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THE CHINA BUSINESS REVIEW

THE MAGAZINE OF
THE US-CHINA BUSINESS COUNCIL

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THE CHINA BUSINESS REVIEW

THE MAGAZINE OF THE US-CHINA BUSINESS COUNCIL

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THE CHINA BUSINESS REVIEW
THE MAGAZINE OF THE US CHINA BUSINESS COUNCIL

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Short Takes

Chinese Are Richer, But Not Happier

Per capita income has more than doubled since 1994, and more Chinese own VCRs, color televisions, and telephones than ever befo a recent Gallup Organization poll shows. But despite this increased wealth and greater access to modern goods, many Chinese say their quality of life has not risen. In fact, the poll revealed that the ratio o Chinese expressing satisfaction to those showing dissatisfaction has actually fallen slightly over time.

The poll, which covered 15,000 adults across all provinces, show Chinese most pleased about their personal health and family life an most dissatisfied with their amount of savings. Curiously, more rur respondents report being satisfied by the communities they live in, although urban dwellers enjoy higher satisfaction in their possessio leisure time, and jobs.

Chinese Brands Don't Pack a Punch

Chinese companies failed to break into the Interbrand-*Businessweek* annual list of the world's 100 most valuable brands. T value of a brand is defined as the likely future earnings of a compan name. American firms dominated the list with 54 brands, represent a wide range of industries including high technology, consumer goo financial services, and entertainment. Indeed, the top five were US brands: Coca-Cola, Microsoft, IBM, General Electric, and Intel, in order of brand value. Thirty-four brands were European while only eight—seven Japanese and one South Korean—were Asian.

Profits in the Countryside

Rural credit cooperatives, one of the few sources of credit in rura areas, posted their first profits in more than 10 years, according to t state's bank regulator. Of the 26,245 rural co-ops, 81 percent were profitable. Overall, rural co-ops reduced their nonperforming loans (NPLs) by $6.5 billion, or 6.3 percent, in 2004. The aggregate NPL ratio of rural co-ops fell from 29.4 percent to 23.1 percent.

The government touted its pilot reform programs in eight regions—Chongqing, Guizhou, Jiangsu, Jiangxi, Jilin, Shaanxi, Shandong, and Zhejiang—as a major reason for the co-ops' recent profitability. These reforms gave subsidies and tax breaks to co-ops, allowed them to exchange bad assets for central bank notes, and per mitted them to restructure their property rights schemes according regional conditions.

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The *CBR* circulates to first and business-class passengers on United, Northwest, Delta, Cathay Pacific, and Singapore airlines. By increasing airline circulation by 26 percent over 2004, *CBR* reaches more corporate decisionmakers involved with China than ever before. To find out more about becoming an advertising sponsor of the *CBR*, contact Jesse Marth (202-429-0340; jmarth@uschina.org).

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THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会
BULLETIN

EVENT WRAP-UP

January

Beijing

Breakfast Meeting on the Future of US-China Trade Relations Featured US Secretary of Commerce Donald Evans

Luncheon Meeting on Current US-China Developments Featured USCBC President John Frisbie

Shanghai

Luncheon Meeting on Current US-China Developments Featured USCBC President John Frisbie

Hong Kong

Luncheon Meeting on Current US-China Developments Featured USCBC President John Frisbie

Discussion of Trade Unions in Foreign-Invested Enterprises Featured Tibor Baranski of Jun He Law Firm's Beijing office

Chicago

Meeting on China Market Trends and Opportunities for Business Featured USCBC President John Frisbie, Director of China Operations Patrick Powers, and Director of Business Advisory Services Mark Mechem. The speakers addressed the business climate in China for 2005, challenges and opportunities for US companies, and prospects for bilateral trade relations.

February

Dallas

Meeting on China Market Trends and Opportunities for Business Featured USCBC President John Frisbie, Director of China Operations Patrick Powers, and Director of Business Advisory Services Mark Mechem

Washington

Forecast 2005 See below and right

Issues Luncheon Featured Everett Eissenstat, chief international trade counsel (majority) of the Senate Committee on Finance, on sentiments on Capitol Hill toward China trade and legislative prospects in the coming months, and Edward Gresser, director of Trade and Global Markets Project, Progressive Policy Institute, on the Bush administration's trade policy priorities

UPCOMING EVENTS

Farewell Reception and Luncheon for Outgoing PRC Ambassador Yang Jiechi
March 3, 2005

Issues Luncheons, Washington, DC
March 17, 2005
Featuring Deputy Assistant Secretary of Commerce for Asia Pacific Policy Henry Levine

April 21, 2005
May 19, 2005

USCBC Gala 2005 & 32nd Annual Membership Meeting
June 8 & 9, Ritz-Carlton Washington, DC
For more information, see p.27

China Operations (CHOPS) 2005 Conference
April 2005

Forecast 2005

The US-China Business Council (USCBC) kicked off its annual Forecast conference with an evening reception on February 2 that featured guests from the US government, the PRC Embassy, member companies, and other China-related organizations.

The conference continued the next morning with presentations by Kenneth Lieberthal and Nicholas Lardy. Lieberthal, a visiting fellow at the Brookings Institution and professor of business and political science at the University of Michigan, discussed Chinese politics and policy trends. Lardy, a senior fellow at the Institute for International Economics, outlined the major issues facing China's economy this year. Charles Freeman, assistant US trade representative for the People's Republic of China, Taiwan, Hong Kong, Macao, and Mongolia, reported on the progress of negotiations on key bilateral trade issues.

During the luncheon program, Brian Pomper, chief international trade counsel for the Senate Finance Committee, presented remarks from Senator Max Baucus, ranking member, US Senate Finance Committee, on US-China trade relations in 2005. The afternoon speaker, Patrick J. Powers, director of USCBC China Operations, presented the top operational concerns of US businesses in China.

Member company representatives then met with USCBC staff for benchmarking sessions on distribution and trading rights (led by Linda Cheever, president of Danaher's China Management Board) and sourcing (led by Roy Sheldon, vice president and director of emerging markets for ITT Industries, Inc.).

Joseph Donovan, director for the Office of Chinese and Mongolian Affairs, Bureau of East Asia and Pacific Affairs at the US Department of State; USCBC President John Frisbie; and Deputy Chief of Mission, PRC Embassy, Minister Lan Lijun, at the Council's Forecast Reception.

Jaqueline Willis, Hong Kong Commissioner for Economic and Trade Affairs; Nicholas Lardy, senior fellow, Institute for International Economics; and Patrick Powers, USCBC director of China Operations, at the Council's Forecast Reception.

John Frisbie and Kenneth Lieberthal, visiting fellow in Policy Studies, the Brookings Institution

USCBC Editor Catherine Gelb and Assistant USTR for China, Taiwan, Hong Kong, Macao, and Mongolia Charles Freeman

Chief International Trade Counsel for the Senate Finance Committee Brian Pomper

Danaher China Board of Management President Linda Cheever and Patrick Powers

Participants in a Forecast benchmarking session

USCBC President Meets with Leaders in China

USCBC President John Frisbie and Vice Minister of Commerce Ma Xiuhong

John Frisbie made his first visit to China and Hong Kong as Council president in January and was pleased to see that many of his Chinese government counterparts are officials he knows well from his work in China over the past two decades.

