems, increase regional cooperation, leads to self sufficiency, and to provide sustainable development.[83] The Zones has been blame for western aggressive capitalists exploiting third world labor (especially women) with no unions to protect their rights. Furthermore the fierce competition of attracting FDI has led develop countries allowing and even in some cases to promote too beneficial legislative relieves on workers rights.[84] Despite previous problems, EPZs have increasingly been seen as a first step in the process of liberating trade and integrating national economies into the global economy. Shanghai, for instance, is like many other cities in Pacific Asia competing to become a global city. Even though the FDI in Shanghai is unequally distributed, with Pudong as the most attractive area, Shanghai's success and potential of becoming a global city wouldn't be possible without the Chinese government's

[80] Wong & Tang (2005)
[81] Firoz & Nadeem (2003)
[82] Dicken (2005)
[83] Reardon (1996)
[84] Abbott (1997)

positive attitude towards FDI.[85] Another example is newly industrial countries such as Taiwan, Singapore, South Korea, and former Hong Kong. Taiwan has increased their GDP per capita from US$ 152 in 1961 to US$ 14,032 in 2004.[86]

7.1.1 Development Zones in China

The Chinese versions of EPZs are commonly known as development zones. The first development zones were established in the beginning of 1980. Even though the bamboo curtain was opened up, the Chinese government imposed heavy import barriers to improve their trade balance. As a mean for Chinese industry to attract capital and technology knowledge of foreign companies, the zones were designed to have preferable agreements and access to Chinese low-cost resources like raw material and labor.[87] Today there are several types of zones and bonded areas which can be categorized in state-, provincial-, city-, and district-levels. Both foreign and domestic companies may set up business in all categories of zones. National zones can be divided in Special Economic Zones (SEZ), Economic Technology Development Zones (ETDZ), Free Trade Zones (FTZ), Chinese Export Processing Zones (CEPZ), Boarder and Cooperation Zones (BCZ), Tourist and Holiday Resort Zones (THRZ), Environmental Protection Zones (EPZ) and Taiwan Investment Zones (TIZ).[88] The current number of zones is today about 2500. It used to be some 6000 zones but the Chinese government reduced the number after experiencing too fierce competition.[89]

7.1.1.1 Special Economic Zone (SEZ)

SEZ was the first kind of development zone to be introduced in China. The zones were strategically placed in Shenzhen (close to Hong Kong), Zhuhai (opposite of Macao), Shantou (opposite of Taiwan), and Xiamen (opposite of Taiwan).[90] To create an attractive environment for foreign companies, special regulations were set up, such as protection of foreign investors' assets, due profit, and legitimate rights.[91] Just as Deng Xiaoping had foreseen with his "feeling the stones as you cross the river" statement, the implementation of the zones was not stone less. In the mid 1980s, critics claimed the SEZs to be foreign colonies sucking the blood out of the domestic economy while at the same time SEZs were involved in smuggling and illegal foreign trade transactions.[92] Despite these and other issues the border village of Shenzhen has today become a city of ten thousands of companies with a population of more than 10 million, an increase of 31 times in 25 years.[93] The experiment was naturally a tremendous success and the Chinese government saw potential of gaining more FDI

[85] Leung & Wei (2005)
[86] Lee et al. (2006)
[87] Murray & Nadeem (2003)
[88] Walton (2003)
[89] Chairman, Beijing Chapter, Swedish Chamber of Commerce
[90] Murray & Nadeem (2003)
[91] Wong & Tang (2005)
[92] Reardon (1996)
[93] Population in Shenzhen increases 31 times in 25 years, http://english.sina.com, 05-08-21

by establishing further zones.[94] Since then, the entire province of Hainan, which is close to Vietnam, also been designated to become a SEZ.[95]

7.1.1.2 Economic Technology Development Zone (ETDZ)

After the first four initial experimental SEZs, the Chinese government wanted a further expansion of their development zone strategy. With a slight of change in course, new development zones were created, not as new cities as the previous SEZs but rather within the limits of existing cities. The aim was to create a complement to improve the existing domestic industry in the cities. The new zones were defined as Economic Technology Development Zones. Unlike the larger SEZs, the ETDZ were controlled and dependent of support by the municipal government of their parent city.[96] Today, there are 54 national-level ETDZ with a majority in the eastern costal regions.[97]

7.1.1.3 Free Trade Zone (FTZ)

During the 1990s the government gave approval of 15 FTZ as a mean to attract business activities thus centralizing operations from bonded warehouses which they considered to be harder to oversee.[98] A FTZ is, in it self, a restricted bonded area of 6 km^2 to 10 km^2 into which companies can import products, parts, and components without having to pay VAT or import tariffs. Furthermore are all equipment and material for self use also duty-free. This lets companies be involved in business activities such warehousing, foreign exchange transactions, marketing, trading, and export processing. It is first when finished products are sold and transported to domestic customers that custom duties and VAT needs to be paid. The amount is based on a ratio of locally sourced inputs to imported components. FTZs offer bonded commodities exchange market that in-zone companies can use to sell to out-zone customers and distributors. However, after December 11 in 2004, as a consequence of Chinas entry to the WTO, a new law was introduced which states that all enterprises are eligible for trading rights. This reduced the advantages of FTZ significantly. [99]

7.1.1.4 Chinese Export Processing Zones (CEPZ)

In 2000, as another attempt to reduce illegal sales of duty-free imports and increase exports, the government introduced so called ‘export processing zones’ which is a fenced, 24-hour by customs supervised zone of 2 km^2 to 3 km^2, that is located within an existing zone. The focus of a CEPZ is naturally to promote export with beneficial regulations for such activities and is therefore more restricted in terms of domestic trade than other types of zones. As a consequence, business activities such as export

[94] Wong & Tang (2005)
[95] Special Economic Zones and Open Coastal Cities, www.china.org.cn, 2006-03-13
[96] Wong & Tang (2005)
[97] National Economic and Technological Development Zones, http://www.china.org.cn, 2006-03-14
[98] Walton (2003)
[99] Walton (2003)

processing, warehousing related to the processing activities of in-zone enterprises, and freight transport are the only ones allowed. All goods, persons, and vehicles must be inspected when entering or leaving the zone. Thanks to a required electronic tracking system on all containers custom clearance is streamlined and processing will proceed faster than in other zones.[100]

7.2 Special growth areas

7.2.1 Yangtze River Delta

China's east coast has historically reached the highest growth in terms of GDP in China's strive to become an industrial country. One of the most successful regions is the Yangtze delta economic circle which comprises the northern part of Zhejiang province, Shanghai, and the southern part of Jiangzhu province. Currently, the shipping on the Yangtze River is estimated to have an annual increase of 25% which reveals some of the economic growth of the area.

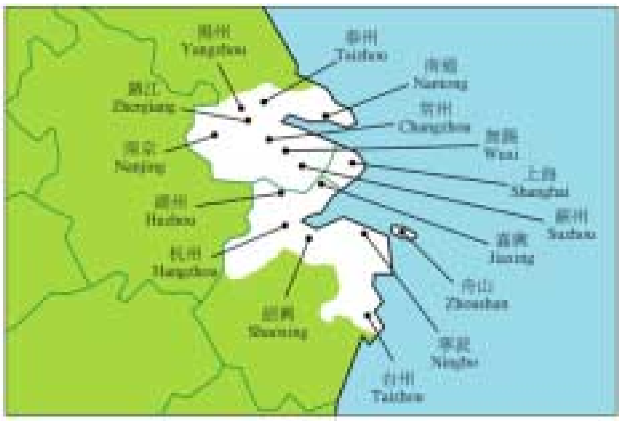


Figure 22. Main cities of the Yangtze delta economic circle

7.2.2 Northern Zhejiang

7.2.2.1 Ningbo

Ningbo is one of the fastest growing areas of China and its development has been a great example of a transformation from a machinery focused area to a more hi-tech area. The Electronic industry for example is emerged from the car-component industry manufacturing that has over time become more electronically advanced. Other major industries are plastic and die-metal molding, car and spare part manufacturing, and telecom. The dynamic development of Ningbo has its roots in governmental support. The rapid development comes from excellent infrastructures, strong private entrepreneurship and strong foreign direct investments which has become a strong competitive advantage towards other zones. Ningbo also has the first sino-foreign university, Ningbo-Nottingham University, which was established in

[100] Walton (2003)

2004. Infrastructure is currently being upgraded which will result in a large bridge crossing the bay which will reduce drive time to Shanghai from four to two hours.

Ningbo has currently four national-level zones, one high-tech zone and a hand full of provincial and municipal level zones and has been privileged to become one of five cities under direct jurisdiction of the state council which gives the city freer hands of planning and managing.[101]

Ningbo Hi-Tech Zone was founded by the Chinese academy of Sciences and the Municipal government in 1999. The park focuses on the electronic information industry, plastic industry, and mechanic or family electronic appliances industry. Just as many other zones in the region SMEs are commonly given special attention in incubated areas. The park offers various types of quality on buildings and some are located on second and third floors which put restrictions on what kinds of machinery that can be used.[102]

In the Zhenhai Economic development zone one of Chinas first wholly owned foreign industrial parks is located and focuses mainly on attracting Nordic companies. Just as the state owned parks it provides its customers with investment advises, infrastructure, facilities, and connections. Currently there are mainly Danish companies located in the zone.[103]

7.2.3 Shanghai

Shanghai started off as a small fishing village and gained its first port in the 1840s. It was part of the western world's colonization which contributed not only to its economic importance but also to its ties to the western countries. During the start up of China's open door policy, Shanghai quickly got to be involved with the creation of an ETDZ in 1984. However, due to restriction on funding and levels of FDI, the city had a below average industrial growth and lost in importance towards other provinces such as Guangdong and Fujian. It was not until the beginning of the 1990s when the city got its needed funding that there was a significant development of the province.[104] From 1990 to 2003 Shanghai's development averaged twelve percent per year. Today, Shanghai has the highest GDP per capita in China, almost reaching five times the domestic average, with Pudong area as the main focus of FDI.[105] As a result wages are quite high which surrounding industrial areas take advantage of in their marketing campaigns.

There are several development zones in Shanghai reaching from local to state level. Main sectors of industries are electronics and IT products, automotive products,

[101] Sigurdsson (2005)
[102] International Co-operation, Investment Promotion Bureau, Ningbo Hi-Tech Park
[103] Nordic Industrial Park, www.nip.com.cn, 06-04-21
[104] Leaung & Wei (2005)
[105] Chi & Yehua (2005)

petrochemical and fine chemicals, fine steel products, machinery and equipment, and biomedical products.[106]

The development of Shanghai is still present. A new industrial area called Lingang is being created in the south east part of Shanghai which is considered to become a tremendous success. The connecting deepwater port of Yanshan, earlier mentioned in the previous chapter, and the reduced importance of FTZs will probably draw some of the attention from Waigaoqiao. Lingang will be an export focused area with an EPZ, FTZ and bonded logistic park which are anticipated to receive the most beneficial policies in China.[107]

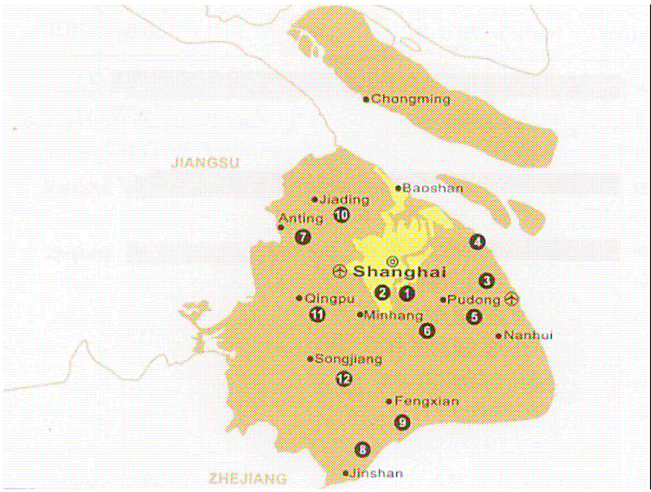


Figure 23. Most imported development zones of Shanghai (1. Caohejing ETDZ, 2. Hongqiao ETDZ, 3- Jinqiao EPZ, Waigaoqiao FTZ, 5 Zangjiang http, 6. Minhang ETDZ, 7. International Automobile Park, 8 Chemical Industrial Park, 9. Comprehensive Industrial Development Zone, 10. Jiading Industrial Park, 11. Qingpu Industrial Park, 12. Songjiang Industrial Park)

7.2.4 Southern Jiangzhu

7.2.4.1 Suzhou & Wuxi

Suzhou Industrial Park is located 90 km west of Shanghai and was founded in 1994 as a joint project between the governments of Singapore and China. With strong governmental support and a highly developed infrastructure the park soon became a popular destination for investment. Despite the success of the park the collaboration was far from smooth even though it fulfilled its goals to transferring Singapore's software in public administration and creating profits for its investors. The issues were mainly related to cultural differences and the following difficult years of the Asian crisis (1997-1999) led to a final disengagement of the government of Singapore

[106] Chi & Yehua (2005)
[107] Consultant, Establish

in 2001.[108] In its first ten years of existence the park managed to increase its GDP about 36 times escalating exponentially. Today the park is composed of an IT park, an international technology park, a life science park, a national software park and a SME park. Major investment focus is on industries such as electronics, mechanical-electronic integration, pharmaceuticals, fine chemicals, precision engineering, and new materials. [109]

Wuxi new district was established in 1992 and in 2004 Wuxi ranked fourth in terms of the volume of foreign contractual investment among all large and medium-sized cities across the country. Compared to Suzhou, Wuxi is located north west which is a disadvantage in terms of closeness to shanghai but an advantage in term of its access to the Jiangyin port. Wuxi has four national-level development zones, five provincial level development zones and five city-level key industrial parks and zones. In the zones, investors are offered a “one-stop” comprehensive service combining industrial and commercial administration, taxation, customs, commodity inspections, financial services and insurance. The manufacturing industry in Wuxi contributes more than 50 percent to the city’s gross domestic product, and consists of the five pillars of mechanical manufacturing (45%), electronics (20%), fine chemicals (15%), pharmaceuticals (10%), and new materials (10%). Forty percent of the investors originate in USA or Europe.[110]

Suzhou and Wuxi are two cities that share many similarities. For one, both cities have development zones established during the same period, attract similar types of companies and have comparable infrastructure and administration. They also share the same ambitions of helping each other to develop and not compete like other development zones. Every three year the mayors of the cities switch positions to integrate their organizations.[111]

7.2.4.2 Nantong

Nantong is a portal city of eight million inhabitants, located north of Shanghai in southern Jiangzhu, and had a total GDP of 123 billion RMB in 2004. There are currently 11 types of zones at national, provincial and municipal level. Main focus is industry sectors such as chemical processing, textile, and information technology. Even though there are investors from more than 80 countries with Japan as the dominant investor, the zones only host a few Nordic companies, none of them from Sweden. In order to attract FDI to the region, the government has made efforts to ensure power supply by guaranteeing power to the city before transmitting to other areas in China.

