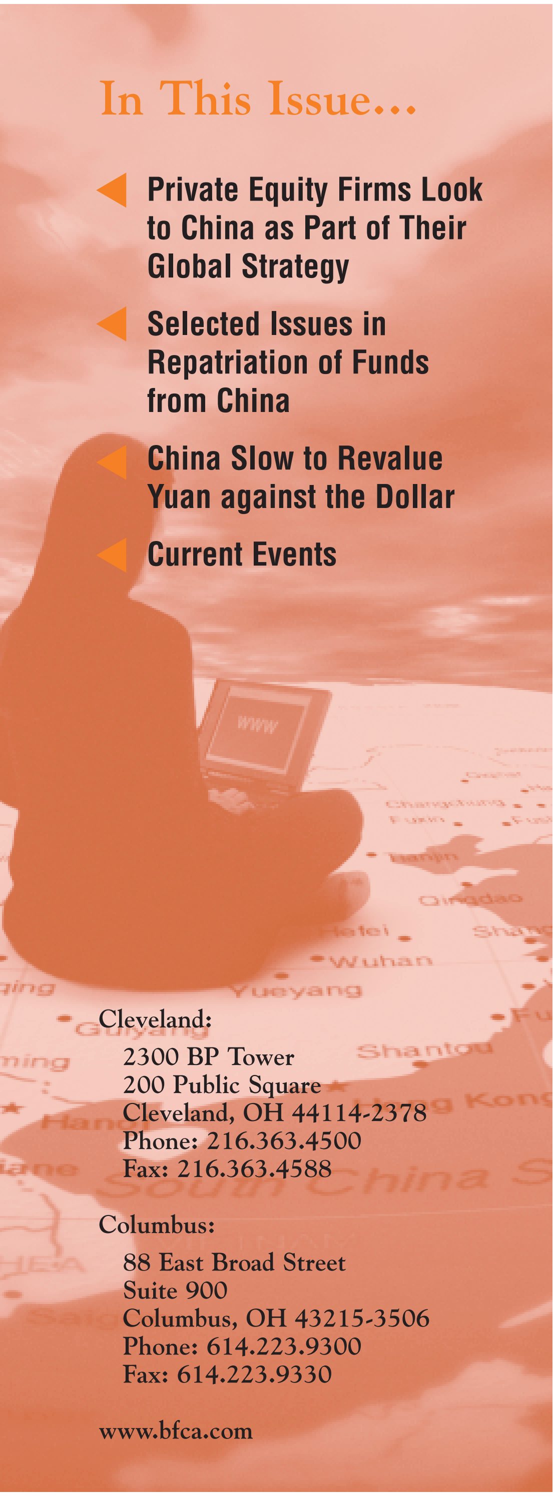
China Insights

Vol. 2, Mar / Apr 2005



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Private Equity Firms Look to China as Part of Their Global Strategy

Is China the next frontier for private equity funds? The November 10, 2004 edition of the Wall Street Journal states, "Nearly every private equity fund looking to invest in U.S. manufacturing has to have a China strategy." U.S. companies are saving costs by shifting manufacturing operations overseas or sourcing product from China, and many of those businesses are sponsor-backed.

Why China? While U.S.-based businesses continue to seek ways to take advantage of the lower production costs in China, many of those businesses have come to recognize that China represents one of the world's largest markets for products and services anywhere - - and it's growing. Some estimate the number of consumers with meaningful disposable income in China to be 65 million. With a country of 1.3 billion people and a rapidly growing consumer class, the demand for, and consumption of, goods and services will continue to increase. In recent years, the economy of China has grown at a rate of around 9%, and there is no indication this growth will stop anytime soon.

Among the private equity sponsors that have decided to actively pursue a China strategy is Cleveland-based Blue Point Capital Partners. Blue Point partner Chip Chaikin, who oversees the fund's China strategy from his office in Shanghai, observes that "effectively planning and executing a strategy to take advantage of opportunities in China may be the most important thing the owner of a middle-market manufacturer will do this decade. It will be a major determinant of market leadership in numerous manufacturing niches, especially those with large multinationals sitting at the top of the food chain."