In meetings with senior officials at the Ministry of Commerce, National Development and Reform Commission, and Ministry of Foreign Affairs, Frisbie emphasized the need for successes by American firms in China in order to overcome much of the negative sentiment building in the United States regarding trade with China. Frisbie emphasized the need for visible progress in leveling the playing field for US companies, including the implementation of China's World Trade Organization commitments, for American firms in China. He highlighted two issues for attention: China's timely implementation of government rules granting distribution rights to foreign firms; and, following on the late 2004 issuance of the judicial interpretation promising tougher penalties for counterfeiting, progress in intellectual property rights (IPR) enforcement.

Frisbie also met with Mayor of Beijing Wang Qishan, Vice Mayor of Shanghai Zhou Yupeng, and Hong Kong Secretary of Commerce, Industry, and Technology Tsang Chun-wah. Beijing Mayor Wang expressed his desire to work with American firms in the run-up to the 2008 Olympics.

John Frisbie with Wan Jifei, chair of the China Council for the Promotion of International Trade

In his stops in Beijing, Shanghai, and Hong Kong, Frisbie met with close to 150 representatives of Council member companies. In luncheon forums in each city, he described initiatives the Council plans to undertake in 2005 and listened to the top issues members would like the Council to focus on in the coming year. In addition to distribution rights and IPR enforcement, issues include standards, China's government procurement regulations, local content requirements in China, and US visa policy.

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Tourism Takes Off

Chinese and foreign tourists are traveling around China like never before, spurring demand for hospitality services

Larry Yu and Ginger Smith

CHINA'S TREMENDOUS ECONOMIC GROWTH OVER THE LAST DECADE IS forecast to continue as the country prepares for the 2008 Olympic Games in Beijing and 2010 World Expo in Shanghai. Tourism, which has played no small part in this growth, now accounts for about 7 percent of China's GDP and is expected to make up 11 percent of GDP by 2020, according to Zhang Guangrui and Alan A. Lew, editors of *Tourism in China*. The World Tourism Organization, headquartered in Madrid, Spain, forecasts that China will become the leading tourist destination in the world by 2020.

This growth is good news for foreign providers of tourism and hospitality services, especially because by December 2005, four years after China's entry into the World Trade Organization, the Chinese government will permit 100 percent foreign ownership in the construction and operation of hotels and restaurants. Wholly foreign-owned travel operations will be permitted by December 2007.

Inbound tourists: From a trickle to a flood

Since China first opened its doors to international tourism in 1978, incoming visits have risen sharply—from 716,000 in 1978 to an estimated 41 million in 2004. International tourism receipts surged from $263 million in 1978 to an estimated $25.5 billion in 2004. (This growth trend was interrupted only three times during this 24-year period: in the aftermath of the government crackdown on the Tiananmen Square student demonstrations in 1989; during the political tension between China and Taiwan in 1995; and during the severe acute respiratory syndrome [SARS] epidemic in 2003 [see p.16].) Rapid economic growth continues to fuel the business travel market, and the diversity of China's tourism attractions continues to appeal to the leisure market. In addition, the Beijing Olympic Games in 2008 and the World Expo in Shanghai in 2010 will generate increases in sports tourism and in the convention and exhibition business. As a result, business opportunities are emerging in hotel development. Particularly popular now are condominium hotels and mixed-use developments such as the Grand Hyatt Shanghai, which offers full services (including rooms and food-and-beverage, catering, meeting, business, fitness, and retail services) to business travelers and high-end leisure tourists. Mixed-use developments are popular because they allow operators of various services to split high development costs, while condominium developments are popular because developers can sell units to recoup costs quickly. Restaurant development, travel agency operations, sports management, and convention, exhi-

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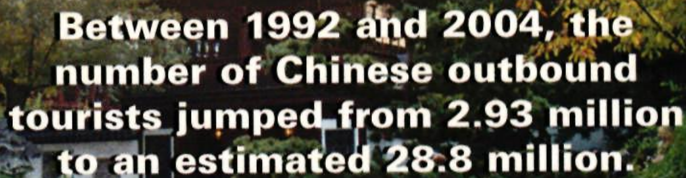

Photos: US-China Business Council

bition, and event management—in short, nearly all major areas important to travel and tourism investors—also offer opportunities.

Chinese get the travel bug, too

China's domestic tourism market has also grown phenomenally since 1994, with the only decline occurring during the SARS epidemic. The market recovered quickly, however: the number of domestic tourists rose from 870 million in 2003 to 930 million in 2004, surpassing the 878 million in 2002. This growth can be attributed to rising disposable incomes, more public holidays, rising interest in travel, and the greater availability of products and services to facilitate domestic travel.

- **Disposable income** Between 1980 and 2000, China's per capita income quadrupled. Living standards in the economically developed coastal regions and major metropolitan areas have risen sharply in recent years, allowing more people to travel to different parts of the country.
- **Public holidays** PRC government attempts to boost a flagging economy in the mid-1990s also boosted domestic tourism. The government instituted three, week-long public holidays surrounding Spring Festival (late January or early February, depending on the lunar calendar), Labor Day (May 1), and National Day (October 1). These holidays also stimulated outbound travel.
- **Rising interest in travel** More income and leisure time have also allowed Chinese to cultivate a wide range of interests, and urban dwellers now travel in search of cultural heritage, natural scenery and wilderness experiences, festivals, sporting events, shopping, and many other activities. The current travel trend focuses on ecotourism. More tourists are also exploring the unique cultures of China's numerous ethnic minority groups.
- **Travel products and services** The attractions and marketing promotions by tourism authorities, travel companies, and hotels also entice potential domestic tourists to visit different destinations within China. Specialized travel services, such as adventure travel and farm stays, have made travel planning less complicated and more destinations accessible. Finally, improvements in infrastructure and transportation services over the last 20 years have simply made traveling much easier.

Outward bound

China's contact with the rest of the world has expanded since the late 1970s, allowing the release of pent-up demand for travel abroad. Between 1992 and 2004, the number of Chinese outbound tourists jumped from 2.93 million to an estimated 28.8 million. The four factors discussed in the previous section on domestic tourism are also key factors influencing China's outbound tourism. But another important factor strictly controls which countries Chinese leisure tourists can visit—the PRC government's designation of Approved Destination Status (ADS). At present, Chinese tourists can only visit ADS countries in group tours run by designated tour operators in the ADS country. The ADS country government designates these tour agencies by business capacity and specialty, often selecting those that have already been working with Chinese travel companies and that specialize in Asian markets such as Taiwan and Hong Kong. The number of agencies in each country is determined by each ADS government. For example, Hong Kong has 175, Macao 76, Denmark 16, and India 768.

Designated, first-tier travel agencies in China, which number more than 400 today, are authorized to market and organize Chinese outbound tour groups (which are then handled by destination country agencies after arrival). First-tier agencies in China can operate all types of travel business: inbound international tourists, out-

Chinese tourists can only visit ADS countries in group tours run by designated tour operators.