Nantong was one of the first 14 cities to be assigned an ETDZ. Today the zone is in itself divided in different parks such as the Jiangsu Nantong Export Processing Area, China Changjiang Int'l Chemical Fiber Industrial Park, Changjiang Int'l New Chemical Materials Industrial Park, and Optical-Mechanical-Electrical Integration

[108] Pereira (2004)
[109] Suzhou Industrial Park, http://english.china.com, 2006-03-01
[110] Project Manager, Foreign Investment Promotion Bureau, Wuxi New District
[111] Project Manager, Foreign Investment Promotion Bureau, Wuxi New District

Industrial Park. Key competitive factors of the zone are the city's injection of 100 000 new workers each year, half wage rates compared to Shanghai, access to 9 higher educational institutions, closeness to bordering cities, the Nantong port which is rated top ten of china, and its service to foreign investor, which it has been awarded for by the central government.

In order to improve the cities infrastructure and thereby getting closer ties with Shanghai great projects has been initiated to connect the city with bridges to Shanghai. One of these projects is the construction of the Sutong Bridge, the world's largest stayed-cable bridge. It is located in the southern part of Nantong and will be available for transportation during 2007. Transportation time will be reduced by fifty percent to a one hour drive. Another project to connect Nantong to the development zones to the eastern parts of Shanghai and Pudong international airport is the eastern bridge project, Shanghai-Nantong river-crossing engineering, which will be in operation during 2009.

Figure 24. Yangtze River delta, development of infrastructure

7.3 Case Besam

Besam is a medium sized company located in Landskrona, Sweden, producing swing- and revolving doors. Even though they have had several years of presence on the Chinese market by their sales and distributor organizations they did not invest in their first production facility until 2005. As a first step, locations such as Beijing, Shenzhen, and Shanghai were considered but the decisive factors for Suzhou Industrial Park were its geographic location in terms of minimizing distance to market and sales office and the different quality of services compared to other parks.

During the registration process, the helpdesk was found quite friendly but there was still a relay of sequential internal processes, which were quite time consuming. After all licenses were acquired, Besam could finally rent a factory. A facility of 3000 sqm was large enough to cover both production and sourcing operations but needed additional restructuring for about one million RMB to fit the required needs. The rebuilding took about three months and some of the electric installations had unfortunately to be remade due to poor safety. Ten months after registration Besam initiated their first assembly. To fulfill the expectations of an opening, Besam rented a staging firm to take care of the ceremony which resulted in huge inflated balloons, fireworks, podium for speeches.

During the recruitment process all employees were mandatory to speak English as a way of mitigating language barriers. The site holds about 32 Chinese employees working with production, sourcing, and logistics. Still, Besam experienced several cultural differences which caused some confusion in the daily work but after they hired a Chinese manager with western experience, cultural differences were mitigated. The manager, who had previous experience with Swedish companies was hired by a headhunting agency and became responsible for the entire site. As a consequence, western presence at the factory became low and with only few visits. As many other western companies in China, Besam has also experienced high rates of employment turnover. A major challenge arose of training the new recruiters since such a young facility hasn't accumulated the necessary knowledge about the parent company and the products to handle the gaps of knowledge lost. As a result, Besam Sweden had to take care of the training programs.

The functions of the factory became multi-faceted. Firstly, it produces products for the Chinese market which product portfolio basically is the same as for western companies except for one special, low-cost product, which is intended to let Besam become better positioned towards Chinese competitors. Secondly, volumes are also produced for other Asian markets such as Malaysia, Singapore, South Korea, and the Middle East and lastly sourcing and semi manufacturing for European markets is also comprised within the scope of the site.

After declining sales rates, the sourcing operations to Europe became increasingly important. Still, Besam considers it time consuming to work with Chinese suppliers. Perhaps not as much in real time as in man time but the relations needs to be uphold to maintain quality. It has been found extremely important to give specific information of how components are wanted to be designed and in which way they are going to be measured and tested.

Despite struggles, Besam's strive for success together with a strong support from park service has helped them reach a point where operations work more smoothly. Key success factors have been patience and micro management.

Source: Plant Manager, Besam China

7.4 Where and How to Establish

Choosing zone can be a complex matter but also fairly straight forward. Most companies going to China will have specific requirement connected to their business structure. These will eventually lead to specific locations that are better suited than others. Larger companies can often afford to neglect and modify given conditions of the environment until their needs are fulfilled. In contrast, SMEs are forced to be more flexible and adjust to surrounding environments.

One of the first factors to work out is the locations and sizes of markets to be served and the amount of goods to be exported. This gives some initial idea of a logistically ideal spot. Zones around this area needs to be compared an analyzed. Key performance indicators (KPI) can be helpful when evaluating different alternatives. In appendix A the four areas of Suzhou, Nantong, Wuxi, and Ningbo has been compared by different KPIs. By structuring offers, logistic costs can then be compared with other geographical advantages such as lower wages or lower procurement costs. Moving west is becoming an increasingly attractive option but the further west companies move, the further back in time they also move in terms of cultural differences, understanding of western companies, developed infrastructure etc. This drastically increases the complexity of operations. Being close to suppliers is also strategically important not just logistically but also because it mitigates some of the risks involved with quality issues.

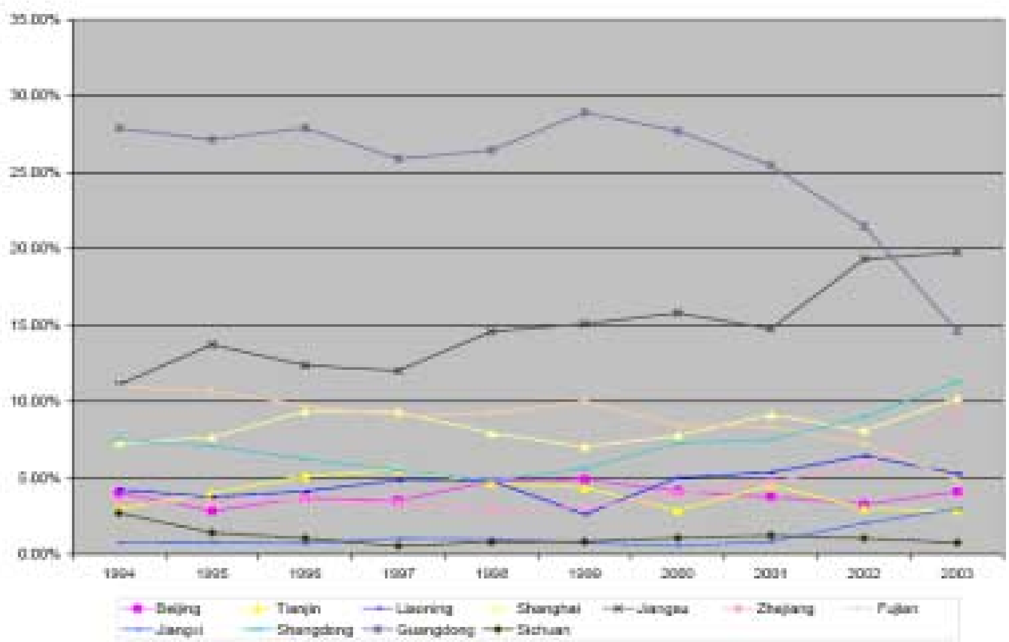


Figure 25. FDI inflows in major regions in China, 1994-2003. Several regions are becoming increasingly popular while Guangdong is has suffered the most perceptually decrease.

The KPIs of the zones need to be carefully considered. Some of these are: type of zone, hierarchal level of zone, tax incentives, preferred industries of the zone, relating industry, infrastructure, and service to foreign companies. The type of zone is highly correlated to the business structure of the company; whether there is a focus on export, R&D, or regular production. Like most other things in China, deals provided by the authorities of the zones are negotiable. Nation level zones have better tax incentives at an initial view but local zones can be more flexible in negotiations. Tax incentives should however not be a decisive factor since they are highly influenced be political fluctuations especially on local levels. In next year for example, just like we discussed in previous chapter, it is believed to be higher income tax rates for foreign enterprises due to the unequal market conditions the current tax rules provide. In such cases timing could be an important factor since tax rules might be grandfathered to mitigate the transformation. The more attractive the company is, the more benefits they will receive when dealing with zone authorities. Since SMEs usually can't use investment size as leverage it is often better to adapt and fit the profile of the preferred industry of the park. Competitors have most likely reasoned in similar patterns and might already be in parks of interest. Since high rates of staff turnover is to be expected, careful consideration have to be made on how to protect the core competences. On the other hand, it might also be easier to recruit skilled personnel if a major competitor with more advanced products is located in the same zone. Finally, just like companies, zones compete for their customers but still the amount and quality of service provided differ quite a lot. Some parks also acts as relational leverage for their companies which can be important for new-comers especially SMEs.

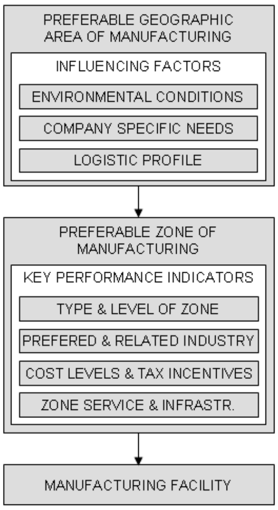


Figure 26. Flowchart of procedure for choosing zone

In the end, the decision of placement comes down to risk versus rewards. Cost reductions need to be compared with complexity and flexibility. For SMEs, unsuccessful investments will have larger impacts than for larger companies. Therefore it is wise to play safe. Choosing eastern parks with more experience and developed infrastructure will probably pay off in the long run even though wage rates increase by 7-10% per year. Renting a facility is probably also a better option because of lower investments and the flexibility to move if conditions change.

8 Investment

In this chapter we address the financial- and investment challenges faced by foreign invested SMEs in China. Issues such as capital structure, tax incentives and best-practice strategies for investments are discussed and analyzed from a SME-perspective. Finally, as a conclusion of this chapter, a feasibility study is presented, including every investment area previously discussed.

In the recent 10 years, the central government has passed considerably legislation to adapt China to an efficient "social market economy". However, at the same time, many new laws and restrictions have passed to protect domestic industry and to create substitutes to the old market barriers.

"The present deregulation of the financial market conducted by the Chinese government is like a dance of tango – two steps forward, one backward."
Johan Andrén, Branch Manager, Handelsbanken Shanghai Branch

The political risk in China is high; it could quickly tear down a break-even analysis conducted in a SME's feasibility study. It is therefore important to understand that a SME should never enter China just to gain tax holidays or other temporarily incentives from the central government or local authorities. However, by analyzing the business practice and the current investment legislation in China we will guide SMEs to utilize the present investment context at its full potential.

8.1 Foreign Invested Entities (FIE)

When setting up a business entity in China numerous licenses at different government levels are needed. The most central license for any business in China, whether domestic or foreign, is the business license. In summary, the business license states the business scope, the industry, and the type of the company.[112]

8.1.1 Business Scope

The business scope is narrowly defined for all businesses in China and an entity may only conduct business within its approved business scope. The setup of a FIE does not automatically imply permits for business activities, the FIE needs to apply for every specific licenses according to their business scope. Usually companies apply for as broad spectrum of business activities as possible, while the local government tries to narrow the list down. Once received the business license, any amendments to it require further application and approval.[113]

The business scope states if the company is classified as trading, production, holding, R&D, or service company. The most common categories are production, trading, and service entities. A business entity which adds more than 30 % value to its products is considered a production entity, while less than 30 % value contribution is classified as

[112] Virchov, krasue & Company and Baker Tilly (2005)
[113] Ibid

a trading company. Traditionally, the Chinese government has favored production companies to trading companies. Trading companies is usually faced with several regulations and restrictions, while production entities get numerous tax holidays and local benefits. Hence, many foreign-invested companies, which main business activity is trading or retailing, try to include some kind of simple assembly to be allowed to classify as production entities. The classification is done by local authorities and faced by negotiations between the parties. The authorities perform random inspections to see if the business entity makes significant contribution in terms of value to its products. If the inspectors are dissatisfied, the company may loose its business license.[114]

8.1.2 Industry Regulations

When establishing a business entity in China, foreign investors need to consult the Foreign Investment Industrial Catalogue and any relevant industry specific laws and regulations. The Investment Catalogue classifies industries into four categories (encouraged, permitted, restricted and prohibited) which indicate the extent to which foreign investment is supported and encouraged by the Chinese government. Industries in the encouraged and permitted categories are subject to very few restrictions, while those in the restricted category (e.g. advertising) are subject to approval from higher level government authorities and other special conditions. Foreign investors are not permitted to invest in industries that fall into the prohibited category, e.g. defense and publishing. In some cases, the Investment catalogue also indicates that for certain industries foreign companies are required to form a Joint Venture with a Chinese company and have the Chinese party to hold the majority of the shares. However, these categories are changing as China complies with its WTO obligations.[115]

8.1.3 Business Types

The most common types of FIEs in China are; Representative Office, Sino-Foreign Joint-Venture (JV), and Wholly Foreign Owned Enterprise (WFOE). These different types of entities differ in terms of owner structure and allowed business activities. However, there are other types of business such as a new type of WFOE which is commonly defined separately as a Foreign invested Commercial Enterprises (FICE).

8.1.3.1 Foreign Representative Office (Rep. Office)

The Foreign Representative Office was the first foreign entity to be approved by the Chinese government in the late 1970s. It is the easiest and cheapest type of entity to set up in China and is often used as first step for single business activities such as sales support or sourcing. Pursuant to a 2004 State Council decision, it is no longer necessary to obtain approval from Ministry of Commerce (MOFCOM) for establishment of the most common types of representative office. Instead, direct registration with the local bureau of the State Administration for Industry and Commerce (SAIC) is permitted. [116]

[114] Branch Manager, SEB Shanghai Branch
[115] Virchov, krasue & Company and Baker Tilly (2005)
[116] Baker McKenzie (2006)

A foreign representative office does not have a separate legal status and the foreign parent is therefore deemed liable for all acts of its representative office. It may neither generate any profits directly nor enter any revenue generating agreements with local business. Instead, the main purpose of the entity is to present a local presence of the parent company for distributors, customers, and suppliers. [117] This local presence is a Key Success Factor for doing business in China, in particular for SMEs due to their unknown status.