Another fund that sees the benefit of being on both sides of the Pacific is Palo Alto-based Crimson Investment, which also has offices in Taipei and Shanghai. For over a decade, Crimson's strategy has been to acquire mid-market U.S. and developing Asia-based businesses and actively help them establish sourcing, manufacturing and engineering capabilities in China. Steven Dollinger, a Crimson Managing Director, notes that "we see the development of China-based capabilities as critical to the success - - and even survival - - of many U.S. manufacturing businesses. Those businesses acting quickly to build or access such capabilities can dramatically improve their competitive positioning and take market share."

Blue Point and Crimson aren't alone in recognizing the benefits of a China strategy however. Funds of all sizes are actively pursuing strategies that they think will enhance their portfolio companies' returns, and seminars and conferences focused on the impact of China on private equity abound. The Carlyle Group, one of the world's largest private equity funds, has deployed more than half of its $750 million Asia buyout fund since 1999. Carlyle executives view China as a huge opportunity and they intend to accelerate its pace of investment in Asia to $200 million a year.

In early 2004, Key Principal Partners (KPP) led a $96.5 million equity recapitalization of Beijing-based Asimco Technologies Limited, one of the largest independent manufacturers of automotive and heavy-duty truck components in China. KPP is not limiting its China

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strategy to its direct investment in Asimco however. The Cleveland-based provider of mezzanine debt and equity financing is also invested in several U.S.-based manufacturing businesses that have operations in China or elsewhere in Asia. Managing partner John Sinnenberg expects to see continued expansion of KPP's portfolio companies' operations on the ground in China. "Our acquisition of Asimco gave us access to a management team with ten years of experience dealing with legal, tax, operating, logistical and managerial challenges in China. We are able to leverage their experiences to help our U.S. portfolio companies as they seek to outsource, manufacture offshore or set up their own operations in China."

While the benefits of lower cost production and large markets can be significant, they must be accompanied by sound business practices. Many new entrants in the China market have relatively untested investment teams with little or no overseas experience - a combination that can spell disaster in any international market. Blue Point's Chaikin adds, "Given its distance and degree of difficulty, we think China is an area where a local presence is a requirement. We think our boots on the ground in China can help the management teams we partner with succeed in this crucial endeavor."

As with any business exploring a China strategy, private equity funds and/or their portfolio companies need to address a number of factors:

- Conduct extensive and rigorous due diligence of financial and corporate records, hard assets (e.g., property, plant and equipment) and soft assets (e.g., reputation and circle of relationships), using the appropriate resources.
- Consider market research studies performed by competent professionals with in-China experience that really understand China markets.
- Recognize and adapt to cultural differences. The pace of negotiating, documenting and implementing transactions can be very different in China than it is in the United States.
- Consider labor cost savings, but also consider transportation, logistics and other factors that may, in the aggregate, result in inefficiencies that outweigh the labor savings.
- Understand your exit strategy. Given the evolving capital markets in China, an exit strategy may need to be more flexible; but the good news is that M&A activity is picking up and may create greater opportunities to divest businesses in the coming years.
- Protect your intellectual property through legal and practical means, and do so sooner rather than later.

> "Consider labor cost savings, but also consider transportation, logistics and other factors..."

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Selected Issues in Repatriation of Funds from China

If your company is considering operations in China, one of the first questions you should want answered is, "What restrictions are there under Chinese law on getting funds from operations in China back to the United States?"

Under Chinese law, it is generally required that transactions in China be made in terms of Chinese currency or renminbi ("RMB") and the circulation of foreign, non-RMB currencies within China is prohibited. In addition, RMB is not permitted to be remitted outside China. So, a process of certain accounts and currency exchanges are necessary. When a foreign invested enterprise ("FIE") invests in China, pursuant to Chinese law, it usually opens two accounts. One is the so-called "current account" and the other is the so-called "capital account." The current account items typically include ordinary business transaction items like: (1) balance of payments from the import and export of goods; (2) non-trade transactions, including services (such as consulting services and transportation), rights and licenses (such as license agreements relating to intellectual property, know-how, good will), repatriation of profits and dividends, payment of salaries, and training and travel expenses; and (3) payments to and from individual residents in China, including expenses from travel abroad and income in foreign currency, and foreign currency carried into and out of the country by residents or non-residents of China. In principle, all current account transactions have been fully convertible since 1996 and all foreign currency earnings from current account transactions are permitted to be repatriated. However, in reality, repatriation of current account earnings remains strictly regulated. If an FIE wants to repatriate foreign exchange receipts, it must obtain specific authorization. Upon repatriation, all outbound payments in foreign currency must be conducted through a designated foreign exchange bank, either by purchasing foreign currency from the bank or through the company's own foreign exchange account. Pursuant to the Regulations on Management of Foreign Exchange (the "Forex Regulations"), in order to transfer the funds overseas, the FIE must provide specific documentation to the bank, proving the authenticity and legality of the underlying current account transaction. The process, documentation and other requirements for an FIE to repatriate funds in compliance with the Forex Regulations and other requirements are as follows:

Types of Money that can be Repatriated

The following non-trade transaction-related money may be repatriated:
- profits and dividends

- salaries and allowances including foreign social security payments, medical, pension and other insurance paid to expatriate employees or such items paid by overseas headquarters or affiliates on behalf of an FIE in China
- overseas business trip expenses and overseas training fees or other expenses paid by overseas headquarters or affiliates on behalf of an FIE in China
- royalties and management fees allocated by overseas companies to an FIE in China
- service fees paid to an overseas company

Procedure to Remit Funds

To make a payment or reimbursement, an FIE must file an application with the State Administration of Foreign Exchange ("SAFE"). Once approved by SAFE, an FIE may purchase the foreign currency and remit the money at a bank that is authorized to handle foreign exchange transactions.

There are different paperwork requirements for remittance of various kinds of money. Generally speaking, payments for services are subject to the least burdensome foreign exchange paperwork requirements, while the payments of royalties are subject to more complex paperwork requirements. Banks will not allow an FIE in China to remit a royalty unless it has obtained a registration certificate issued by the Ministry of Commerce of the People's Republic of China ("MOFCOM"). Among royalties, a know-how royalty is easier to remit than a patent royalty in that a patent royalty remittance must be also be accompanied by a return receipt issued by the State Intellectual Property Office. A trademark royalty remittance must also be accompanied by a trademark registration issued by the Trademark Office which is part of the State Administration of Industry and Commerce.

> **"There are different paperwork requirements for remittance of various kinds of money."**

All non-trade account repatriation must be coupled with a copy of the inter-company agreement such as a license agreement or a notice of payment issued by the overseas headquarters or affiliated company. Remittance of profits and dividends requires a resolution from the FIE's board of directors regarding the distribution of profits, and a finance report audited by the FIE's certified accounting firm. In addition, a tax payment certificate issued by the local tax bureau reflecting payment of the requisite taxes must be obtained and delivered to the bank.

And the tax payments and requirements vary, depending on the source of funds. In China, the tax rate applicable to profits and dividends generally is 30%. However, an FIE may have been established with tax incentives, reducing the applicable tax rate to 15% or even a zero tax rate. Royalties are subject to both a 10% withholding tax and a 5% business tax. In the case of a trademark royalty, there would be 10% withholding tax and 5% business tax. By contrast, a know-how royalty may only be subject to a withholding tax of 10%. Further, a business tax exemption may be obtained. Service fees paid by the FIE to its parent for services performed in China are subject to a deemed corporate income tax and also to business tax. These taxes would apply to that portion of the services performed in China. If the services were performed 100% offshore, they would not be subject to any remittance tax in China.

Additional restrictions also exist, requiring companies to retain minimum levels of profits and certain designated reserves. Repatriation processes and strategies remain complex, requiring appropriate advice from professionals.

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China Slow to Revalue Yuan against the Dollar

For several years, various U.S. business and labor organizations have urged authorities in China to allow its currency, the yuan (also referred to as renminbi or RMB), to rise in value against the dollar. Advocates of "un-pegging" the yuan argue that by holding the yuan at approximately 8.27 per U.S. dollar, manufacturers in China gain a significant competitive advantage over their U.S. competition. These organizations and many commentators attribute job losses and the enormous U.S. trade deficit to an undervalued yuan. Indeed, the U.S. trade deficit with China has increased from $6.2 billion in 1989 to a record $162 billion in 2004. While there is little consensus about the extent to which China's currency may be undervalued, most experts seem to agree that there is clear evidence of undervaluation.