Territories with Approved Destination Status

1. Hong Kong
2. Macao
3. Thailand
4. Singapore
5. Malaysia
6. The Philippines
7. Australia
8. New Zealand
9. Korea (Chaoguo)
10. Japan
11. Vietnam
12. Cambodia
13. Myanmar
14. Brunei
15. Nepal
16. Indonesia
17. Malta
18. Turkey
19. Egypt
20. Germany
21. India
22. Maldives
23. Sri Lanka
24. South Africa
25. Croatia
26. Hungary
27. Pakistan
28. Cuba
29. Greece
30. France
31. The Netherlands
32. Belgium
33. Luxembourg
34. Portugal
35. Spain
36. Italy
37. Austria
38. Finland
39. Sweden
40. Czech Republic
41. Estonia
42. Latvia
43. Lithuania
44. Poland
45. Slovenia
46. Slovakia
47. Cyprus
48. Denmark
49. Iceland
50. Ireland
51. Norway
52. Romania
53. Switzerland
54. Liechtenstein
55. Ethiopia
56. Zimbabwe
57. Tanzania
58. Mauritius
59. Tunisia
60. Seychelles
61. Kenya
62. Zambia
63. Jordan
64. United States
65. Great Britain

Note: Ranked by date approved

Source: China National Tourism Administration

bound Chinese tourists, and domestic tourists. Second-tier agencies can operate only ground services for international and domestic tourists in China but cannot promote international markets to Chinese travelers. Third-tier agencies can handle only domestic tourism. The outbound Chinese tourists themselves are required to deposit cash as collateral to ensure their return to China (the amount varies by destination country).

At present, China has granted 65 countries ADS. The latest ADS country is Great Britain, assigned in January 2005. In 1983, Hong Kong and Macao became the first two places to receive ADS. The first foreign country to receive ADS was Thailand in 1988, but it was not until the 1990s that overseas travel became affordable for many Chinese. In an important new development, the German tourism authority is considering permitting Beijing and Shanghai residents to travel as free independent travelers (FITs) in Germany in 2005. This new policy, if authorized, may mean that Chinese FITs may then be eligible to travel to the other countries in the Schengen area (all EU members except Britain and Ireland, plus non-EU countries Norway and Iceland).

China and the United States signed a memorandum of understanding (MOU) on December 6, 2004, to grant the United States ADS. The MOU stipulates that Chinese citizens will be able to travel to the United States in May 2005, at the earliest, or no later than the end of 2005. Chinese travel service agencies have designed several products to accommodate Chinese tourists visiting the United States, including tours to the major cities of New York, San Francisco, and Los Angeles; the casino cities of Las Vegas and Atlantic City; the natural wonders of the Grand Canyon and Niagara Falls; and the theme parks of Disney and Universal Studios. A US tour will cost about ¥25,000 ($3,019), and tourists will have to pay a refundable deposit of ¥100,000 ($12,077) to qualify for travel to the United States.

Build it and they will come

Hotel development in China has paralleled tourism development in the last decade. By the end of 2003, star-ranked tourist hotels reached 9,751, with a total of 992,800 rooms, according to the China National Tourism Administration. More than half of tourist hotels in China were owned directly either by government departments or by state-owned enterprises, and about a quarter were privately owned and operated. Developers from Hong Kong, Macao, and Taiwan invested in about 5 percent of the hotels in China. Although foreign companies owned only 3 to 4 percent of hotel properties, international hotel companies have been jockeying for position in the Chinese hotel markets through direct investments, franchise and management contracts, and strategic alliances. Luxury brands such as Four Seasons and Ritz-Carlton are now developed in Shanghai. Marriott International, Inc. has been focusing on both upscale and mid-market segments. Familiar brands such as Holiday Inn, Sheraton, Hyatt, Hilton, and InterContinental continue to expand in major and secondary cities and other tourist destinations.

Market opportunities for budget and mid-market segments for the growing numbers of Chinese domestic tourists have prompted Cendant Corp. (Days Inn, Howard Johnson, Ramada, and Super 8 brands) and Choice Hotels International, Inc. (Clarion, Comfort, Quality, and Sleep Inn brands) to expand operations in China (see p.24). Like many other sectors, China's hotel industry is being shaken up by privatization. Hotel consolidations and mergers are occurring at an increasing pace, and several Chinese-branded hotel companies, such as the Shanghai-based Jinjiang International Hotel Management Co. and the Beijing-based Jianguo Hotels International, have emerged to compete with other international and regional hotel operators, in part because they are recognizable domestic brands with competent expatriate and Chinese managers and good locations.

Tips for building your presence

China's robust growth will continue to fuel tourism and hospitality business development and create opportunities for many ancillary services. Hospitality development in China will focus on the mid-range and budget segments of the travel market to accommodate ever-growing Chinese domestic tourism. Brand development is a key opportunity for international hospitality companies, as most Chinese hotels are not currently branded. And as the state-owned hotels are privatized, the new owners will want to rebrand them as private-sector enterprises.

As for market-entry choices, franchise and management contracts are particularly effective ways to develop new tourism and hospitality businesses in China. International developers can expand their businesses by franchising (as Holiday Inn successfully did) or by contracting for management services (as Marriott has done) to minimize upfront capital investment and reduce business risk. Chinese owners will also find the franchising

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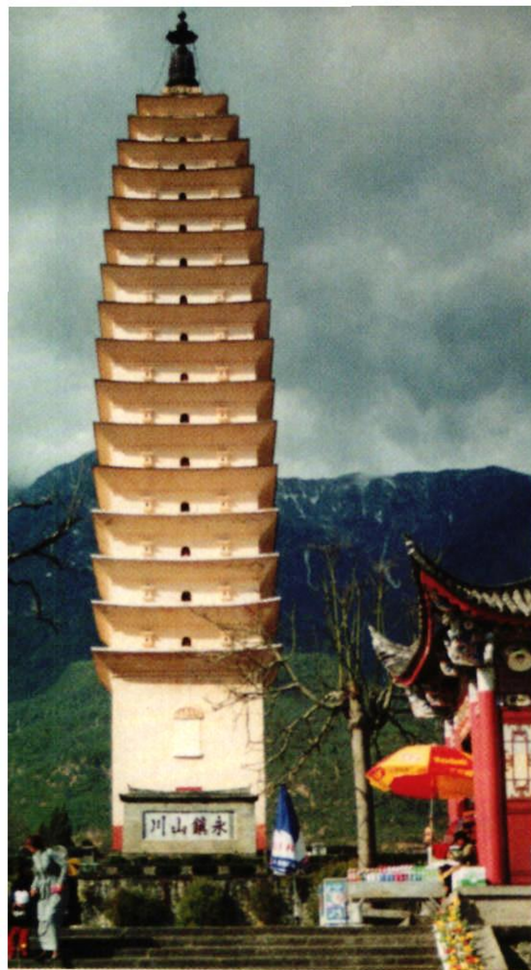


Franchise and management contracts are particularly effective ways to develop new tourism and hospitality businesses in China.

and management contract arrangements beneficial because they instantly gain brand recognition and advanced technological and managerial know-how.