A foreign representative office may hire foreign employees which are in general considered representatives of the office, no matter what positions they have in the organization. The office is also allowed to hire Chinese staff through an employment service agency authorized by the government to supply Chinese employees to representative offices.[118]

8.1.3.2 Sino-Foreign Joint Venture (JV)

The Sino-Foreign Joint Venture consists of two types of entities; Equity Joint Venture and Cooperative joint venture. Today, the dominant form of JVs is the equity joint venture. The main difference between the entities is that a cooperative joint venture has no legal entity. Instead the parties make their contributions to the project and bear the risk of profit and loss directly. [119]

One of the reasons why many foreign investors in the past have chosen the cooperative joint venture is because of the more flexible regulations on the contributions to the JV. The parties may also agree on different ratios of profit distribution, other than the actual capital contribution of the project. Cooperative joint ventures are favorable for hotels, commercial complexes and infrastructure projects where the parties intend that the assets will stay with the Chinese party after the end of the joint venture term.[120]

An equity joint venture is a Chinese legal entity with limited liability and is setup by a joint venture contract between Chinese and foreign parties after approval of MOFCOM. After approval (maximum 3 months) the JV must be registered at SAIC within one month. The JV will then be issued a formal business license. Under the joint venture law, all contracts must be governed by Chinese law and be written in Chinese. Moreover, all accounting records, books, and statements are required to be prepared and kept in Chinese. [121]

Capital contribution from the foreign party may take several different forms; foreign currency, RMB profits derived form other Chinese businesses, equipment, machinery, industrial property, and proprietary technology. Valuation of non-cash contribution must be agreed by the partners on the basis of fairness and reasonableness. The board

[117] Virchov, krasue & Company and Baker Tilly (2005)
[118] Baker McKenzie (2006)
[119] Virchov, krasue & Company and Baker Tilly (2005)
[120] Baker McKenzie (2006)
[121] Ibid

of directors is the highest authority in a joint venture. The appointment of the board is done according to the ratio of capital contribution. The party with most contribution will choose chairman of the board, the other party automatically chooses vice-chairman. Any profits from the JV are to be distributed according to the ratio of capital contribution. [122]

8.1.3.3 Wholly Foreign Owned Enterprise (WFOE)

The Wholly Foreign Owned Enterprise (WFOE) is a limited liability company wholly owned by the foreign investor(s). In China, WFOEs were originally made for manufacturing activities that were either export and/or hi-tech oriented. However, with China's entry into the WTO, these conditions were gradually abolished and the WFOE is increasingly being used for service providers such as a consulting, software development, and trading. Today export and hi-tech oriented production entities are encouraged rather than permitted.[123]

The approved capital contribution to a WFOE is similarly as to the foreign party in an equity JV. One significant difference between a WFOE and equity JV is that WFOE must allocate 10 percent of its profit to a statutory fund for 5 years, where the board of equity JV may decide how to use its profits by them self. [124]

For WFOEs, a business license is usually valid for 10-30 years. However, for projects in which the amount of investment is large, or the construction period is long and the return on investment low the term may be extended to 50 years. Also projects that are producing sophisticated products using advanced or key technology provided by the foreign partner, may benefit of longer terms. The WFOE may be terminated under certain conditions such as the inability to operate due to heavy losses.[125]

8.1.3.4 Foreign Invested Commercial Enterprise (FICE)

Under the new Foreign Invested Commercial Enterprise (FICE) regulation, foreign investors are allowed to set up wholly owned commercial enterprises in China to engage in wholesale, retail business and trading activities, starting from December 11, 2004. The new measures also permit existing WFOEs to expand their business scope to include commission agency, wholesale and/or retail distribution of non self-manufactured products.[126]

Prior to the FICE regulations WFOEs were subject to high asset base or annual turnover requirements. Also, the minimum registered capital have been substantially lowered and follows those set out in the PRC company law, i.e. RMB 300 000 for retail enterprises and RMB 500 000 for wholesale enterprises. There are some exceptions for enterprises engaged in wholesale distribution of books, newspapers and magazines (minimum registered capital of RMB 30 million applies) and

[122] Baker McKenzie (2006)
[123] Virchov, krasue & Company and Baker Tilly (2005)
[124] Baker McKenzie (2006)
[125] Virchov, krasue & Company and Baker Tilly (2005)
[126] Ministry Of Commerce (2005)

commercial enterprises engaged in the retail distribution of vehicles (minimum registered capital of RMB 10 million applies).[127]

In the past WFOEs were not directly allowed to import and export products freely. Instead, indirectly strategies were used to bring products in and out from mainland. First, foreign company could setup a trading entity in a Free Trade Zone, such as Waigaoqiao in Shanghai. The benefits of this strategy are the ability to have bonded activities within the zone and have full control over the process. Second, a trading sino-equity JV entity with a Chinese business was setup. A condition was naturally that the Chinese partner had export and import licenses. Third, Chinese trading agencies are used by WFOE or Foreign representative office to import products. Finally, some foreign companies used Free Trade Agreements such as CEPA (Hong Kong) and ASEAN(Thailand, Singapore, Malaysia, and Vietnam). By shipping products through these countries custom duties would also be lowered.

However, today with the new regulations a FICE license has the benefit of free trading activities, i.e. there is no volume limit on import/export. Thus, many of the old import/export strategies are obsolete. Some restrictions still exist. In general the imported/exported products must be related with the conducted business activities of the company. Also, businesses in industries considered restricted still need licenses for import/export.

Several SMEs, which already have established business in China, may want to change their business from a production FIE to a FICE, to be able to have distribution and trading rights. However, we believe that production FIEs may need to consider the following issue when deciding whether to expand their business scopes to include distribution. If revenue derived from distribution of non-self-manufactured goods exceeds 30% of the total revenue of the production FIE, it would lose its status as a production type enterprise. This in turn would prevent the FIE from continuing to enjoy any tax holiday or other incentives provided to production type enterprises.

8.1.3.5 Other Types of Companies

Beside the three most common types of entities there are some other categories approved by the Chinese government. One of those is a holding company which is limited company established as a WFOE or an equity joint venture. A holding company allows foreign investors to coordinate and centralize some of its business activities from other business entities in China. Some of the approved business activities for the holding company include; centralize purchase of raw materials and equipment, act as a distributor, provide transportation and warehousing facilities, and establish a R&D center. Holding companies are permitted to engage in production activities.[128]

Another type of company is a branch office. With some exception, such as banking and financial business, companies are not allowed to setup branch companies. Branch

[127] Virchov, krasue & Company and Baker Tilly (2005)
[128] Baker McKenzie (2006)

offices are allowed to conduct more business activities than representative office and are often used as a local presence in diverse provincials. Today, as alternative, foreign investors are forced to setup representative offices. However, it is believed that branch offices will be open for all companies in the future.[129]

8.2 Financial & Capital Issues

8.2.1 Capital Structure

The most important concepts relating to the capitalization of FIEs are registered capital and total investment. Registered capital refers to the total amount of paid-in capital contributions by the foreign investor and/or the Chinese party in an equity JV. Total investment equals registered capital plus permitted debt financing of the FIE. The permitted debt finance does not need to be settled initially. The financing may be debt from onshore or offshore banks in RMB or other currencies. This amount is the same as the FIE's foreign currency debt ratio, which is frequently and effectively controlled by the authorities. This issue is very important to the central government as it affects the valuation of the RMB. [130]

As a result, the foreign currency debt ratio affects the capital structure of an FIE, as it must meet certain debt to equity ratios. If the total investment is less than US$3 million, at least 70 percent of the total investment must be registered capital. Thus, a total foreign currency debt ratio of 30 % is allowed. The required amount of registered capital is decreasing as the investment size increases (USD $3-10 = 50 %, USD $10-30 = 40 %, USD $30+ = 30%).[131]

In addition, onshore banks may issue additional debt financing in RMB to an FIE, if they believe the FIE may handle higher risk. However, foreign banks operating in China may also be able to offer debt financing of machinery and equipment in foreign currency for additional needs. In that case, the FIE use the foreign bank's foreign debt ratio, instead of their own.[132]

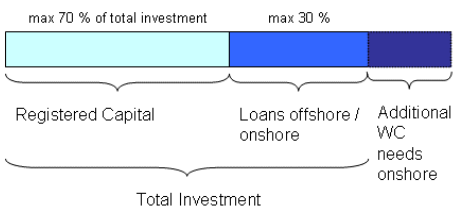


Figure 27. Capital Structure (Applied to investment size less than USD 3M)

[129] Baker McKenzie (2006)
[130] Branch Manager, Handelsbanken Shanghai Branch
[131] Ibid
[132] Ibid

When setting up a FIE a company needs to decide the amount of its total investment and registered capital. The registered capital is easy as it is the amount of the capital brought into the investment. However, the amount of total investment may be anything from the registered capital to registered capital plus permitted debt finance. Once setup, you have to re-register the FIE if you want to change the amounts. Thus, SMEs should not rush into the decision. We have recognized a few issues to consider when deciding the amount of total investment and registered capital. First, the amount of registered capital does not change according to the company's equity. Thus registered capital could not be directly compared to equity, as western companies are used to. Second, even if there is initially no debt financing of the FIE, the foreign investor should use their full debt ratio by setting a total investment 30 % higher than the registered capital. This way the FIE may use debt as financing in the future and most importantly, still have the ability to raise debt in foreign currency and use their permitted foreign debt ratio. Third, SMEs should consider overcapitalizing the company, to at least include working capital until break-even. Otherwise SMEs may have to re-register the amount several times in the years ahead which is a fairly expensive and time consuming process, in terms of accountant and lawyers fees.

8.2.2 Capital Account and Current Account

A business entity's assets are divided into two important concepts; Capital Account Items and Current Account Items. Capital account items include registered capital, foreign debt, and investment capital. These items are carefully controlled by State Administration of Foreign Exchange (SAFE) and may not benefit from free currency exchange. Current Account items include operational accounts and temporarily accounts. These items are allowed to be exchanged into foreign currency by banks, if documents such as invoices are presented. Money can easy be transferred from capital account to current account, but not the other way. Having this system, SAFE my effectively control foreign exchange.[133]

8.2.3 Foreign Exchange

The Renimibi (RMB), China's legal currency, is issued and controlled solely by the People's Bank of China. In the past the RMB was fixed against US Dollar, which has, according to many western politicians and banking officials, created an exceptionally undervalued currency (up to 40%). They also imply that the undervaluation have created some huge trading deficit for the US and Europe. In July 2005, the Chinese government addressed this international problem by making the RMB fluctuate against a basket of currencies (US Dollar, European Euro, Japanese Yen, and South-Korean Won). The immediately response was a revaluation of the RMB by 2.1 %. However, many western officials say the reform was too small and awaits further revaluation. [134]

Because the RMB is not yet fully convertible, restrictions apply to the exchange for capital account items, such as foreign exchange loans and contributions to share capital in an enterprise. These transactions are effectively controlled by SAFE.

[133] LehmanBrown, http://www.lehmanbrown.com/FAQ/FAQ-Forex/3.htm
[134] Hand (2005)

However, the banks are obliged to review the documents to be submitted. If the banks allow an illegal money transfer they will be directly liable for their actions.[135]

Foreign exchange for Current account items and profits to be distributed to foreign investors is both fully convertible. No approval by SAFE is required for the acquisition and transfer of foreign exchange to settle debts based on legal transactions that are classified as Current account items.[136]

The foreign exchange implications for SMEs may be tough. If the sales are channeled from abroad through distributors or agents in China, our recommendation is to always have sales in Euro or Dollar. That way SMEs will minimize the cost of exchange and risks.

When investing in a foreign country a general rule is to use the domestic currency. By having both income and expenses in the same currency an investor will minimize the macro economic risk of exchange rates.[137] However, as the RMB is not fully convertible, we believe that the foreign investor should use foreign currency, and thus take advantage of their foreign debt ratio when investing in China. The FIE may suffer great micro economic chocks by having cost and revenue in different currencies but should be able to mitigate this risk by buying financial instruments.

8.2.4 Debt Financing

Research shows that the lack of capital is the number one issue why SMEs fails with their investment in China. Consequently, the needs of debt financing are vast. However, the banking industry is still regulated in China including legislated differences between Foreign and Chinese banks.

Foreign banks are still very restricted by the central government. For example, to be able to handle RMB the bank needs to be operational for three years in China and then apply for a license. Only some MNC banks have the required license. Also, foreign banks may not serve customer in provinces other than the one they have a branch office in. However, some restriction has been lifted. In 2005 some financial products such as interest swaps, options and hedging instrument were open for foreign banks. And the central government has flagged for a huge relief in the end of this year (2006), as the geographical and currency restriction is thought to be lifted for foreign banks.

In the past, Chinese banks were subsidized by the Chinese government to give out non-performing loans based on *Guanxi* to any SOEs. Neither risk analysis nor feasibility studies were conducted. Some researches still believe Chinese banks have 40 % non-performing loans. As a consequence, Chinese banks do not have long experience on calculating risks. Instead still many loans are issued on the basis of

[135] LehmanBrown, http://www.lehmanbrown.com/FAQ/FAQ-Forex/3.htm
[136] Ibid
[137] Ulf Silbersky

Guanxi. In general foreign invest SMEs do not have *Guanxi* on the desirable levels, which results in expensive debt and vast demands for collateral.

However, recently there has been a significant and noticeable increase in RMB borrowings by foreign invested enterprises from Chinese banks. These loans are often secured by foreign currency cash deposits or by using foreign banks as intermediaries. A foreign bank may use the parent's assets as collateral. RMB financing are favored as it is in, most cases, cheaper than foreign currency financing. [138] This strategy is favorable for SMEs, which in most cases lacks the required collateral in China.

8.2.5 Stock Market

There are currently two stock exchanges in China; Shanghai Securities Exchange and the Shenzhen Securities Exchange. Although the Shanghai Securities Exchange has a history of only sixteen years, the market has become one of the largest stock markets in Asia.[139] There is segmentation in the market, in which local firms issue two classes of shares: class A shares available only to Chinese citizens and class B shares available only to foreign citizens. Significant stock price discounts are documented for class B shares. A reason for this is that B shares are adjusted to foreign investors' higher trading costs.[140] As the Chinese stock market becomes further integrated to the global economy, the market will become more mature and efficient, playing a more significant role in the global economy.[141]

The listings requirement of Shanghai Securities Exchange obliges a total share capital of 50 M RMB. As there is no other market for small ventures, foreign invested SMEs may unlikely be able to use the Chinese stock market for equity financing.[142]

8.3 Taxation in China

8.3.1 Value Added Tax (VAT)

China's current VAT system was introduced in 1984 and is, even after unification reforms in 1994, somewhat different compared to what the western world is used to. China is using a product-basis for their VAT-system (P-VAT) rather than a consumption-basis (C-VAT) which is commonly used by western states.[143] The main difference of the P-VAT system is that capital goods are not included in the VAT base, i.e. the input tax of fixed-assets, such as houses, construction and equipment, can't be deducted from the output tax when computing the tax payable. Furthermore, calculations are made on each product rather than as a consolidated difference of companies' activities and also, some industries such as consulting, financial, transportation and construction are subject to business tax instead of VAT. Thus by

[138] LehmanBrown, http://www.lehmanbrown.com/FAQ/FAQ-Forex/3.htm
[139] Seddighi & Nian (2004)
[140] Chen, Lee, Rui (2001)
[141] Seddighi & Nian (2004)
[142] Shanghai stock exchange, http://www.sse.com.cn/sseportal/en_us/ps/lc/lst_req.shtml
[143] Briefing of VAT under China's tax systems, www.itdweb.org

having the P-VAT system, the Chinese government may benefit from vast revenues from VAT, but also limit investments from foreign investors. [144]

In China, VAT is administrated by the State Administration of Taxation (SAT) and the revenue is shared between the central government (75 %) and the local governments (25%). VAT is obligated to basically all enterprises and individuals which conduct business within the boarders of the Chinese territory. Taxpayers can be divided into two categories; normal taxpayers and small taxpayers. The definition of a small taxpayer is either a taxpayer who is engaged in production of goods, in the provision of taxable services with a turnover less than RMB 1M, or when the taxpayer is engaged in wholesale or retail of goods with a turnover less than RMB 1.8M. The Applicable rate is 4% for the commercial sector and 6% for other sectors.