Proponents of a flexible exchange rate argue that it is in China's own interest to adopt an independent monetary policy that is not linked to the U.S. dollar system and that would allow Chinese policymakers to adjust to internal and external macroeconomic considerations. With China's economy growing by as much as ten percent a year, with inflation at around five percent, Chinese officials concerned about an overheated economy could use a flexible yuan to help control China's economic growth.

Other commentators say that a revaluation of the yuan is unlikely to affect the U.S. trade deficit since China's advantage in exports is supported by many factors that will likely help China maintain its role as a manufacturing powerhouse. For example, wages in China, sometimes as low as $1 per hour, are often coupled with free room and board, which is an important incentive for millions of migrant workers. Another example is Chinese-made industrial machines, such as injection molding machines for the plastics industry, which can cost a third less than comparable American-made models. Moreover, some experts have noted that if the yuan is allowed to increase in value, any benefit

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from decreased volumes of Chinese exports and increased U.S. exports to China would be dwarfed by higher costs for Chinese-made products, resulting in a significant net loss for the U.S. economy.

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According to some economists, increased global productivity, including China's, is the cause of the U.S. trade deficit, not an undervalued yuan. The U.S. dollar's decline of twenty percent on a trade-weighted basis over the past two years lead to an expectation that import prices would rise and thereby stem the flood of foreign-produced goods arriving in the U.S. However, China and the rest of the world continue to produce more for less, causing the U.S. trade deficit to continue to grow.

Treasury Secretary John Snow seems content to allow China to proceed at its own pace in addressing the issue and has rejected more aggressive measures advocated by U.S. interest groups. Secretary Snow has stated that "...the most effective way at this time to achieve the goal of a flexible, market-based exchange rate in China is to maintain the persistent engagement we have established rather than through a trade petition. Economic isolationism does not work and it's a path we will not follow."

Although Chinese authorities have expressed an interest in allowing the yuan to float against the U.S. dollar, they have made it clear that they will proceed on their own terms without yielding to U.S. pressure. Authorities state that they will continue to improve China's banking system to ensure that it will be able to handle a flexible exchange rate regime. China has already taken significant steps to liberalize various aspects of its financial markets by introducing new financial instruments and by providing greater access to accommodate foreign participation. However, China has been careful not to provide any sort of timeline or guidance on the plan for revaluation that would promote wide-spread currency speculation. In the coming months, the U.S. and the world will have an eye on China's policymakers as they articulate their plans to revise the value of the yuan.

For more information on this topic, contact Daniel Lok at 216.363.4448 or dlok@bfca.com.

Current Events

April 21 – May 1, 2005
Benesch China Group partners Peter Shelton and Megan Mehalko will be in China. In addition to meeting with, and working on behalf of, clients, they will be visiting:

- Auto Shanghai 2005 - The 11th International Automobile & Manufacturing Technology Exhibition
- The 2005 China International Forum for the Development of Automobile and Auto Parts Industries (Qingdao, China)
- Numerous factories owned by U.S. and Chinese manufacturers
- Government officials to discuss policies and business trends in China's auto and auto parts industries
- China-based service providers and business consultants

Their itinerary also includes meetings in Beijing.

May 6, 2005, Fremont Ohio
China Group attorneys will be presenting and co-sponsoring "The China Challenge: How to Compete and Win" at Terra Community College. Contact Megan Thomas at 216.363.4174 for additional information.

How We Work With Clients

We help U.S. companies: (1) develop U.S.-based solutions to competition from China; (2) source components and products from China, and deal with related logistics issues; (3) establish China-related strategic alliances and joint ventures for assembly, R&D, manufacturing and distribution; and (4) establish wholly owned manufacturing and other business operations in China.

We help clients structure, negotiate and document China-related transactions, and provide counsel with respect to capital structure, operating control, governance, contracts with customers, and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers enable us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost effective manner.

FOR MORE INFORMATION OR TO DISCUSS ANY ASPECT OF YOUR CHINA STRATEGY, CONTACT ANY MEMBER OF OUR CHINA GROUP:

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