Opportunities for foreign firms

The privatization and sale of state-owned hotels have created demand for professional hotel appraisers. As competition intensifies with the arrival of international hotel companies, domestic branded hotel chains are aggressively recruiting competent executives and managers in strategy, asset, and distribution management. For example, the CEO of Jinjiang International Hotel Management Co., Christopher Bachran, is an American expatriate. This demand for competent executive and managerial professionals creates opportunities for institutions of higher education and executive and professional training firms.

The arrival of Chinese leisure tourist groups in the United States and other ADS destinations presents business opportunities for travel companies in areas related to ground operations in ADS territories. For example, Hong Kong-based China Travel Service (CTS) has already begun to expand its US operations in anticipation of the influx of Chinese tourists to the United States. US travel companies that understand Chinese tourists' travel behavior and have staff with Chinese culture and language skills will find a niche serving Chinese tourists.

Yet international tourism and hospitality companies will also face challenges in developing business in China. Financing for hotel project development is extremely limited in China since the state-owned banks are not currently interested in funding new, potentially speculative hotel projects.

American Express in China

It may come as no surprise to the typical *CBR* reader that American Express (Amex), a global leader in corporate travel and financial services, formed the first joint-venture corporate travel service in China, together with state-owned China International Travel Service (CITS), in 2002. After all, says L. J. Jia, vice president and China country manager, Amex counts among its corporate clients 90 percent of the Fortune 100. And the joint venture, CITS American Express Travel Services Ltd., is designed to provide the same level of service to Amex's multinational clients traveling in China as the company provides to its clients anywhere in the world.

These business travel services include not only better prices on hotels and airline tickets but also tailored expense-management programs. The closed-loop information network provided by Amex's corporate card services allows Amex clients to keep track of employee spending on the road.

Jia stresses that this joint venture is only part of the company's "long-term commitment" to China, which he explains began early in the last century, when the company established banks in Beijing, Shanghai, and Tianjin in 1918. The company returned to China more than 25 years ago, setting up in the Beijing Hotel to liaise with CITS to conduct group tours around the country. Amex established its formal representative office in 1982.

Today, Amex has representative offices in Beijing, Guangzhou, Shanghai, and in Xiamen, Fujian; two bank offices in Beijing and Shanghai, and three joint ventures in Beijing, Shanghai, and Guangzhou. CITS also acts as Amex's representative in cities like Chengdu, Sichuan—where Amex cardholders can report their lost cards and arrange replacements. Amex sells 90 percent of the traveler's checks that PRC government officials and other Chinese citizens use when they travel overseas.

Support for the travel industry

Other efforts the company has undertaken in China are aimed at "helping China develop its service capability and standards," Jia says, such as awarding scholarships to tourism managers to enter master's degree programs at the New School in New York City and the University of Hawaii. The company has also established a training center at Beijing Tourism College.

Amex funds numerous heritage preservation projects in China. In Beijing's Forbidden City, for example, Amex funded the replacement of the Palace Museum's old description plaques with new ones in three languages—Chinese, English, and Japanese. Amex is also an "anchor sponsor" of the World Monument Fund, a New York-based organization that identifies 100 endangered sites each year that it targets for restoration. Amex has donated $10 million to the organization since its formation in 1995. The fund selects one China site each year, such as the Shaxi Marketplace in Yunnan, which Amex supports directly.

The financial dimension

Of course, Amex's financial services are integral to the company's goals in China. The firm recently partnered with the Industrial and Commercial Bank of China to introduce the Peony dual-currency network card to Chinese customers. The company also has a relationship with other local banks to conduct payment settlement for tens of thousands of merchants working through local bank branches throughout China. When China opens its banking sector further to foreign investors, Amex hopes to explore opportunities in that sector as well, Jia says.

—Catherine Gelb

Financing is available from Chinese private companies, however, and a partnership with a reputable Chinese company may help a foreign investor secure financing.

Whether a company serves Chinese and international tourists within China or Chinese outbound tourists elsewhere in the world, opportunities for new ventures and partnerships beckon in every corner of the hospitality industry. Companies that can strategically identify a market and find a Chinese partner will reap the benefits of an increasingly vibrant Chinese travel and tourism industry. 完

Ensuring Quality Service

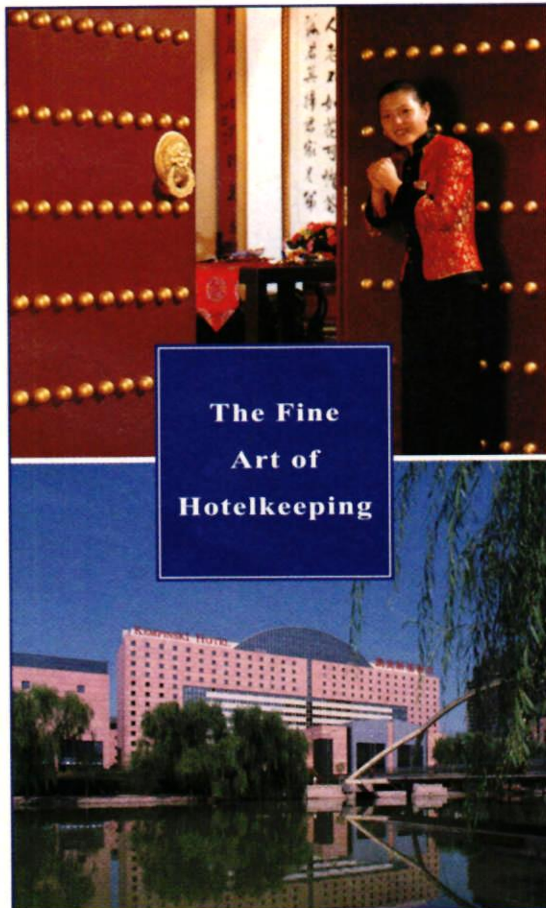
International tourism and hospitality companies often face inconsistent levels of service quality in the Chinese tourism industry. Service performance varies from organization to organization and from region to region, typically between international and domestic companies, and between coastal and interior regions.

The China National Tourism Administration (CNTA) has set up a national hotline for international and domestic tourists to complain about poor service on their trip, and China International Travel Service (CITS), the largest first-tier travel agency, has deposited ¥1.6 million ($193,237) with CNTA to settle any disputes between CITS and tourists over poor service.

Quality service, customer-service training, and the development of a service culture are essential to provide travelers with a consistently positive experience. Any firm involved in tourism development in China needs to focus on personnel training, and in fact, many foreign investors consider it a significant part of their investment in China. Currently, most firms are pursuing various training strategies to raise the competency level of service professionals. Such strategies include rigorous in-house training by experienced managers or consultants with diverse cultural backgrounds, education at tourism and hospitality management schools, or quality service training for selected managers and staff.

As many longtime travelers to China can attest, good quality service has been lacking until fairly recently. But as China's economy shifts into greater reliance on the service industry, the country will have to develop a nationwide culture of quality service. The greater involvement of international tourism and hospitality companies in China will help speed the development of such a culture.