Normal taxpayers and VAT for imported goods are mostly faced by the applicable rate of 17% VAT. Exceptions exist, such as media, agriculture, raw-material, and petroleum products, which have an applicable rate of 13 %. Exported goods are in title of a refund of the VAT. The size of the refund varies between industries and comprises in a range of 3% - 17% depending on government regulations. The government frequently changes the size of the refund to either protect domestic industry or to strain over heated industries.[145]

Calculations of VAT	
Small tax payers	***VAT = Sales volume × Applicable rate***
Normal tax payers	***VAT = Output tax payable for the current period - input tax payable for the current period*** ***Output tax payable = Sales volume in the current period × Applicable tax rate***
Imports	***VAT = Composite assessable price × Applicable VAT rate*** ***Composite assessable price=Customs completion price □Custom Duty***
Exports	***VAT refund of 3%-17%***

Table 10 Calculations of VAT

For making an equitable market environment and stimulating the investment, the Chinese government prepares to make a reform of VAT, which will change the type of China's VAT from the P-VAT type to the C-VAT type. This change would not only result in capital goods would be included in the tax base, but also that exported goods would receive full refunds. However, transformation will probably last several years because of the challenges involved.[146] One major challenge is the vast loss of income, in 2004 VAT accounted for 34 % of China's total tax revenue.[147] Another challenge is the transformation that would result in considerable losses for local

[144] Ministry of Finance of P.R.C (2005)
[145] Briefing of VAT under China's tax systems, www.itdweb.org
[146] Singh (2004)
[147] Ministry of Finance, www.mof.gov.cn

governments which would require an adequate compensation system. Such a system will be complex to implement and handle since different regions would benefit differently of a change towards a C-VAT system. [148] In March 2005, at the International Tax Dialogue, China reported its first experiments, conducted in a few north-east provinces, had been initiated. In these provinces, normal tax payers of VAT in eight selected industries may deduct the input tax of equipment used for production. [149]

We believe that, with the development of Chinese economy and the increase of reform experiences, the central government will in a few years implement the VAT reform in all industries and provinces of China. Also, for setting up a uniform and equitable turnover tax system, some industries subjected to Business Tax would be levy on VAT at an opportune time.

8.3.2 Business Tax

Some industries such as transportation, construction, post, telecom, consulting, financial, insurance, and other service industries are liable to business tax instead of VAT. Business tax is levied on gross turnover instead on a value added base. The rate differs from 3% to 20%, but limited exceptions from business tax may apply to some services. The conversion from P-VAT system to C-VAT may imply that business tax will disappear in favor of VAT in the future. [150]

8.3.3 Custom Duties

Customs duties are paid when importing or exporting goods to or from mainland china. China has complied with WTO commitment and significantly lowered custom tariffs on important industries. Some industries, such as computer circuit boards may even benefits from zero rate duties. Other industries such as the automotive industry, which suffered from 100% custom tariff in 2001, have been granted 20 percent custom duties in 2006. The average custom tariff in 2006 is 9,9 percent.[151]

The 149 members of WTO are obliged to the Most Favored Nations (MFN) tariffs. However, China has signed other trade agreements such as ASEAN (Thailand, Singapore, Malaysia, and Vietnam) and CEPA (Hong Kong). These special agreements may benefit from up to 50% less applied tariff than the MFN tariffs. Countries that do not have any trade agreements with China and are not members of WTO are obliged to the highest applied tariffs, the general tariffs.[152]

Custom duties and VAT are exempt on machinery and equipment which are within the amount of the FIEs total investment and used by a production FIE. Also the

[148] Singh (2004)
[149] Briefing of VAT under China’s tax systems, www.itdweb.org
[150] PricewaterhouseCoopers (2004)
[151] Lim E., China Supply Chain Council Conference
[152] Consultant, Swedish Trade Council

project needs to include technology transfer and fall within the encouraged category in the investment catalogue.[153]

8.3.4 Enterprise Income Tax

The general Enterprise Income tax is 33 percent, which 30 percent benefits the government and 3 percent the local authorities. However, foreign investor may benefit from vast tax holidays of. As shown in Table. 11, many development zones have incentives for foreign investors depending on the nature of its business. Traditionally, export oriented and hi-tech industries are encouraged industries, and thus subject to vast tax benefits.

Special condition	Enterprise Income tax
None	**33 %**
FIE localized in national development zones and special economic zones	**15 %**
Production FIE in national development zone and more than 70 % export	**10 %**
Production FIE with operation period exceeding 10 years	**0% for two years after the first year of profit, then 50% reduction of the income tax for three years**
Adoption of advanced technology	**0% for two years, then 50% reduction of the income tax for six years**
More than 70% of sales volume is exported	**50% reduction of the income tax**
Obtained profit reinvested in a project that exceeds no less than five years.	**Refund of 40% on the income tax already paid on the invested amount**

Table. 11 Enterprise Income Tax

Several domestic companies have complained about foreign investors' tax holidays which they say creates unfair domestic competition. WTO also states the requirement of fair competition domestically. Consequently tax holidays for foreign investor will be gradually removed in the future. Most interviewees believe that the new enterprise income tax rate will be around 20-25% for all companies in China. It is also discussed if the existed terms for foreign investor will be grandfathered or not. The concept of grandfathering mean that the terms will be subject of heritage when the rate changes, e.g. an existing production FIE will face the new rate but still be valid for the 0% two year holiday and 50% three years on the new tax rate. Though, no one, except the Chinese government, knows when the new tax rate will be implemented and at which rate. Some banking firms recommend SMEs to establish production FIEs before the beginning of 2007 to be able to benefit from grandfathering, but others believe there is no rush, as the government would not be able to implement a full scale change of the income tax in less than a year. But prior records from the Chinese government show proof of vast irrational behavior. Thus, the political risk in this issue is large.

[153] PricewaterhouseCoopers (2004)

8.3.5 Individual Income tax

Individual income tax is paid monthly by every employee in China who earns more than RMB 500 per month. Expatriates working in China for a Chinese registered company will also be deemed the same income tax rates as shown in Table 12.[154]

Monthly taxable income		Tax on lower amount	Percentage on excess
Over	Less than		
0	500	0	5
500	2,000	25	10
2,000	5000	175	15
5,000	20,000	625	20
20,000	40,000	3625	25
40,000	60,000	8,625	30
60,000	80,000	14,625	35
80,000	100,000	21,625	40
100,000		29,625	45

Table 12 Individual Income Tax

8.3.6 Other Taxes

Other taxes include consumption tax, land appreciation tax, and stamp tax. Consumption tax is paid by manufactories and importers which produce/import consumer goods such as alcohol, tobacco, fireworks, hair and skin products, and jewellery. The rates differ from 5% to 50% and are paid after custom duties and VAT. Land appreciation tax is levied on real estate gains at a progressive rate from 30% to 60%. Stamp tax is levied on anyone who receives or executes “specific documents”. Rates differ between 0.005 % on loan contracts to 0.1 % on property leasing and property insurance contracts. Royalty on software has a flat tax rate of 10 %.[155]

8.4 Feasibility Study

The feasibility study is a way to analyze the possibility of success of an investment. We have created a model, based upon a feasibility study, which will guide SMEs investing in China. A feasibility study is actually also required by the authorities when investing in China.

First of all, the investment’s needs are fetched from the previous perspectives in the best-practice model. Thus the conclusions from previous chapters are inputs to the feasibility study. A key success factor for the investment is to design an accurate business setup that corresponds to the investments needs. After that the pros and cons of different business entities need to be considered. Next step in the study shows how the investment is to be financed. Lastly, quantitative analyses need to be done. The

[154] PricewaterhouseCoopers (2004)
[155] Ibid

types of these may differ, but usually an investment analysis, a break-even analysis, and a risk analysis should be conducted.

A feasibility study should help top management to define their business in China and to make sure it will be profitable in a long term perspective. It will result in an investment proposal which is to be examined by the top management. The study should be regarded as support for decisions but also a way to legitimate the investment for board members and stock holders.

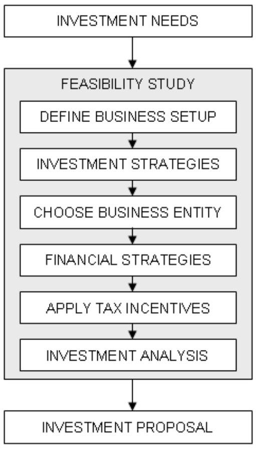


Figure 28. Feasibility study

8.4.1 Define Business Setup

When defining a SME business setup, many factors have to be considered. All conclusions from previous perspectives have to be accounted for as the needs of the business will appear. Issues such as import/export, domestic logistics, and potential production sites will create the uniqueness of the business setup.

However we have some general recommendations on how to define the business setup. When choosing business setup one has to consider flexibility. The Chinese market conditions are highly flexible, thus we believe an investment in China needs to be the same. The option of buying a land-use right and building a factory may be a good investment for the future. But it such a commitment lowers the enterprise's flexibility and raises the risk of the investment. For example, in a couple of years the wages in this area might raise significantly which consequently makes the company loose its competitive advantage.

Most companies stand between the choice of a sales setup and/or a production setup. MNCs have the capital to invest in both sales channels and production sites at the same time. Investing in both setups may increase the total risk but will probably increase the expected rate of return of the investment. There are significant benefits having both production and sales in China. A local production site in China will boost sales to Chinese customers as the cost structure will decrease due to low-cost labor and local suppliers.

Naturally, SMEs have a much more limited resource of capital than MNCs. An investment for SMEs is most likely to be a bigger proportion of the capital base and thus, SMEs need to make incremental investments over time. The setup of a production facility is most likely to be a full-size investment. However, without sufficient demand, an investment in a merely production facility would result in overcapacity. An investment in a merely sales setup is also expensive, in particular the cost of branding, recruitment, and training staff. Eventually, the sales force will not be successful in the highly competitive business environment due to fact that in most industries local production is a qualifier for doing business in China.

As shown in Figure 29, we have identified some general recommendation for different SMEs depending on two factors; an established sales network in China and what type of goods the company produce. The competitive environment in China is not to be underestimated, thus we believe it is most likely to begin with production setup for home market. However if the products are high-end and there are existing sales channels in China, a sales setup will make sense.

	Existing Chinese sales channels	No sales channels
High-end products	**Sales Setup for the Chinese market**	**Production Setup for overseas markets**
Low-end products	**Production Setup for overseas and Chinese markets**	**Production Setup for overseas markets**

Figure 29. Sales/production setup matrix

8.4.2 Investment Strategies

Statistics show that there are not that many FIEs which have actually been forced to redraw from China. Most foreign investor has instead been committed to feed FIEs with new capital to maintain a loss business in China. One reason for continuously supporting the loss is a sound long term commitment of the investment. Most companies realize that the investment will be profitable in time, at least as cost effective productions center for home markets. A strategy to temporarily finance a FIE is to give accounts receivable with exceptional long terms, when buying products from the parent. Another way is to use transfer pricing. Transfer pricing is effectively controlled by the authorities as they want to assure that all products being imported have market values. As a consequence we do not recommend changing value of the goods more than +/- 10%.

As most business will be successfully in time, we believe it is important to have a long term commitment in an investment. At least 5 years are appropriate. However, for a SME this long term commitment might not be possible. Thus, it is also important to form an exit strategy. An exit strategy lies within the need of a flexible strategy. Although it is not encouraged, the option to redraw from an investment is existent. In general, after paying off all debt, the foreign investor should be able to retain most of its capital if they decide to redraw from its investment in China.

8.4.3 Choosing Business Entity

In particular for SMEs, the option between a representative office, JV, and WFOE is a very important choice for its future China strategies. The most common way for SMEs to start business in China is to establish a representative office. We believe this is a very important step for a foreign invested SME to learn from the Chinese market, culture, and business practice. The costs are fairly low, RMB 0.5M in investment and RMB 0.5M / year is a fair estimate of a small representative office with local Chinese staff and 150 m2 office area in Shanghai. However, hiring expatriates will easily double or triple the running costs of the office. The process of setting up a representative office is rather easy and quick and do not need registration by MOFCOM. The main purpose of the office is to support distributors and customers as well as engage it sourcing activities for its parent. Other favorable business activates is branding and non revenue after sales and support. If the SMEs goal is just to source in China, no other setup is necessary.

	Rep Office	Equity JV	WFOE
Legal status	**Not a legal entity, represents and engages the legal responsibility of the parent**	**A foreign invested limited liability company under Chinese law**	**A foreign invested limited liability company under Chinese law**
Ownership	**100% Parent**	**50/50 Chinese/foreign**	**100 % Foreign(s)**
Minimum registered capital	**None**	**RMB 500 000**	**RMB 500 000/ 300 000**
Revenue generating	**Prohibited**	**Allowed**	**Allowed**
Profits	**Negative**	**Shared with partner**	**Positive**
Income Tax	**Calculated on costs**	**Calculated on profits**	**Calculated on profits**
Receive money from parent	**Allowed**	**Allowed**	**Allowed**
Send money to parent	**Prohibited**	**Allowed**	**Allowed**
Office area	**Restricted to approved office buildings**	**Few restrictions**	**Development zones preferred**
Investment incentives	**-**	**Medium**	**Very High**
Import/export	**Prohibited**	**Allowed with licenses**	**Allowed with FICE**
Patents and trademarks	**-**	**Shared with partner**	**Owned by parent(s)**
After sales & repairs	**Prohibited**	**Allowed**	**Allowed**
Prohibited industries (examples)	**Publishing, Media, Military industry**	**Publishing, Media, Military industry**	**Publishing, Media, Military, Automotive and Oil industry**

Table 13. A comparison between enterprise types in China

However, several SMEs start to realize the benefits with local production and/or the possibilities of the world's biggest market. Hence, the representative office may no longer support all business activities needed by the SME. For most SMEs, the second choice is between to setup an equity joint venture with a Chinese party or to form a WFOE. A summarized comparison between these most common choices of business entity is shown by Table 13.

The advantages of establishing a WFOE include the independence and freedom to implement the worldwide strategies of its parent company without having to consider the involvement of the Chinese partner. As being 100 % foreign owned the SME may also better protect intellectual know-how and technology. WFOE, in particular high tech production entities, may also benefit from high investment incentives from development zones.

However, an equity JV do have some benefits over a WFOE. In particular SMEs may not have either the financial strength or the internal resources to setup a WFOE business. The foreign investor may lack local market knowledge and authorities connections. A normal setup for an equity JV is by having a Chinese party responsible for labor and factory facilities, while the foreign investor contributes with products, know-how, and technology. Another benefit with the equity JV is that the risk of the project is shared.

In the past, the most common way to setup a business was as an equity joint venture with a Chinese party. The main reason for this was strict industry regulations by the Chinese government but also foreign partners' lack of Chinese business practice. Today, most foreign investors believe being wholly owned, may achieve greater efficiency in operations, management and future development. Hence, several equity joint ventures have ended up in the foreign party buying out the Chinese party and becoming wholly owned.

We believe that the benefits of setting up an equity joint venture are continuously shrinking as the WFOE gains access to more and more industries and business activities. Today, with a FICE production entity, a foreign investor may conduct most business activities needed for cost effective production and sales in China. Thus, our main recommendation is to setup a WFOE.

However, there are situations when an equity joint venture still makes sense. For instance, if the SME have truly good relationship with a Chinese party that has the resources the SME lacks, a joint venture may make sense. The synergies have to be vast and company specific, rather then just general for the industry. It is common to base a joint venture on a Chinese party's contacts to authorities, clients and/or suppliers. We believe it is very risky to rely on a complete business case on contacts from a Chinese party, and most definite not enough to build a long lasting relationship. The synergies should rather be a couple of diverse factors that will complement the competencies of the SME's in different ways. To mitigate the risk of entering a JV with a partner which has bad intention, a vast due-diligence should be conducted. The process of due diligence is not merely to look at balance sheets in China, especially when there is a lack of transparency and hierarchical structures. Intelligence is utterly important and should be used to find out who is running the company, what are their backgrounds and credentials, what are their competences, and if there are any hidden connections.

