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China Joint Ventures: Understanding the Intangibles

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Part Four in our "Joint Ventures as a Strategic Investment" series

By [Chris Devonshire-Ellis](#) and [Richard Hoffmann](#)

Nov. 4 – The intangible aspects of entering into and running a successful joint venture in China include the business areas where culture, common sense, law and an understanding of finance all cross over and weave together. They are not often included in a checklist of things to do when evaluating a joint venture partner, or considering the management of one. Yet the intangibles are very much part of the sensibility of getting into a JV in the first place.

Much has been written about the undesirability of having a JV in China at all, with most of the criticism pointed towards both the perceived unlevel playing field the contract provides, coupled with an inherent and largely irrational distrust of the Chinese. Yet the paradox is that many joint ventures in China quietly go about their business and are profitable for both foreign and local investor alike. We should know; as apart from providing corporate establishment services, our firm audits businesses in China and we get to see the books. Successful foreign investors in JVs in China have understood the importance of the intangibles.

Let us first consider some of these, as they are the key to understanding the nature of the apparent paradox between JVs as a good investment versus JVs as a bad investment:

Establishment in China is a finance and tax driven question

Corporate establishment in China, be it a humble representative office, a wholly foreign-owned enterprise, a foreign-invested commercial enterprise or a joint venture, is more of a tax related issue than it is a legal procedural matter when it comes to the creation of a legal entity. The legal procedural issues in China are relatively well defined, and although bureaucratic, are fairly easy to navigate through if assisted by an experienced lawyer. The tax and financial aspect of them however is a very different matter and requires specific professional tax expertise to solve them. Matters that can affect the very effectiveness of a business in China that require particular attention to detail include on the financial side, the relationship between registered capital and total invested capital, the inclusion of machinery and related items as capital, staff welfare payments, and profits repatriation abilities. On the tax side, these include the status as VAT registered tax payer, deposits that may be required to be lodged with customs, the component parts of withholding taxes against permissible double tax treaties, the ease of obtaining export related tax refunds, and so on. When dealing with a JV, the matter is even further compounded. The foreign investor needs to have both sides of this equation in hand and not only the legal procedural aspect. If the financial and tax issues are not adequately dealt with, the business is at a disadvantage from day one. Financial efficiency is paramount in any business and within a JV especially.

The unlevel playing field

Usually this is regarded as an impartiality issue when the process to sue in China should a JV fail is heard in a Chinese court. Yet in reality, the onus is on the foreign investor to sort the matter out before it gets to this stage. Legal action should be a last resort. Suing your own business partner in China (or anywhere else) is an indication that the relationship has broken down irrevocably and requires a third party to administer differences. There are exceptions, but the unlevel playing field warned about by pursuing legal action in a Chinese court against a Chinese national can usually be avoided. Even then, in clear cases of fraud, Chinese courts are becoming more balanced, and not less when it comes to viewing the position of the foreign investor. There will always horror stories, but much as Frankenstein does not exist in real life,

and only appears when we chose him too in film or in books, much the same is true of errant JV partners where the only course of action is to sue. Litigation is immensely damaging, and most difficult issues in China can still be solved if both parties wish to do so and have a thorough understanding of the matters that preceded any dispute.

Lack of attention to due diligence

We have covered some of the aspects of both legal and financial due diligence in this series. Yet many foreign investors do not heed such advice, and will enter into a JV without sufficient scrutiny. Basing an investment decision on purely a personal relationship, especially in China with its different culture, language and systems, is far from wise. We find that the financial due diligence aspect in particular, if carried out competently, can provide far more insights into how the potential local partner runs his business, treats his employees, and handles his fiscal and legal responsibilities. If these show the mechanics of their own business to be problematic, then they are likely to be problematic in the JV also. Due diligence exists for a reason; and if it is either not carried out, or is ignored, then the investment risk increases manifold. Many of the problems we have been called into when in dealing with problems in JVs have often been down to a lack of initial due diligence on the foreign investors part, and could largely have been avoided. If the due diligence highlights areas of concern – including those of integrity – then you can always say “no.” Better a bad deal not done than getting further into troubled waters.

Lack of foreign management investment

Many foreign investors do not invest sufficient management time or expertise into the operational aspect of a JV. In our opinion, the foreign investor must position a senior management figure into the JV or risk the consequences. Just visiting every now and then, even with an apparent reporting mechanism in place to us seems to be inviting trouble. A JV is not just a vehicle to allow a Chinese partner to get on with it at minimal executive time from the foreign investor. If you do run your JV in this fashion, gaps will appear in areas such as management, financial reporting, production and quality. If you can't afford to send a full-time manager to China to help run the business, then you shouldn't be investing in China at all. Treat your JV with respect, attention to detail and dedicated management and your chances of risk are greatly reduced, while those of success (assuming you employed a decent manager and not some bloke who hates it and can't wait to leave) are enhanced. Indeed, with the explosion of Chinese language as an internationally taught commodity, and with plenty of young expatriates floating around China, the opportunities for recruiting someone to help manage your JV are higher than ever. Ideally, an engineer familiar with your product is perfect, but if not, there are numerous other employment options out there for you to take and keep a watchful eye on things.