—Larry Yu and Ginger Smith



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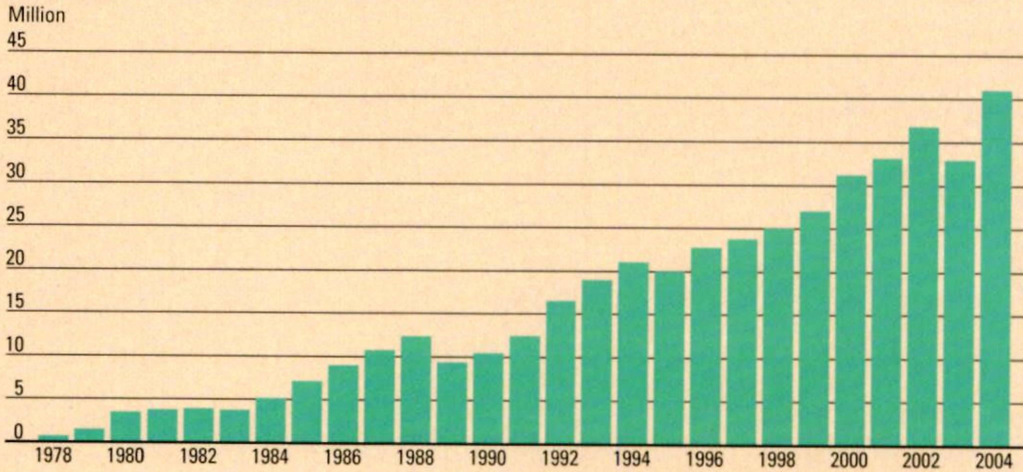
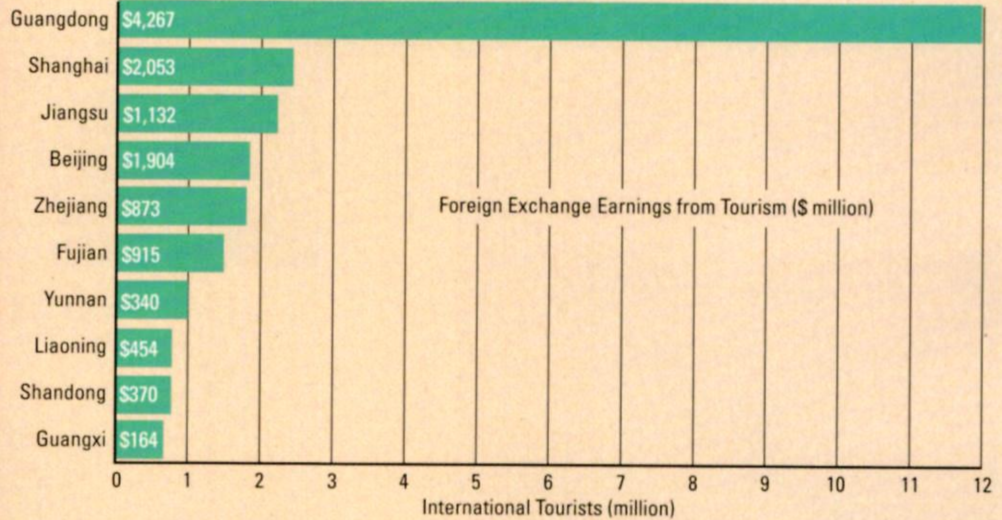
CHINA STATS: Tourism

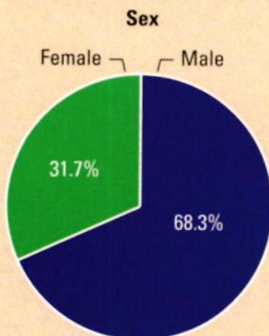
International Tourist Arrivals, 1978–2004

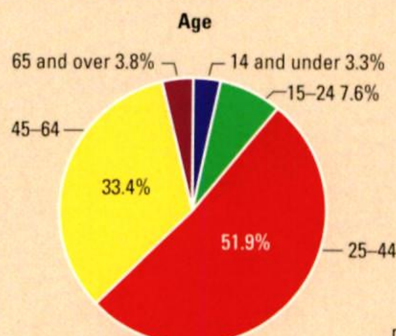


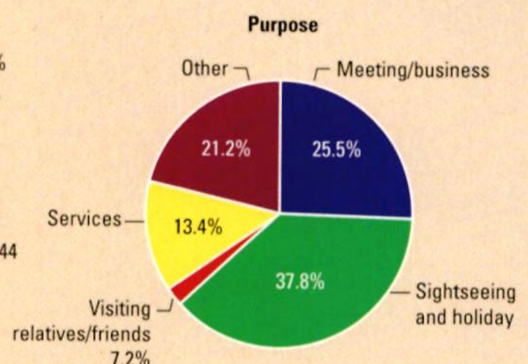
Top Ten Destinations, 2003



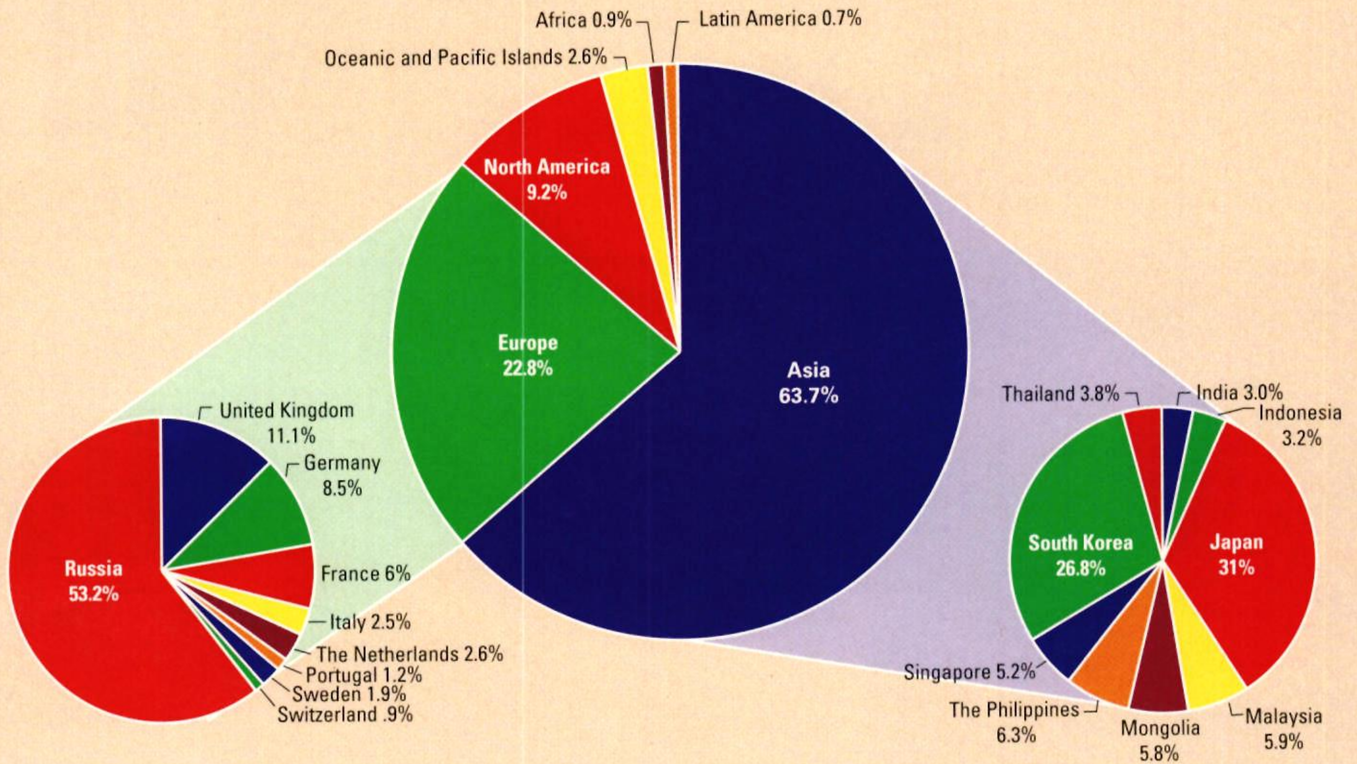
International Tourists by Sex, Age, and Purpose, 2003