8.4.4 Financial Strategies

When investing in China it is very important to comprehend the concept of registered capital and total investment. A common mistake, often done by SMEs, is to use the same amount for these two concepts. By doing this the SME may not be able to raise any debt or use its foreign debt capacity. A small investment (less than USD 3M) should state a 30 % higher value for total investment than registered capital. This strategy will be beneficial as the full potential of the debt to equity ratio (1:3) can be used for debt financing.

We also recommend the SME to over capitalize their investment, at least to include the cost until break-even. Otherwise the firm will need to file for a new business license every time the registered capital amount is changed. This process may be time consuming and costly.

When using debt finance we recommend using an acknowledged foreign bank with a branch office in China, as an intermediary for raising debt in RMB. The benefits of having a foreign bank are many. Foreign banks know SMEs from their home market and may use parents as collateral for debt financing. They also prove to be much better at risk analysis than domestic Chinese banks. A huge cut is that foreign banks may not yet issue debt in RMB, instead they will most definite use a Chinese bank to issue the actual debt in RMB. This setup is naturally more expensive than borrowing directly from a Chinese bank. However as all foreign banks will gain the RMB license in the end of this year (2006) we believe SMEs should go use a safe foreign bank which they already have business with at their home market.

8.4.5 Apply Tax Incentives

In the beginning of this chapter we stated that regulations and laws changes significant over time in China. We believe that most tax incentives for foreign enterprises will gradually disappear as the Chinese government strives to create a market with fair competition between both domestic and foreign invested companies. The domestic companies have gained intense competition from foreign invested businesses which have since the recent 10 year benefited from tax holidays. Most people believe that the tax holidays in enterprise income tax will disappear within a year. We believe that SMEs should consider a formal registration of the entity before the beginning of 2007 to benefit from the alleged grandfathering rules. Thus, we think that SME should take advantage of the beneficial terms still available to foreign investors but be they should not be calculate to last in indefinite. The incentives should rather be treated as bonuses than a decisive factor for the choice of an investment.

Other reforms are more enjoyable for foreign investor. For example, the VAT reform will play a significant role. Today the system is complex and expensive for foreign investor. A transition to the western C-VAT system will make it less complex and costly for foreign investors in China. The new system is already at a test level, which means it will likely be implemented in a short future.

8.4.6 Investment Analysis

Many foreign companies invest in China on the basis of a top management positive feeling rather than a well studied investment analysis. Management realizes the company needs to be in China to survive the competitive environment in their home markets. However an investment analysis will most definitely help top management in their decision process and legitimate the investment for board members and stock holders.

The investment analysis may differ depending on which project is studied. For a full setup, including both a production and sales setup in China, usually a break-even analysis showing volume and price sensitivity should be conducted. This way the company may mitigate the risks of a failing in the market by setting up a worst case scenario. Investing in a solely production setup for home markets may be easier to calculate on, as the demand for home markets are steady. In this case the calculation should rather be based on cost reduction for the parent than sales in China. For production setups, an aspect to consider is the amount of domestic sourcing versus imported components used in the production. This amount will likely change over time, and thus affect the calculated net present value of the investment.

Another important tool is cash flow analysis which will show the total amount of cash needed until break-even. This amount should be used as total investment when formally register the FIE, to mitigate the need of re-registration of the investment.

9 The STAR model

As we explained in the initial chapters, SMEs faces particular difficulties when entering the Chinese market. Our best-practice model is based upon five perspectives. All five perspectives have been analyzed separately in depth in the previous chapters. The goal of the model is to present SMEs a comprehensive picture of doing business in China. Due to the vast amount of issues that need be considered, we believe the model will help foreign invested SMEs not to neglect or overlook any key issue. In other words, our model is not just a framework for creating a sound entry strategy for China but also a framework for controlling whether a company, in the process of entering, has done their homework or not.

When applying the model to a business case, we recommend a grounded sequential analyze of the different perspectives. This approach will assure that no important issues will be overlooked when analyzing the vast information. As seen, the perspectives are in a rational order starting with human resources and culture and finish with the investment perspective. Naturally, in the end of the investment perspective there is a feasibility study, which feeds inputs from all other perspectives and results in an investment proposal.

The essence of the model is to make sure that all five perspectives have been considered. Naturally business setups may differ vastly and as a consequence the perspectives do not need equal attention. For instance, a foreign investor investing in a production setup for home markets will not need to analyze the sales & marketing perspective. Also a sales setup has no need for the development zones perspective. Thus, the best practice model is a dynamic model which may be applicable on most SME's ventures in China.

Before applying the model on a framework, the limitations of the model needs to be considered. First of all does the model need to be complemented with the text in the report, i.e. it is important for users to have a full understanding of what the concepts in the model is about before using it. Second, the model might have weaknesses in terms of important data that didn't become available for us during our interviews that might be relevant for SMEs. Third, the model is a perishable in terms of the dynamic market and political environment in China. However, as a first test, the model has been successfully applied on Emotron AB, a second wave-company in process of investing in China. Still, further testing is needed and we believe that such testing could contribute to a updating of the model since new issues will be found in the ever changing environment of China.

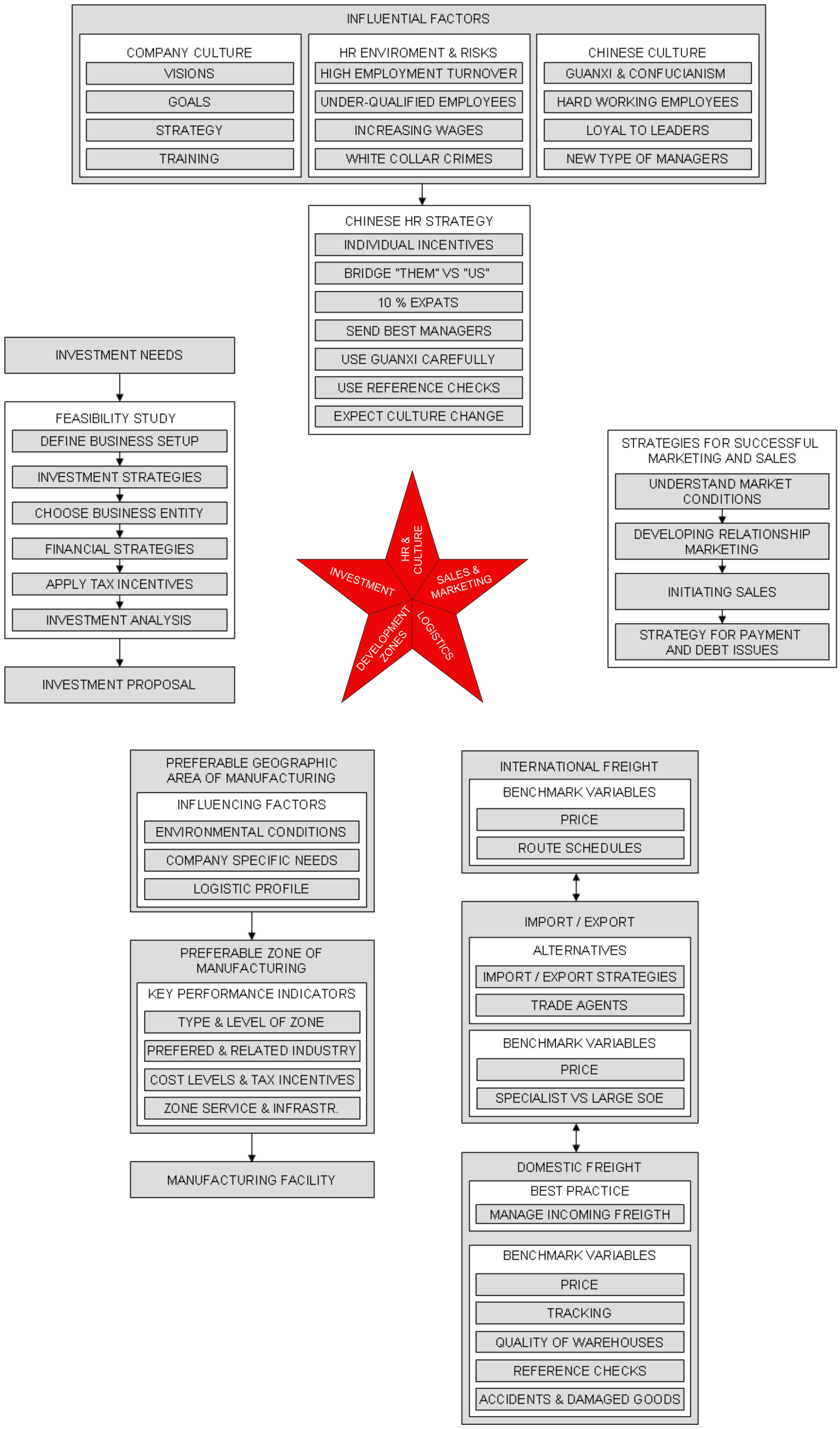


Figure 30. The STAR model

10 Applying the STAR model

To be able to validate the STAR model a test is conducted on our case company, Emotron. Firstly, we introduce the case company and its current business. Thereafter we apply the STAR model's different perspective subsequently on Emotron. Finally we provide Emotron with recommendations on their future strategies in China.

10.1 Introduction to Case Company

Emotron Group is a second wave company that recently has initiated business activities in China. The group's headquarter was founded in 1992 in Helsingborg, Sweden. After a couple of tough years consisting of mergers and acquisitions, high R&D expenses, and declining profits the top management was replaced in 2002. Since then Emotron has managed to retain black numbers at the bottom line and is now looking at China both as new potential market, and as a future platform for production.

10.1.1 Business Model

Emotron's sales are in general generated through large OEMs and a global network of distributors whose customers mainly buy Emotron's products for single various projects. Main markets are all close to the locations of the production sites in Nordic countries, Germany, and Benelux. In periphery markets such as South America and Asia, distributors and support organizations are established to co-ordinate business between customers, distributors, and Emotron.

The market is considered mature as the volume is steadily growing with only three percent per year. This forces its actors to find niches in segments and application, if they do not wish to compete merely on price. Emotron's strategy is to use their core competences of creating specially designed algorithms that provides superior applications for the segments of water, industry, and HVAC. Even though Emotron's market shares are increasing they still face fierce competition from competitors such as Siemens, ABB, and Vacon which all have larger accumulated sales volumes than Emotron.

Figure 31. Distribution of Emotron's sales per market and sales per market group

10.1.2 Product Portfolio

With focus on solutions to start, stop, protect, monitor and control machines and processes, driven by electric motors, Emotron's product portfolio consists of three major product groups; shaft-guards, soft-starters, and frequency-inverters. Shaft-guards are Programmable Logic Controllers that protect motors from malfunctions caused by dry running, cavitations, or jamming. Soft-starters are based on the technologies from the shaft-guard but can also control the torque-ramp for electrical motors thereby reducing the starting current. The soft-starters are also used as soft-stoppers in situations such as prevention of water hammering. Frequency-inverters, also known as variable speed drives comprises the technologies of both shaft-guards and soft-starters while also controlling motor and process behaviors.

10.1.3 Production

As a result of its mergers and acquisitions, Emotron's production facilities are localized in Sweden, Germany, and Benelux. The production process is fairly straight forward and is, due to modularizations techniques, divided into two steps. (See Figure 32).

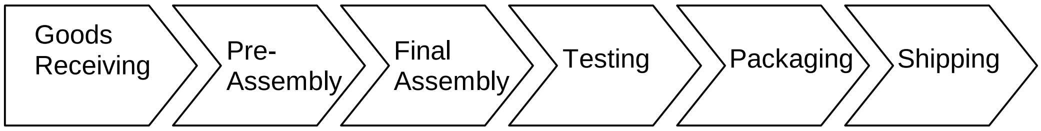


Figure 32.Flow chart of Emotron's production and distribution process

10.1.4 Sourcing

Emotron's sourcing network is scattered all over the world with a concentration of suppliers in Europe and Sweden. Even though less advanced products, such as shaft guards, are purchased from OEMs, most of Emotron's products are assembled in-house. Electrical components such as circuit boards are purchased from east-European assembly suppliers, which use Chinese companies as their suppliers. Despite a scattered scouring network most of the components are subjects to lead-times of five to six weeks which is considered to be an industry standard.

10.1.5 The Chinese Strategy

With increasing profits Emotron is now looking for ways to expand their sales volume. This can be done by expanding current market shares and / or finding new market opportunities. In the last couple of years China has become an increasingly interesting market for future expansion. First of all is the need for Emotron's product groups particularly high because of the proliferation of new projects China's expansion is providing. Furthermore have Emotron's competitors already a head start of a couple of years in the market which creates a need to participate in order to become internationally competitive. Finally, competitors have already built Chinese production facilities that give them lower production costs and shorter lead times to their Chinese customers.

In 2005 an opportunity opened up when Emotron initiated contact with two Chinese professors formally in business with one of their competitors. With the professors' market knowledge and business connections Emotron managed to set up a distribution network as a first step to support future sales. In January 2006 Emotron established a foreign representative office in Shanghai to support the sales setup.

The current order procedure in Chinas could be illustrated by figure 33. This procedure is very common as the first step for SMEs in a sales setup. Emotron's customer, the distributors, channels the orders through a foreign representative office. However, the representative office is not entitled to sign any contracts. The contract is settled directly between the distributors and Emotron Group. Some distributors have import licenses but most lack the license. Thus, in most cases import agents are needed for the actual importing procedure of the goods. In the case of Emotron, most distributors use their own import agent. When importing products the import agent is the formal owner of the products.

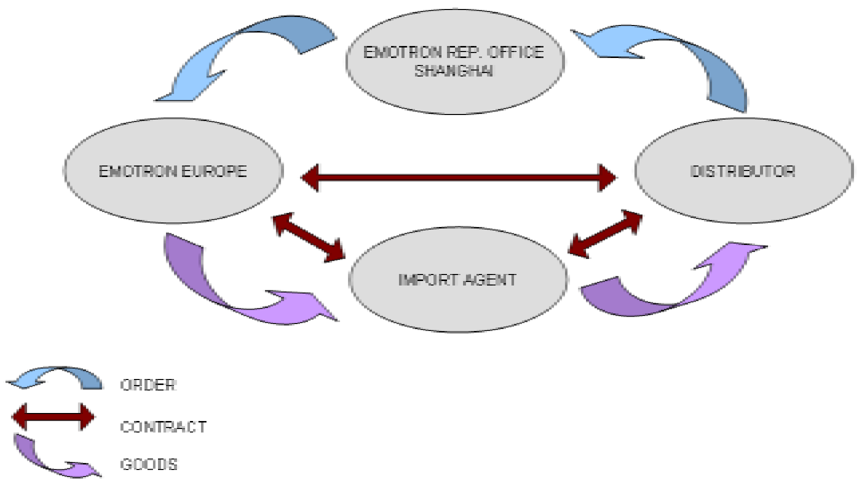
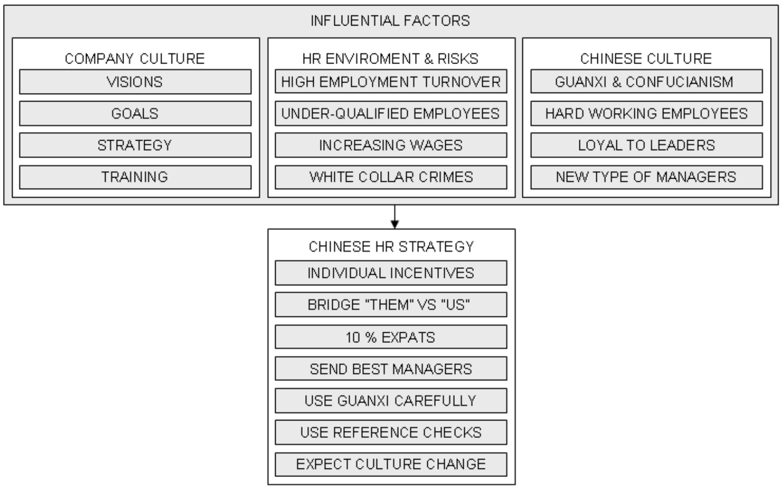


Figure 33. Emotron's order procedure in China

By using this order procedure Emotron have initiating their first sales in China. However the products have been victim to both high transport costs and import tariffs leading to high landed cost. The top management is convinced that the landed cost needs to decrease, thus making the products more competitive in China.