Government involvement

Often at some point you may be introduced to a local government official, especially in the outer areas of China. While this is designed to give you “face” – to show your investment is welcomed by the local government – proceed with an element of caution. These people, while well meaning, are not businessmen and they also have their own agendas. The central government still gives regional governments investment targets to meet, and this passes down to local government officials. They may not be familiar with investment law and may provide unsound assistance or advice. It is imperative that any incentives, or fast tracking of land use rights, tax breaks or any other issues they get involved with in “helping” you secure your investment are double checked. We have faced numerous issues over the years whereby what a local government official promised, and what was delivered, proved to be completely different things often with damaging repercussions for the foreign investor. Cue the largest investment in a major northeastern city whose factory was built on land partially owned by the military; or the factory built on land reserved for agriculture, not commerce. In both instances the foreign investor had been assured by a government official there “wouldn't be a problem” in securing permissions. By the time the investment was made, the factories had gone up and no permission was ever forthcoming, with disastrous consequences. Even when advice comes from government officials, it is important to conduct due diligence to check that what you've been told is correct. Additionally, attempts by government officials to secure employment for their family or friends in your business should be politely declined, as should any other negotiations that involve investment in anything other than your own business.

Culture

There are cultural issues in running joint ventures (in fact any business) in China. These need to be understood as much as possible by an on-the-ground foreign manager. If not, such matters can be exploited. For example, migrant workers in a factory living far away from their hometown may be entitled to additional leave during the important annual Chinese New Year holidays purely based on the length of time it takes them to travel home. This can add up to five to six additional days mandatory leave if they live way out in China's hinterland. If that is not understood, it can lead to conflict, or to abuse. Cultural differences are very much part of business life in China. They are not insurmountable, but they are more readily apparent in a JV. Managing your JV with dedicated executives on the ground will help both with cultural relations and developing morale and mutual respect. This in turn leads to a better run business. Denying that running a business in China has cultural overtones, as some people do, demonstrates an ignorance of what it takes to successfully operate in the country. It is also neglectful, and ignores the very human element of running a successful business in China – interaction with your Chinese employees and partners.

Professional advice

These are just some of many intangible issues that need to be addressed when considering a joint venture in China; they vary depending upon each specific case. A good professional firm will be able to discuss all the issues with you, assess what needs to be checked through, and allocate dedicated on the ground staff to look into and report back. Above all are the tax and financial implications – setting up in China is more of a finance question than a legal administrative process. Successful foreign investors understand this and get it right. We also do not recommend using any services firm that subcontracts such work and only recommend using firms with a proven track record and with applicable resources and offices in China.

Chris Devonshire-Ellis is the founding partner of Dezan Shira & Associates and lived in China for 21 years. He has over 17 years of experience in establishing JVs in China. He is now based in Mumbai.

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To contact [Dezan Shira & Associates'](#) business advisory services division for JV advice and other corporate establishment issues email info@dezshira.com.

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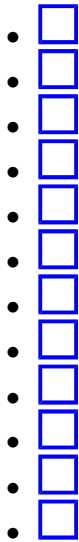
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6 Comments To "China Joint Ventures: Understanding the Intangibles"

#1 Comment By [Pluto, Donald & Minnie](#) On November 5, 2009 @ 2:32 am

Excellent timing folks – Disney just announced the biggest JV in China ever at some USD3.5 billion for their new Disneyland in Pudong. Congrats for keeping flying the JV flag when all others lost their heads!

#2 Comment By [Chris Devonshire-Ellis](#) On November 5, 2009 @ 2:41 pm

Ha ha yes thanks. JV's are entirely appropriate (in fact mandatory) for investments such as these, and they're not going to go away despite the doom and gloom merchants or people who don't understand how to negotiate or structure them properly. We've seen some poor JV's over the years, but the majority of ones we've been involved with professionally are doing just fine (we often handle the accounting, so we know).

I think this series really writes the common sense book on how to judge whether or not a JV is likely to be a good investment. The guidelines are pretty clear. Good luck in Shanghai guys! – Chris

#3 Comment By [Jeffrey J Davis](#) On November 6, 2009 @ 3:40 am

Great Tips and Advice.

From my experience with our current JV and others, the points about taking any offers of "special help" from the local government officials with a grain of salt is sage advice indeed.

Get it writing and chopped, and check the legality and consistency with other local treatment. Also ensure that any special tax or investment deals your partner may have negotiated are legit, documented and transferable to the new ownership structure. It's is not uncommon for Industry Classification of your enterprise to suddenly change, once a Western investor joins the ownership structure, which can potentially have massive tax implications.

Best,

Jeffrey J Davis
President & COO, AGY

#4 Comment By [Chris Devonshire-Ellis](#) On November 9, 2009 @ 5:31 pm

Thanks Jeffrey. As you know, we've been involved in structuring China JV's for many many years in China, we've seen pretty much everything! JV's can be a very sound investment indeed, however its always the due diligence aspect that often lets the foreign investor down. Trying to rush into JV's in China is never a good idea, and not paying attention to due diligence is just asking for trouble. With sensible clients as much as our own expertise we've been largely able to keep the majority of our JV foreign partners out of trouble, and indeed have advised on many occasions not to proceed. JV's are a bit like Longfellows' nursery rhyme: "When they are good they are very very good but when they are bad they are horrid."

We're pleased you found the series of use and thanks for your comment – Chris

#5 Comment By [Johnny Ong](#) On April 19, 2010 @ 6:04 pm

Very interesting article. Read that Millennium & Copthorne recently lost a lot of money due to the unlawful sale of assets by its JV partner. How did that happen and how could it be prevented?

#6 Comment By [Chris Devonshire-Ellis](#) On January 14, 2011 @ 2:35 pm

@Johnny, it's difficult to comment without knowing the details of the case. However, it would either be fraud, or the foreign partner leaving their partners with more admin and finance authority than was wise. – Chris

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