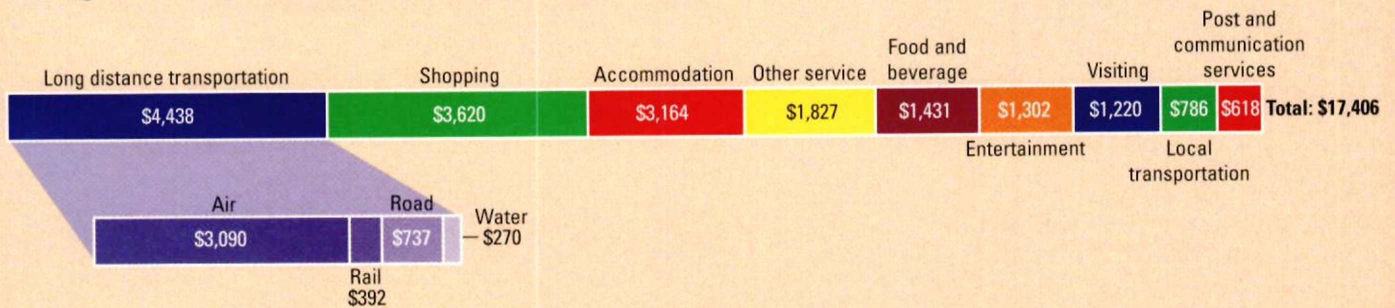




Foreign Tourists by Country and Region, 2003



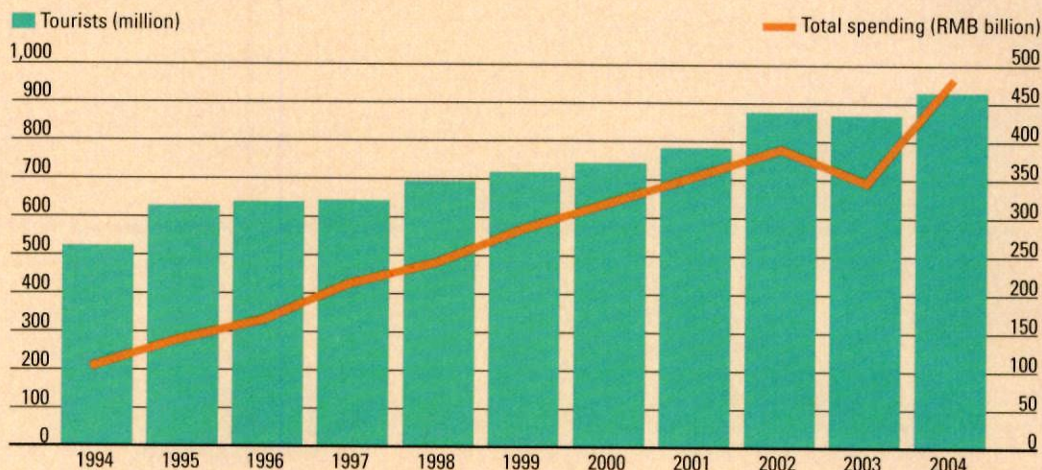
Foreign Exchange Earnings from Tourism, 2003 ($ million)

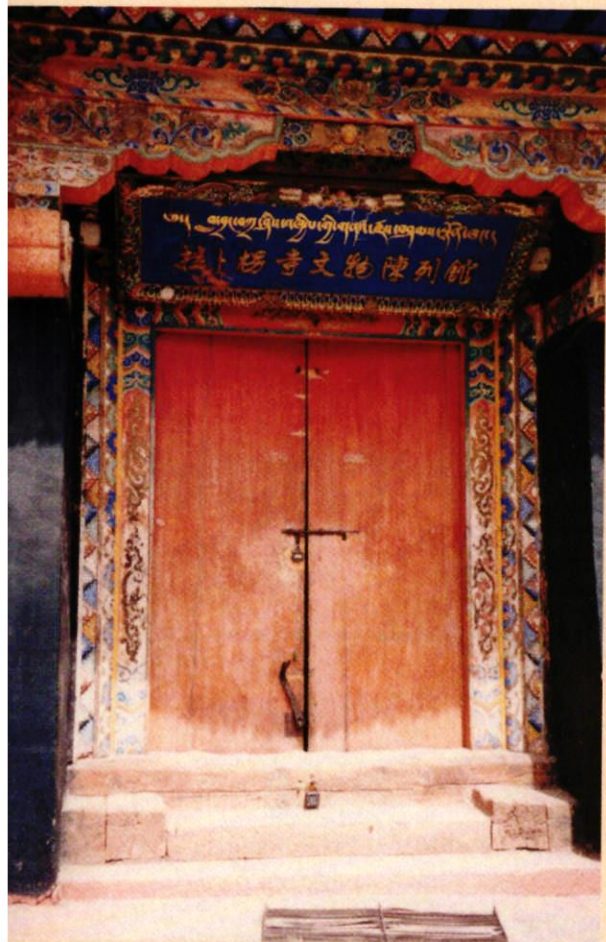


Sources: China National Tourism Administration; National Bureau of Statistics *China Statistical Yearbook*, 2004