10.2 HR & Culture

One of Emotron's biggest advantages is the two newly hired Chinese professors in China. These managers have excellent market connections with a network of distributors, which is a key success factor to do business in China. The managers have worked abroad and are used to do business with foreign companies. We believe the relationship between them and the top management of Emotron is trustfully and sincere. However, Emotron's Chinese venture is very depending on these two individuals and should consider engaging strategies to mitigate this negative power balance. Today, without them, sales will definite fail in China as the head quarter does neither have the experience nor the relationships needed to be successful independently in China. We recommend an active strategy to initiate more formal and long term contracts with the distributors, instead of relying on guanxi of their employees. However, relationship needs to be built and maintained by Emotrons European staff. As long as no expatriate is on site in China, Emotron need to send top managers to China. Naturally this is very expensive, but we believe it is of most importance to gain direct personal relationships with the distributors and other customers or suppliers without having the Chinese employees as intermediaries. This will mitigate the risk of losing important distributors if key personal decide to leave the company.



A future production setup will naturally need a more predominant HR strategy. One important component is to leverage the strong company culture. Emotron’s visions, goals and strategies need to be communicated to the Chinese staff. Also, the key personal in China needs to be fully integrated in the group organization. This will be achieved on site at the head quarter by company training. The costs of training will be high. However, we believe it is wisely invested money as these key players are extremely important to keep. Also, individual incentive programs need to be implemented for all personal, not only managers. Incentive structures are the best way to mitigate high employment turnover, which will be a vast future challenge. We also believe it would be sound to send an expatriate manager, who can complement the Chinese managers and bring company goals and visions to the production facility. Sending a representative from the parent will also lower the cost of relationship building as the top management may de-centralize relationship building to the manager. The expatriate manager needs to be open to culture challenges and be prepared to follow up and micro-manage decisions. The current Chinese employees may be of vast importance to mitigate culture differences due to their ability to bridge the gap between Chinese employees and the western business practice.

When hiring employees in China the top management of Emotron needs to use strong reference checks. We recommend Emotron to consult western headhunting and HR firms, at least for key personal. These firms may also assure qualified employees.

Another recommended strategy is to have a strict employment policy should that limits the FIE from hiring relatives and close friends of current employees.

As Emotron's core competence lies within its software, we believe it will be hard for competitors or, in a worst case scenario, in-house white collars to counterfeit Emotron's products. We do not recommend Emotron to move any actual R&D to China at this stage. This might be needed to gain the hi-tech incentives from authorities but would jeopardize Emotron's core competence. We also believe that counterfeit would probably occur at MNCs where the products and brands are well-known and the reference control of employees less effective due to the total number of employees and high employment turnover.

10.3 Sales & Marketing

Today, Emotron is doing business in China using merely a sales setup. The strategy is to export their products through Chinese distributors to the Chinese market. The market for Emotron's products in China is huge but the competitive environment, in particular on price, is way fiercer than in the company's home markets. As previously discussed in the HR & Culture perspective, the network of distributors are a key success factor for Emotron's market penetration in China. It is thus very important to keep this network by all means. However we believe that there are some other strategies which will help boosting sales in China.

Initially, it is important to fully understand the market conditions. Emotron's products are currently very hard to sell in China. The products are over-priced due to high landed cost and the brand is yet unknown in the Chinese market. These two challenges needs to be addressed if sales are going to rose.

Landed cost needs to decrease, but as our analysis will show in the logistics perspective, any immense changes will be hard to achieve in the current sales setup. Another way to address the problem is to use a penetration price strategy to be able to gain some initial market shares. However, this strategy may be expensive in the long term as the margins will drop. If investing in a production setup, the landed cost will most definite be significantly decreased. Thus, great synergies are created when setting up a full setup instead of a merely sales setup.

The second challenge is already addressed in a small scale by the foreign representative office, which has started branding activities in China. However, these activities need to be intensified and focused on Emotron's core competence and its benefits. We believe using case examples would be an excellent marketing strategy in China. Empirical evidence shows that, in particular, Chinese customers often may need to be educated in how to use different products and applications. Concepts such as quality and long term perspectives may need to be emphasized. We believe that case examples will address these issues.

If invested in a more dominant sales setup Emotron would be able to create a more powerful sales force. Empirical evidence show that market conditions in China is exceptionally local. Instead of having a big sales force in Shanghai, we recommend to have local sales people with local knowledge in many provinces. Guanxi and personal relationships should be used but needs to be systematized. A good strategy is to map the current relationships in CRM software or a relationship diagram and actively work on maintaining and gaining further important relationships.

Despite the importance of local markets in China, some of Emotron's potential customers are nationwide and OEM-customers which demand special attention from the sales force. It is therefore advisable to have key account managers on a national level to handle OEMs and other national customers. This strategy will also mitigate the risk of channeling all sales through the distributor network.

It is of most importance for Emotron to have a strategy for payment and debt issues. Today all orders are paid up front using letters of credit. We recommend Emotron to continue with this safe strategy as long as the current sales setup is not changed. With no formal legal entity in China, it could be incredibly hard to retain accounts receivable. However, if a legal FIE is set up in China the risks will decrease, as reference checks and better relationships will be available. In this case Emotron should consider using less strict terms, at least for loyal customers. Empirical notions show that Emotron's customers will buy significantly bigger volumes, if they were allowed to purchase on credit or at 50 % up front.

10.4 Logistics

Emotron has, at its head office, designated one member of the staff to coordinate its logistics. The company has a history of organizing their logistics both from suppliers and to customers. Emotron's ambition to have large volumes gives them more beneficiary deals. Currently several 3PLs are used depending on which mean of transportation is used and where the goods are shipped. China is a relatively new market, and therefore few goods have at this time been sent. So far, all products, service material, and promotion materials have been transported by air freight. The cost of air freight is high but convenient since volumes have been low and distributors are scattered all over the eastern parts of China.

The cost structure of imports was investigated in case 6.4. Many of the aspects in that case also apply to Emotron. Still, Emotron has a slightly different cost structure which mainly depends on the products ratio of weight versus price. In our efforts to visualize the cost structure without knowing how large volumes that will be shipped, we have made estimations on the impacts of shipping and air freight. As shown in case 6.4 rail freight is not yet an alternative for Emotron.

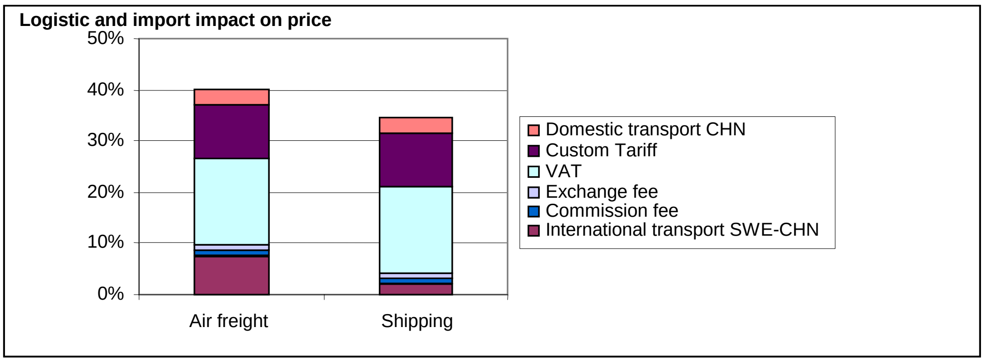


Figure 34. Cost structures of shipping and air freight

As we discussed before, Emotron has shown concern about their landed cost. From Chinese sources Emotron has been informed that the import adds up to about 40 percent compared to the cost of ex-work. Our analysis has shown that this is an accurate estimation but the question of the possibility to lower the landed cost still remains. The initial view of Emotron's distribution chain is visualized in Figure 35.

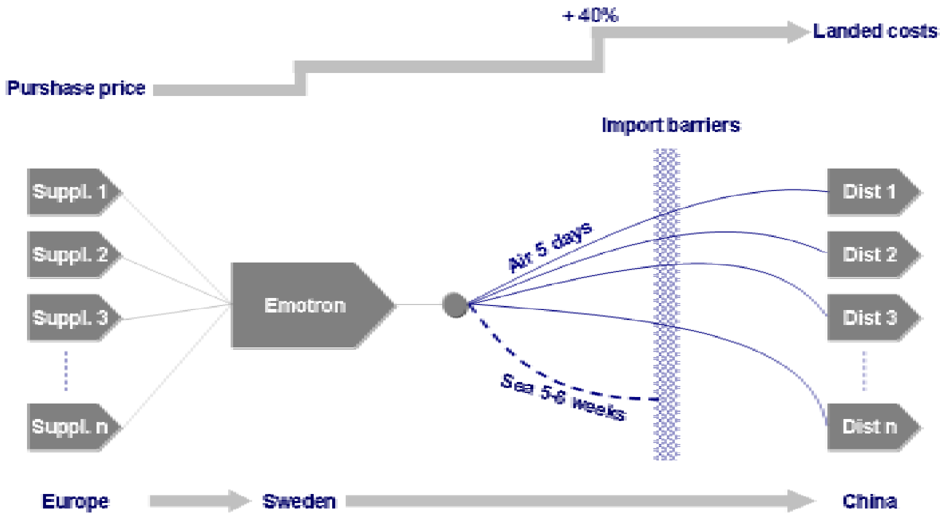
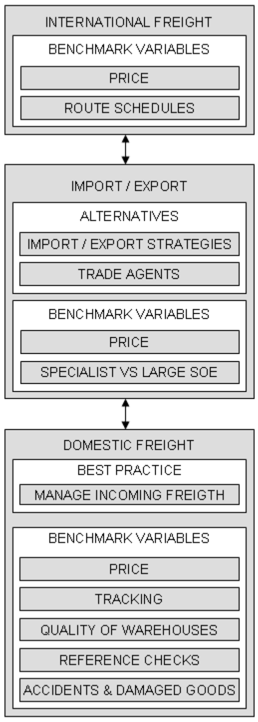


Figure 35. Current distribution chain to China

In order to lower Emotron's landed cost we use the logistic part of the STAR model. The different parts of the model will ensure us that costs are lowered and different import/export strategies will be analyzed.



10.4.1 International Transport

Emotron is one of the few companies exporting products to the Chinese market. Most companies are doing the contrary i.e. exporting from China to western countries. Empty containers being shipped back to China give Emotron potential leverage when dealing with different 3PLs. Furthermore, Emotron also carries the advantage of using their other transport volumes as additional leverage. Air freight has currently several advantages compared to shipping. First of all, routes are more specialized since goods can be transported to nearest city of destination thereby reducing domestic logistic costs. Second, short lead times are something the distributors and customers strongly prefer. Our recommendation is therefore to keep using air freight and do a thorough benchmark effort to reduce international logistic costs with frequent checks to ensure low prices.

10.4.2 Import and Export Strategies

As for now, Emotron has been using three different import agents which are business partners of their distributors. The commission fees are about one percent which corresponds to the market average. An exchange fee is also applied which we believe is mandatory. This strategy has the advantage of using import agents with previous experience of Emotron's products. Furthermore, it might not be wise to change trading agent if Emotron doesn't also want to change import strategy since the learning costs might become high. However, if Emotron do decide to change their strategy we recommend them to use a private import agent since such an importer will probably have specific knowledge of their products and will give Emotron better attention. In case of sales volumes start to increase unexpectedly high and Emotron decides to build a factory, we recommend that an import/export license is acquired.

One way of reducing commission fees of trade agents would be to consolidate volumes to one trading agent. This would also lower air freight costs which are dependent on volume. However, domestic logistic costs would be higher (even though we might have over-calculated them in the following example) and warehouse solutions might be necessary. But if customers already purchased the goods or distributors can provide warehousing for some of the products cost reductions can be made. Another advantage would be the benefit of using only one import agent which would streamline the current complicated import procedures.

Example 1 – *Consequence of consolidating volumes and reducing import agents*
If goods for RMB 10 000 000 are being sent to China this would correspond to approximately 200 units. In this example the order is shipped to Shanghai and taken care of by only one import agent. The goods are then equally divided to Emotron's five distributors spread throughout the east coast of China. Each unit weighs about 25 kg. The domestic costs which are based on using a full two tons truck are illustrated in Table 14 on calculated on case 6.4 from the Logistic chapter.

Distributor	Distance from Shanghai	Units	weight	Logistic cost
Guangzhou	1848 km	40	1000 kg	RMB 930
Hangzhou	218 km	40	1000 kg	RMB 1450
Nanjing	350 km	40	1000 kg	RMB 3450
Quingdao	899 km	40	1000 kg	RMB 5950
Shenyang	2100 km	40	1000 kg	RMB 7450

Table 14. Domestic logistic costs from Shanghai to distributors

The domestic logistic cost adds up to approximately RMB 20 000. The savings from the distributor would be 0,5 percent of the product value. This corresponds to a value of RMB 50 000. Furthermore are there saving to be found in the international logistics cost as well. If each product would be sent to a specific distributor, each shipment would cost about RMB 17 000 with a total price of RMB 84 000. If all products would be consolidated the price of transport would be RMB 80 000 and result in a cost reduction of RMB 4 000. The total cost savings would be RMB 34 000 which correspond to 0,3 % of the ex work value.

Even though this example does not generate impressive cost savings it still provides an important aspect to our future recommendations. If Emotron is to place a factory in China, logistic costs will not affect the current supply chain negatively, given the numbers in our example.

□□

Another way of lowering import costs would be to import goods at a lower price than today. If Emotron were to have a company in China that purchased all components from Emotron in Helsingborg cost saving would be collected from lower commission fees, tariffs, and exchange fees. Example 2 will provide a short description of the case.

Example 2 – *Import alternatives; products & components vs. Chinese production*
In this case Emotron has an assembly facility somewhere in Shanghai and attempts, in some way, to add value to the product. In Figure 36 the difference in variable costs are illustrated. The figure also visualizes the cost structure of a 100 percent sourced product that is assembled in China.