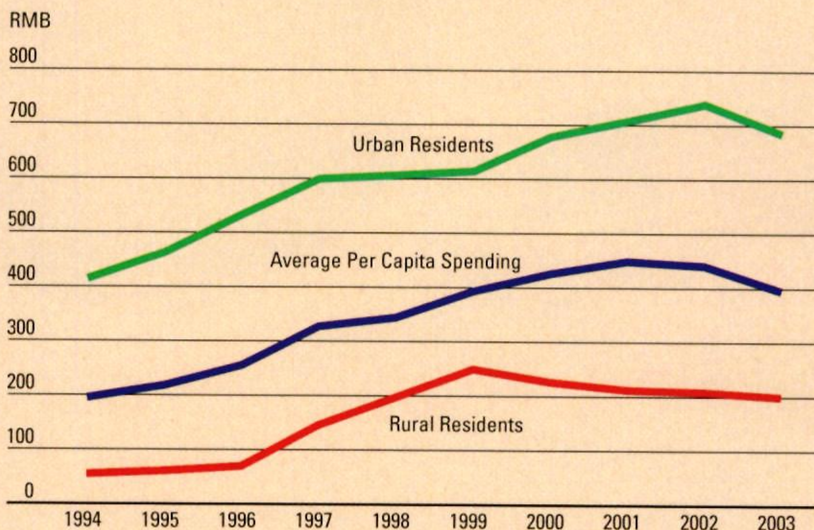
Greetings FROM CHINA

Domestic Tourists, 1994–2004

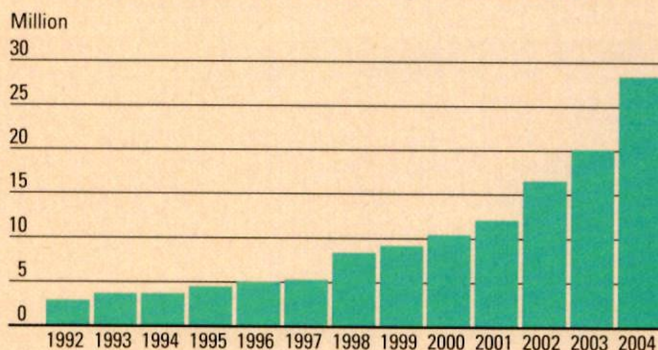




Domestic Tourists' Per Capita Spending, 1994–2003



Chinese Outbound Tourist Trips, 1992–2004



Number of Hotels, 2003

Region	Total	Number of Rooms: 500 or more	300-499	200-299	100-199	Fewer than 100
National Total	**9,751**	**83**	**349**	**680**	**2,324**	**6,315**
Guangdong	967	15	37	62	198	655
Zhejiang	733	3	13	59	190	468
Beijing	617	26	63	53	132	343
Jiangsu	590	2	24	42	154	368
Yunnan	572	3	9	20	81	459
Hubei	540	0	10	20	99	411
Shandong	482	3	14	37	138	290
Liaoning	379	3	10	30	99	237
Henan	359	0	8	27	111	213
Hunan	356	0	4	11	44	297
Sichuan	346	1	9	31	122	183
Shanghai	338	15	33	41	109	140
Hebei	313	1	4	18	111	179
Fujian	305	0	10	19	63	213
Anhui	298	0	28	25	22	223
Guangxi	293	2	14	28	88	161
Xinjiang	239	0	7	17	65	150
Shanxi	236	0	1	9	65	161
Shaanxi	229	2	11	17	42	157
Heilongjiang	205	0	2	11	46	146
Hainan	199	3	12	31	67	86
Jilin	192	1	3	10	32	146
Jiangxi	187	0	3	13	31	140
Gansu	157	1	5	11	44	96
Chongqing	147	0	7	15	44	81
Inner Mongolia	132	1	0	4	30	97
Guizhou	112	0	1	7	38	66
Tianjin	87	1	4	10	26	46
Tibet	58	0	1	2	5	50
Qinghai	50	0	2	0	15	33
Ningxia	33	0	0	0	13	20

Sources: China National Tourism Administration; National Bureau of Statistics *China Statistical Yearbook*, 2004

William P. Weidner, president and COO of Las Vegas Sands Corp.

GAMBLING ON CHINA'S EDGE

The Venetian has big plans for Macao

CBR Associate Editor Virginia Hulme recently spoke with William P. Weidner, president and COO of Las Vegas Sands Corp. (LVS), which opened the Sands Macao in May 2004 at a total development cost of about $265 million. The company has already broken ground on a Venetian Resort Hotel Casino similar to its Las Vegas, Nevada, flagship and plans to recreate the Las Vegas Strip in Macao. Macao broke its gaming monopoly in 2002 by giving licenses to Wynn Resorts, Inc. and the Galaxy Casino Co. Ltd. (LVS's Chinese co-venture). As the new casinos and resorts open one after the other, the formerly sleepy backwater has taken on new life and is poised to overtake the Las Vegas Strip in gaming revenue this year.

CBR: You've already opened the Sands in Macao. How is that going?

Weidner: We have opened our main, 100,000 m^2 building, with about 16,000 m^2 dedicated to the casino. The rest is food and beverage, entertainment, back of house, etc. It is right near the ferry terminal and is aimed at today's Macao—primarily a day-trip market with an average length of stay of less than 1.2 days. (The average stay in Las Vegas is 3.6 days.) The idea, as we pledged to Macao when we won the license, is that we will change Macao forever by building a full-fledged, multi-property destination resort development. Our concept has been to recreate what has made Las Vegas so successful by developing a Las Vegas Strip in Cotai, which is landfill between the Macao islands of Coloane and Taipa. We have master-planned a total room capacity of 60,000 rooms for the Cotai Strip.

CBR: So how far along is the project? Have you started construction yet?

Weidner: We are building the 105,000 m^2 Venetian in Macao. The Venetian, with its huge convention space, exhibition space, shopping mall, and 18,000 seat arena, is the demand driver for the strip. We have signed memorandums of understanding for a Four Seasons brand hotel, as part of the strip, and for a Holiday Inn brand. We have also signed with a developer to bring a Marriott Renaissance brand, and we have attracted the Regal brand. The idea is that you'll see hotel brand after hotel brand along the strip. So there will be seven branded hotels, each with a master plan for as many as 3,000 rooms.

CBR: I understand you also have plans for Hengqin Island [part of Zhuhai, Guangdong]. How are those projects progressing?

Weidner: Macao has a limited amount of land. We have formed a wholly foreign-owned enterprise and applied for 5.2 km^2 on the neighboring PRC island called Hengqin Island. Hengqin Island is connected to Cotai by the Lotus Bridge and in turn is connected to Zhuhai by the Zhuhai Bridge. The concept for Hengqin Island is to develop nongaming-related destination activities by building golf courses, a tennis center, a recreational center, a marina, water sports, and about 20,000 m^2 of meeting, convention, and activities space. We are building over 100,000 m^2 of meeting space on Cotai for large trade shows and large corporate meetings, and we would plan to use Hengqin Island and the convention center on Hengqin Island for pre- and post-[conference] activities and for meetings that would rather have a PRC address than a Macao address.

But the idea is to have the developments support one another. Cotai is a more urban-style, Las Vegas-Strip-style destination, but Hengqin Island is pastoral, with a more recreational orientation to complement the Cotai Macao development. The combination will create a world-class destination resort straddling Macao and Zhuhai, embodying the concept of economic integration and cooperation between the People's Republic of China and its special administrative regions (Hong Kong and Macao).

CBR: How far is Hengqin Island from Cotai? How long will it take to go from one to the other?

Weidner: Well, you see that building over there [pointing to a building a few hundred yards away]? A

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Roulette at the Sands Macao

Las Vegas Sands Corp.

little more than walking distance, and the beauty of Hengqin Island is that Hengqin Island faces urban Macao. So while you're in urban Macao, you can see the recreational and conference offerings of Hengqin Island. Hengqin Island faces Macao directly, so people who come to Macao can see that there's a marina, there's tennis, there are meeting facilities, and there are more recreational opportunities.

CBR: Have you made any changes or features specifically for the Chinese market in your projects so far?

Weidner: Everything has to be adapted to the Chinese market itself. The idea of the Venetian, though, is that it is a world-class destination resort that will draw both Westerners and Easterners. But the primary target market is Chinese, so we want the foods, beverages, the things that the Chinese will touch, to have familiarity and comfort for our primary target market.