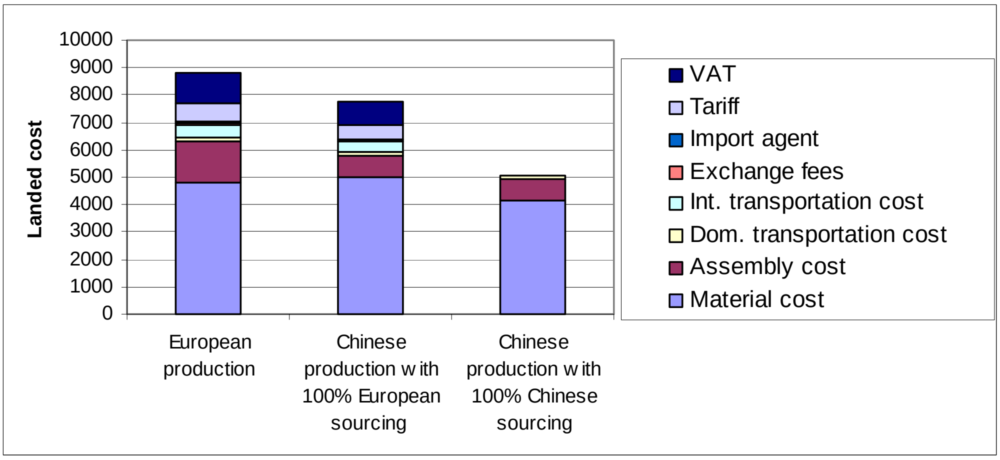


Figure 36. Landed cost in China for a product assembled in Helsingborg, components imported from Europe and assembled in China, and in China fully sourced and assembled products

As can be seen in Figure 36 the in Helsingborg assembled product will be the most expensive when considering variable costs. If the product is imported as components, the landed cost will be lowered with about fifteen percent. However, this is a small cost reduction to the alternative of sourcing all components in China. In such a case (in which competitors already might be) landed cost is lower.

Our second example provided an overview of how variable costs are affected by different strategies. This gives an initial understanding of how to proceed with a successful strategy towards China.

An additional alternative that might be of interest is to start a sourcing operation aiming towards Europe in China. Working with suppliers takes a lot of effort but on the other hand are there three potentially important advantages of doing it. The first advantage is of course to lower sourcing costs of the European production. Prices are for some parts believed to be 50 percent lower than those of current supplier prices. The second advantage would be for Emotron's Chinese venture to put large volumes on suppliers in China to gain stronger bargain power. Lastly, with a quick start, many child diseases like misunderstandings and quality problems could be mitigated with a pre-production contact with Chinese suppliers.

Example 3 – *Chinese export strategies*

In this case Emotron chooses to source products from the Chinese market. When exporting goods from China an export fee of 3-5 % is added before the goods are shipped. When importing goods to Europe, VAT and tariffs are based on the sum of the value of the goods to be imported and the cost of its freight. Tariffs are highly dependent on the goods to be imported but Table 15 provides an example of some articles related to Emotron's products.

Article	Import tariff
Frequency converter	3,3%
Metals	0%
Electronics	2,5-3,5%
Cabling	3,5-4%
Cooling flanges	3,5-4%

Table 15. Europe import tariffs (Source: Tullverket, Sweden)

As a first step Emotron has found eight metal components of their product that are possible for sourcing. The parts are valued a quarter of a units material cost and are believed to be sourced for about two thirds of its current purchase price. Most of these products can most likely be classified as metals which will result in zero tariffs. In this case the cost of transports may be a bit higher than our estimations due to low and scattered volumes. Still, step one result in a five percent reduction of the sourcing cost.

As a second step we suggest that ten other components that were originally meant to be source for the Chinese market alone can be interesting even for the European production. In this step, components such as printed circuit cards and cabling are included. The average import tariff on these components is three percent. However, in this case, transport costs might be even lower since components such as printed circuit cards are expensive but small and light. Step two results in a ten percent reduction of the landed cost.

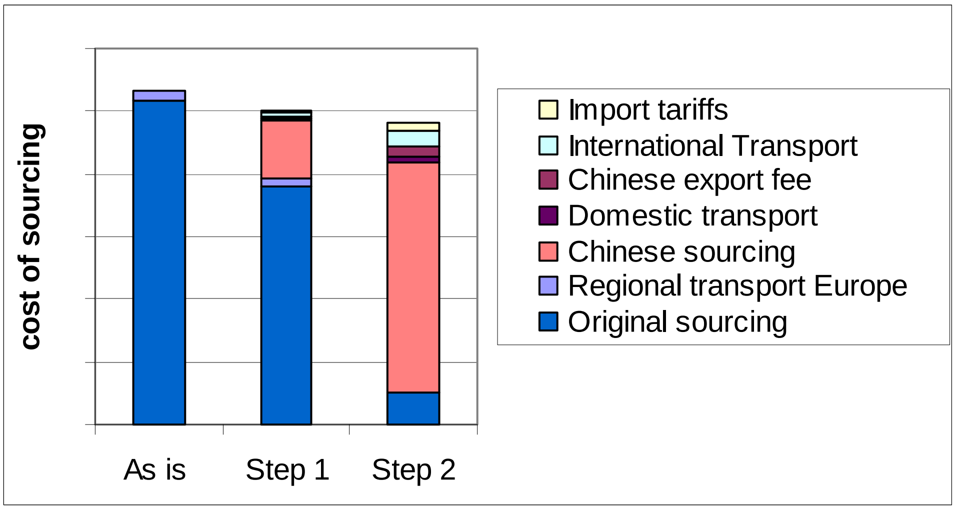


Figure 37. Sourcing strategies for Emotron from China to Europe

Our third example shows that Emotron have much to save by engaging in sourcing activities from China. Furthermore, pre-initiated sourcing activities will of course also have a positive impact on the profits of a future assembly site, especially when considering the results from example 2.

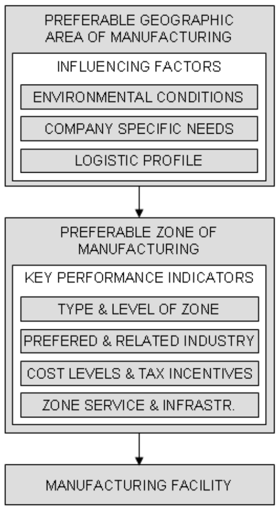
10.4.3 Domestic Logistic

In the current sale setup, Emotron does not have any challenges of domestic logistic. Currently, their products' transports are handled by their distributors, just as our model prescribes. However, if Emotron were to build a production facility they would most likely be forced to start handling local transports from their suppliers. In absence of data for distance to future suppliers, volumes to be shipped, and cost of Chinese trucks it is not possible for us to do calculations on this matter. Nevertheless, our generic recommendations from the model on domestic logistics would still apply to Emotron when searching for suitable 3PLs.

10.5 Development Zones

10.5.1 Preferable Geographic Area

In order to localize the right spot for Emotron to set up a potential production facility several factors needs to be considered. When considering the factors of environmental conditions, company specific needs, and the logistic profile, trade-offs have to be made in order to find the preferable geographic area of manufacturing.



When interviewing both management personnel in Helsingborg and China several areas were identified as potentially suitable locations for production. Three major alternatives were given. First of all does the outer Shanghai area have the capable suppliers and potential capability to fulfill Emotron's needs. This also applies to the area around Shenzhen, close to Guangzhou, which is the second alternative. The third alternative is to place the assembly factory in the central or western parts of China in order to reach further cost reductions.

As a first task we will locate Emotron's logistic centre of gravity which we will calculate based on equal sales volumes and circular distances. However, when calculating the spot, which is illustrated in Figure 38 no regard has been taken to potential exports. If shipping will be used as a mean of transport, the logistic ideal spot will move towards nearest harbor. It is also possible that the network of distributors will expand as future business increase.

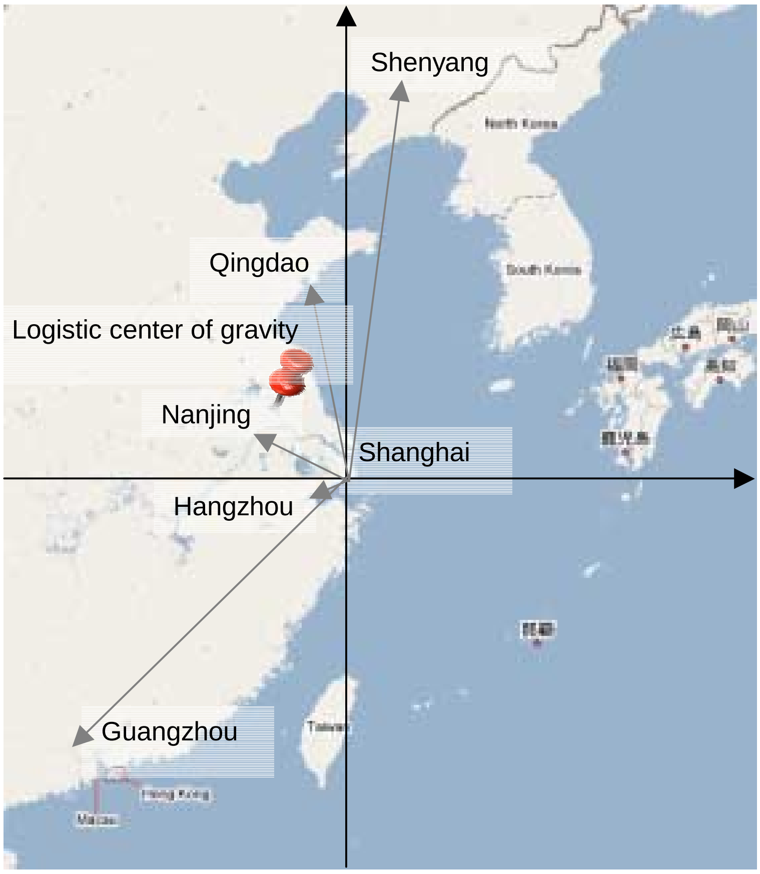


Figure 38. Emotron's current logistic centre of gravity

However, considering that Emotron is a medium-sized company without previous experience of the Chinese market we believe it to be wise to eliminate as many risks as possible. To set up a factory in western China would certainly result in lower labor and material costs but on the other hand it will probably also result in lower quality of suppliers, less developed infrastructure and more expensive logistic costs. As we discussed in chapter 7, a movement towards west can be compared to a movement back in time in terms of complexity of handling a business. The question is if Emotron is ready for such a challenge. Additionally, exporting goods by shipping would become more expansive to perform in such an area.

The trade-off between Shanghai and southern China is costs of material versus cost of logistics. In southern China cheaper material and labor can be found but on the other hand are Emotron's distributors located further away. Emotron has also less previous experience of this area which demands further research before southern China would be more interesting as an alternative. Shanghai on the other hand is close to Emotron's logistic centre of gravity. The region is also well known to both the Chinese employees of Emotron and the top management in Helsingborg.

10.5.2 Preferable Zone of Manufacturing

We believe a national level ETDZ would be preferable for Emotron due to their long term support from the central government and their preferable tax incentives for FIEs. It is also in ETDZ that most of Emotron’s competitors have placed their facilities. However, there could also be some advantages of locating the production facility in a HTDZ. First, Emotron is marketing their products with regard to their advanced technologies if a HTDZ would be chosen. Even though they currently do not have any planes of developing their software in China, their brand would still be associated with high and new technology. Second, if Emotron were to conduct some of its development in China, they would already be preferably located. Third, if Emotron were to receive a hi-tech classification further tax incentives would be gained. However, a hi-tech classification is decided on a provincial level and may be difficult for a FIE to receive. It should therefore be considered as a bonus. Furthermore, such a classification is not zone dependent and does not have impact on income taxes until three years after first profit.

As previously discussed in chapter 7 there are several interesting areas around Shanghai like Nantong, Wuxi, Ningbo, and Suzhou. In all areas suitable zones are also placed. However, in Ningbo for instance, the HTDZ is not on a national level and will therefore not be able to provide equally beneficial tax incentives. An investment in this zone would result in an income tax of 24 percent instead of 15 percent. Still, Ningbo has an ETDZ which is on a national level.

Emotron is in need of local and skilled suppliers, at least when it comes to electronic components. All areas can provide such suppliers but it is important to consider the fact that suppliers outside a province may result in more complicated logistic procedures, in terms of both regulations and distances.

When choosing zone the chance of Emotron to end up in the same zone as its competitors is more than likely. In both Suzhou and Wuxi we have already found presents of competitors. Being located in the same zone as competitors is both an advantage, in terms of suitable suppliers, and a disadvantage, in terms of China’s high rate of staff turnover that might lead to lower protection of trade secrets. However, we believe that the advantages overcome the disadvantages. A sense of competition will almost certainly have a positive impact on the ventures performance. Another factor to consider when choosing zone is the potential of OEM-customers that we have not been able to consider due to lack of information is the location of potential OEM-customers.

Official cost levels and tax incentives are fairly transparent China. However, like most other costs and regulations in China, everything is negotiable. Since we, during our analysis, were not able to negotiate, our analysis is based on official numbers.

One of the most important factors for Emotron to regard is the service of the designated zone. Transparency in decisions, help to find suitable suppliers, and suitable personnel are critical for success. In all areas, the zones have high quality of its service towards FIE. However, we believe that zones which host companies from the same countries may have an advantage in terms of zone service. For example, we consider the low presence of Nordic companies in Nantong to be a disadvantage for Emotron.

The situations of the infrastructure currently differ even though it in a near future will be better in both Nantong and Ningbo.

In chapter 7 we have performed an evaluation on the different areas based on the data gathered in appendix A. Since data is merely collected on a formal basis the analysis has been quantified in six discrete steps ranging form + to +++++.

	Nantong	Wuxi New District	Ningbo	Suzhou Industrial Park
Types of Zones	++++	+++++	++++	+++++
Level of Zones	++++	++++	+++	++++
Preferred and related industry	+++	+++++	++++	+++++
Cost levels	+++++	++++	++++	+++
Tax incentives	++++	++++	+++	++++
Zone service	++++	+++++	++++	+++++
Infrastructure	++++	++++	++++	++++
Sum	28	31	26	30

Table 16. Evaluation of areas around Shanghai

Our analysis shows that Wuxi is the most suitable area for a production facility. Wuxi is slightly cheaper than Suzhou and has a long history of being host to Nordic companies. Also, Emotron's industry is encouraged. Depending on the deals Emotron receives while dealing with government officials from Wuxi, we recommend to either place a manufacturing facility in a HTDZ or in an ETDZ.

10.5.3 Manufacturing Facility

On the Chinese market Emotron still lacks contracts with OEM customers. Additionally, sales are based on forecasts and can be highly volatile. Furthermore, China is developing in fast pace and the growth of wages and tax incentives is hard to predict. Therefore, our recommendation to Emotron is to rent a facility. It might be a more expensive solution in the long run, but during that period, Emotron will have the benefit of being highly flexible.

10.6 Investment

The investment needs are gathered from the other perspectives in the STAR model such as where to establish a production facility and HR strategies. A feasibility study, including an in-depth investment analysis, will summarize the analysis of Emotron's business case in China. What future investment strategies should the company engage in considering their present and future needs?

10.6.1 Define Business Setup

Emotron's business setup today is a sale setup. This setup is, as previously discussed, done by exporting products from Sweden through distributors to China. Also, a foreign representative office has been established to support the sales. The competition is fierce and Emotron's products are priced high. As a consequence, the company suffers from high landed cost. Still, Emotron have successfully gained important sales channels in China. However, we believe that only high-end goods could survive such as sale setup in the long run. Emotron's products do not fully comply with a high-end categorization. Compared to its competitors, the products may deliver some more value for the customers but it is not enough to support an additional 40 % price tag. In the logistics perspective we analyzed the landed cost figures, and found out that not much could be done to significant lower the landed cost, without extending the business setup.

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="4">Production</th></tr>
<tr><th colspan="2">Domestic</th><th colspan="2">China</th></tr>
<tr><th rowspan="4">Sales</th><th rowspan="2">Domestic</th><td colspan="2" rowspan="2">Status Quo</td><td colspan="2">Production Setup</td></tr>
<tr><td>Outsource</td><td>FIE</td></tr>
<tr><th rowspan="2">China</th><td colspan="2">Sale Setup</td><td colspan="2" rowspan="2">Full Setup
FIE</td></tr>
<tr><td>Dist.</td><td>FIE</td></tr>
</table>

Table 17. Strategies for doing business in China

Most SMEs may neither be able to raise the capital needed nor willing to take the risk to invest in a full setup at once. As a natural result SMEs often invest step-by-step in China. The top management of Emotron argues to invest in a production setup only when the sale setup may support a production setup. However, it is important to acknowledge the relationship between the different setups. A production setup wills definite boost sales in China as local presence may offer better customer support and most important, significantly lower the landed cost. We recommend the current business setup to be extended into a full setup, thus including a production setup. Also, it would be advisable to have a production setup that could support other Asian markets and the Australian market. This strategy would help stabilizing the demand curve for the new production setup, in particular if sales figures are not developed as planned in China. It will also lower the lead-time to neighboring markets.

10.6.2 Investment Strategies

The Chinese market is growing steadily and bears a huge potential for Emotron. We believe that the key to be profitable with these products in China is local production. However, an investment in a production setup should not just be considered a long-term investment in China, but also a necessary step in the company's corporate strategy. The main competitors in Europe already have production facilities in China and it is just a matter of time when Emotron will be out-priced in Europe as well. Also, new Chinese and South-Korean companies will eventually take a shot on the European markets with highly competitive pricing. As a consequence, we would like to stress that an investment in a production setup is desirable not just in a Chinese market perspective, but in a corporate long-term perspective.

10.6.3 Choose Business Entity

Today a foreign representative office is operational in Shanghai. However, a new production setup requires a new entity or an outsourcing strategy. Outsourcing may be beneficial when producing a non-core competence product to home markets. Emotron would produce its core products for the Chinese market, thus an outsourcing strategy is not to recommend. Instead there are two realistic opportunities for Emotron; establish an equity JV with a Chinese partner or set up a WFOE.

To set up a business in China many capabilities and resources are needed. Emotron has already established good sales channels through a distribution network. Local market knowledge, Chinese business practice, and contacts with authorities are provided by the two Chinese professors already employed. Other required capabilities such as technology know-how are available in-house from the HQ. As Emotron do not lack any essential capabilities or resources needed to establish a production setup we believe that the incentives to establish an equity JV with a Chinese company are small.

Instead we recommend Emotron to setup a WFOE under the FICE regulations, which will grant full trading rights. By using a WFOE the FIE and 100 % of its future profits will stay in the supervision of Emotron. However using a WFOE will not fully ensure the safety of the core-competence, the software, but will definite lower the risk of being exposed to counterfeit or other crimes. Also a WFOE production entity will be encouraged and be beneficial of tax holidays. A high-tech certificate will grant even more benefits from the authorities.

10.6.4 Financial Strategies

In general, Chinese banks may be able to deliver lowest interest rates in RMB. However, not many Chinese banks, if any, have long experience working with foreign invested SMEs and vice versa. We believe Emotron should use a safe foreign bank instead of a Chinese bank. It is imperative that the foreign bank have a branch office in China. Otherwise the bank will lack local knowledge, contacts with authorities, and leverage against domestic banks. We recommend that Emotron should preferably choose a bank that they have prior experience with. This will lower the risk and bureaucracy compared to dealing with a Chinese bank. Also, if the parent is well-known by the bank the debt will be cheaper and the parent’s assets may be used as collateral. A disadvantage using a foreign bank is that they may not be able to handle RMB. However, this vast issue will be changed at the end of this year (2006), when new WTO regulations are implemented.

As a SME, it might be tempted to start with a low amount of registered capital and then gradually insert more capital into the entity. However, we would like to stress the importance of including working capital until break-even in the calculations for total investment. Investing more capital into the SME later on might be complicated and expensive. The amount of total investment should be set with future debt in consideration. Thus, the allowed debt/equity ratio of 30% should be used.

10.6.5 Apply Tax Incentives

As analyzed in the development zone chapter we believe a suitable location for Emotron is in Wuxi, a national development zone, which still gives foreign enterprises tax holidays. The available tax holiday for Emotron is 0 % enterprise income tax for two years, after the first year of profit, then 50 % reduction for the next three years. If qualified as a high-tech company the 50 % reduction will last for additional 3 years. However, it is still uncertain if Emotron may be qualified as a high-tech company or not. According to our knowledge there are no real formal demands from the authorities, as the certificate is issued on a case to case basis.

It is important to emphasize the requirement of setting up a production entity rather than a trading entity. Thus, at least 25 % value needs to be added to the product. A trading entity will have much less government incentives and stricter regulations than a production entity, and is thus not recommended.

As implied throughout this paper, regulations and laws changes continuously. These incentives for foreign enterprises will disappear in the future. In our calculation of Emotron’s business case, we have treated the tax holidays as bonuses rather than a decisive factor for an investment proposal. However, most versed believe there will be some kind of grandfathering of the incentives. Therefore we believe that Emotron should consider registering a formal production entity before the beginning of next year (2007).

10.6.6 Investment Analysis

Due to restrictions this sections is censured from this report.

10.6.7 Investment Proposal

In conclusion, we recommend Emotron to start a production entity in Wuxi. With the right preparation, the investment will be profitable in a long term perspective and important in the overall corporate strategy. The net present value is positive (4.2 M) and the discounted pay back is 4 ½ years. However, two key success factors need to be considered. Firstly, since price has a strong impact on performance, pricing strategies needs to be analyzed further through in-depth market research. Secondly, when starting the production facility, at least 40 % of the value needs to be derived from Chinese suppliers. Thus the work of assess and quality assure Chinese suppliers need to be conducted long before the implementation of the facility.

If Chinese sourcing activities would be available in a world wide sourcing strategy, the investment would be even more profitable. Chinese sourcing activities could go on without a further investment, but will definitely benefit from the investment. Thus, some savings at the European production facilities derived from Chinese sourcing could be accounted for when making the final investment decision.

The investment needs ~7 M in working capital. Therefore we recommend the investment to be financed by having 6 M equity and 1.8 M debt. The registered capital is consequently 6 M and the total investment should be set at 7.8 M. The debt/equity ratio is set to the permitted level of 30%. This financial strategy will over-capitalize the entity slightly but will ensure liquidity when temporarily fluctuations in sales and accounts receivable occur. It will also provide possibilities to invest in additional equipment.

The implementation time frame is shown by Figure 39. Empirical findings show evidence of 3-12 month for setup of a leased facility in Wuxi. With proper preparation a production facility should be operational in 6 month. As discussed, we strongly recommend time consuming activities such as assessing suppliers to be initiated by the representative office before the formal registration. Sales and sourcing staff could be operational from the representative office until the facility in Wuxi is fully operational.

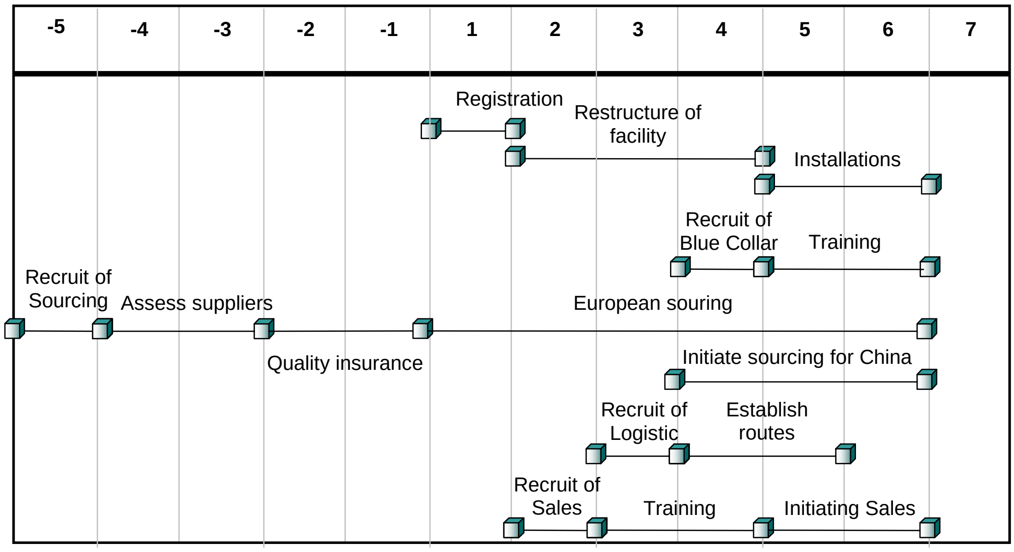


Figure 39. Recommended implementation model for Emotron

11 Conclusion

In the final chapter we conclude the paper by reflecting over the STAR model applicability. Finally, to validate and improve the STAR model we suggest areas for further research.

China is a fiercely competitive market but also a promising and cost effective location for both production and sourcing. SMEs doing business in China are faced with challenges that they need to overcome and risks that needs to be mitigated. The current literature aims mainly at MNCs and therefore neglecting the specific challenges SMEs stands in front of.

In this paper we have structured our findings in a comprehensive best-practice model, called the STAR model. It has five important perspectives; HR & Culture, Sales & Marketing, Logistics, Development Zone and Investment. The STAR model addresses challenges and opportunities in all these perspective. The model has successful been applied on Emotron AB, a middle-sized company which just started doing business in China. The test of the STAR model was successful. All areas of the model were covered. By using the model we have defined Emotron's current business setup and recommended future changes to it. An important outcome from the model is also an investment proposal based upon a rigorous investment analysis.

While using the STAR model we would like to stress that the model does not need to be used sequentially or completely. It can, for example, be applied to companies solely engaged in sales or other companies solely engaged in production for home markets. In those cases, not all perspectives need to be considered.

We discovered that the model lacks some potential organizational issues when moving production and sourcing from Europe to China. For example, companies that choose to reduce staff will probably face difficult organizational change and suffer from lower productivity at home production facilities. We also acknowledge that our construction of the model have been influenced by the situation of the case company, Emotron. Consequently, the STAR model is targeted on companies mainly in the production industry. Modest regard has been taken to companies solely in the tertiary industry. Companies in the service industry would probably have other SME specific challenges in China than listed in the STAR model. Therefore we believe it might be even more interesting to test the model on another company in a complete different industry.

There are several advantages with the STAR model. The main advantage is the vast contemporary information available in the different perspectives. We believe that SMEs will find fitting models that helps them consider important factors without neglecting key steps. By following the model SMEs will mitigate the most dominant and common risks faced in China. The STAR model can therefore both be used as a guide and as a checklist. While reading this paper, companies may easier do their necessary homework before doing business in China. Several cases are also integrated in the different steps to provide a more pragmatic illustration of how to cope with the specific challenges for SMEs. Furthermore, the STAR model could be used for a post-analysis of strategies in China. We believe it would serve a purpose of both question and validate a business strategy in China.

We recognize that the STAR model have disadvantages such as its contemporary dependency if it is not updated. The model can also be complemented with other areas to increase its scope even further. Due to the lack of time, the quality of our references may also in some cases been comprised. In order to mitigate the risk of letting the contemporary information become an obsolete, we have discussed some of the future changes that are likely to occur in China. However, it is recommended for companies to cross-check information to ensure its validity.

As further research of the STAR-model we recommend that additional testing is conducted to ensure its validity. Furthermore would it be interesting to see how the model would differ in different industries, in particular the service industry, and how it stands out in literature targeting the same situation in other geographical markets.

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Appendix A – Comparison of development zones around Shanghai

KPIs	Nantong	Wuxi new district
GRP	RMB 3,3 Billion (ETDZ)	RMB 23.6 Billion
Population	8 million	5 million
Types of zones	Chinese EPZ, HIDZ, ETDZ	Chinese EPZ, ETDZ, HTDZ, EPZ
Preferred Industries	Electronic communications, textile fabrics and new chemical materials, investments related to upgrading traditional industries	Mecanical manufacturing, Electronics, Fine Cemicals, New materials, Pharmaceutical
Min. investments	No requirements	No requirements
Presence of Nordic companies	Few, non from Sweden	Astra Zeneca, Atlas Copco, Volvo, IRO, Allgon, Conag, Lgp, Nefab, Trelleborg
Rent cost per sqm and month	RMB 9	RMB 10-15
Land cost per sqm	N/A (Depends of priority of investment)	RMB 300
Cost of production facility per sqm	N/A	RMB 1000
Monthly wages **-Blue Collar** **-White Collar** **-Middle Management** **-Additional expenses**	 RMB 1000 RMB 1500 - 2000 RMB > 4000 Additional 30% (insurances)	 RMB 800-1500 RMB 2000-3500 RMB >3500 Additional 43% (insurances)
Power supply	By province protected area	2 power plants
Distance from Shanghai	95 km (2 hour with boat, after 2007 1 hour drive on bridge)	120 km
Airport	Shanghai Hongqiao Int. Airport (100km)	Domestic airport (0 km) Shanghai Hongqiao Int. Airport (120 km)
Port	Nantong Port (0km) Shanghai horbour (km)	Jiangyin port (38 km) Shanghai harbor (165 km)
Special requirements	---	- Pollution policies
Advantages	- Geographic location - Designated areas for SMEs - Awards for services to foreign investors -Bonded activities -Port ranked top ten in China	- Local customs office - Bonded Activities - Sino-German Wuxi Technical Training School -Yearly seminar on park status -One stop company support
Disadvantages	Bonded activities require minimum of 5 million US$ and have 50-100% higher land costs	-Several large companies that reduces importance of SMEs -Long registration process

KPIs	Ningbo	Suzhou Industrial Park
GRP	RMB 25 billion	RMB 36.5 billion
Population	6 million	6 million
Types of zones	HTDZ, ETDZ, FTZ	SEZ, HTDZ, EPZ
Preferred Industries	Electronics, machinery, Micro- and Optoelectronics, telecom, software, new material and biomedicinical industries, port related industries	Electronics, mechanical-electronic integration, pharmaceuticals, fine chemicals, precision engineering, new materials
Min. investments	No requirements	No requirements
Presence of Nordic companies	Several, mainly from Denmark and Norway Nilfisk-Alto (Den), KSI Grenland (Nor)	Besam, Haldex, Getinge,
Rent cost per sqm and month	RMB 20	16 RMB + 8 I maintenance
Land cost per sqm	N/A (Depends of priority of investment)	N/A (Depends of priority of investment)
Cost of production facility per sqm	RMB 750-850	N/A
Monthly wages **-Blue Collar** **-White Collar** **-Middle Management** **-Additional expenses**	 RMB 600-1000 RMB 800-1200 RMB 1500-2000 Additional 70% (various expenses)	 RMB 600-1200 RMB > 1200 RMB >5000 Additional 22% (insurances)
Power supply	---	1 power plant
Distance from Shanghai	Currently 4 hours by car (300 km), after 2008 2 hours on bridge (170 km)	90 km
Airport	Ningbo Lishe domestic airport (15km)	Shanghai Hongqiao Int. Airport (80km)
Port	Ningbo-Beilun port (20km)	Zhangjiagang Port (90km) Shanghai harbour (120km)
Special requirements	N/A	---
Advantages	- One stop company support - Incubator areas for SMEs - 2nd largest port in China	- Park service - Support from Park administrators - Local customs office - Bonded Activities
Disadvantages	- Current status of infrastructure - No insurance of power supply -24% income tax except for FTZ -No convenient international airport	-Several large companies that reduces importance of SMEs -Long registration process