Now, Chinese generally enjoy gardens. So we've created a tropical garden sense and feel on our strip, and it tells the story of the eight immortals. [The eight immortals are popular characters in Chinese folklore.] Each section is dedicated to one of the stories of the eight immortals. So in addition to flowers, trees, and water, we want to make it spectacular, interesting, entertaining, but yet familiar, so that Chinese visitors can identify with it. In the central part of this strip, we have a very large waterfall. On the inside of the mountain—the mountain where the waterfall is—are lifts that bring up professional divers who put on a spectacular diving show in and around the waterfall. And we're including references from the stories of the eight immortals in the show.

We're also developing a very large mall in the Venetian. Our Venetian in Las Vegas has a 50,000 m^2 mall featuring gondolas with singing gondoliers. A Venetian streetscape abuts a curved canal, and you can ride in a gondola and have a gondolier sing to you along the streets and canals of Venice! And we're going to do the same thing in Macao, only we're going to have three canals. Two canals are going to be Italian. But the Chinese had the Grand Canal long before the Italians, so to salute that fact, one of our three canals is a Chinese Grand Canal. The boats will be Chinese style, with flat ends and with a traditional Chinese musician. So you can take a ride on the Chinese Grand Canal and be entertained by traditional Chinese musicians.

CBR: And you must have some sort of Chinese consultant helping you with these cultural aspects?

Playing baccarat at the Sands Macao

Las Vegas Sands Corp.

"The *feng shui* master... advises us on the correct design right from the beginning, every color, every shape, every entrance, every exit."

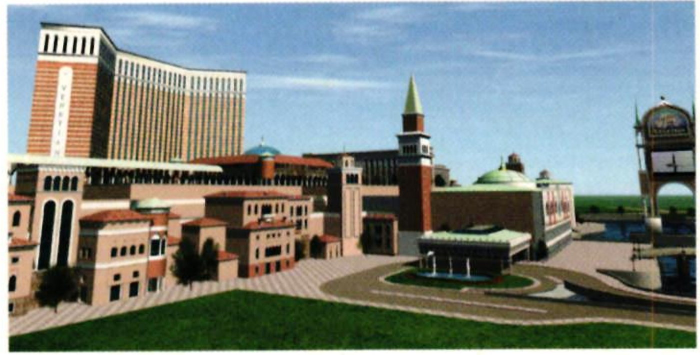
Weidner: All of our programs are design-assisted by local architects and designers and by a *feng shui* master from Kowloon [in Hong Kong]. Our designers in Las Vegas use the latest design software to produce a three-dimensional view of what they're designing, to show us, for example, what an entrance looks like, or how one room relates to another. Then we take DVDs of the design and fly over to Kowloon, go down the back streets of Kowloon, and sit down with a man who is the embodiment of a 5,000-year-old tradition. The *feng shui* master watches the DVDs and advises us on the correct design right from the beginning, every color, every shape, every entrance, every exit. Every aspect of what we do, we run by our *feng shui* master.

In fact, I'll give you a good example. The Sands Macao is oriented on a north-south axis, and our Western designer originally had done a feature in the corner that had a sharp edge. But our *feng shui* master said if the *qi* comes from the northeast, you don't want a pointed shape or the *qi* would be deflected. So if you go to the Sands Macao, you'll see a round feature on the corner and that feature was driven by the advice of the *feng shui* master. Every aspect of the building has been vetted by the *feng shui* master.

Another thing we did is kind of interesting. I've been traveling to the far east since the late 1970s and Macao since 1981. We in the gambling business were surprised at the contrast between the high quality of Asian hospitality and the lack of hospitality in the casinos of Macao. Even what seemed to be the very simplest thing—a welcoming cup of tea at the table—was non-existent. On the main floor of the primary place, the Lisboa, it was either too crowded or no one cared—the customer service attitude was very poor. So we challenged ourselves. There are two key things we've got to deliver. Number one: we've got to have our employees feel good about working for us because they're the ones that represent to the customer coming in that they are welcome in our home; and number two: When any Chinese welcomes you to their home, the visitor is greeted with a good, fresh, hot cup of tea. It was harder than we had imagined initially. Because, if you think about it, if we serve 35,000 people a day, how do we get fresh tea and hot water to that many people? So on the floor we built service bars, essentially a large area that actually filters the water, keeps it at the right temperature, etc., and we have dumbwaiters, so that the tea and supplies are delivered from below.

We have tea servers who wear traditional conical tea-picker hats and on their back is a basket where they would put the tea leaves if they were picking tea, but actually in the basket is a thermos. The thermos has a sort of a hose that comes down to the hand, with a nozzle on the end, and they go from glass to glass adding hot water. It sounds like a small thing, but it's an important symbol of welcoming people to our home.

"The idea is to make a spectacular world-class destination resort experience that people will enjoy and talk about, to do the things that make Las Vegas one of the world's most-visited destinations."



CBR: How do you go about finding staff? Have you given them special training?

Weidner: First of all we sent our people over to Macao, for example, for the tea training. They traveled all over China to learn about tea. We Westerners think that a good cup of tea is Earl Grey in a bag, so we had to understand it ourselves first. And then we found that there are more than 200 varieties of tea in China. There are tea masters in Hong Kong and some in Macao too, and they import, export, store, and sell tea, so we had to learn ourselves first, and from there we taught our people.

Then we taught about 6,000 folks from Macao how to deal cards, how to serve teas, foods, etc. We trained them right there in conjunction with the Institute for Tourism Studies and Macao Polytechnic Institute—we joint ventured with the universities—our supervisory people train Macao folks in the institutions, and the institutions help develop curriculum. We are training people for our expansion right now. We've promoted about 280 residents of Macao since May. We've now brought over to the United States more than 100 supervisors from Macao to train in our facilities in Las Vegas. And we have eight of our chefs from Macao in Las Vegas helping us get ready to open our high-end Chinese club, called the Paiza.

We take folks out of Macao, bring them over to the United States, help them to get a sense that they're really part of this broader, wider world, and when they return to Macao—it's just a wonderful phenomenon, when they tell about their experiences, they speak very animatedly and feel very proud of what they do. It's the most enjoyable part of what we do.

CBR: How many people will you employ altogether?

Weidner: The total when we finish the first phase of Cotai will be around 25,000. Most of the supervisory folks will be from Macao, because many of those folks in our current operations will be promoted. Then we'll bring in more folks from Hong Kong and mainland China into the beginning levels. As we go into the second phase, you'll see more of a mix in the supervisory level, with most folks from Macao, some from Hong Kong and some from the mainland, particularly on Hengqin Island. And we have a core of expatriates who are doing the planning, but the lion's share of all the supervisory and line employees will be from Macao.

CBR: Your main market is the mainland. How do you plan to market your facilities within the mainland?

Weidner: I think the highest percentage of people will hear of us through word of mouth. The idea is to make a spectacular world-class destination resort experience that people will enjoy and talk about, to do the things that make Las Vegas one of the world's most-visited destinations. Las Vegas is an extraordinarily successful destination. Thirty-six million people come to Las Vegas every year. It's in the middle of the desert, there's no reason for it to be there, there's no industry around it, it simply is what it is—a place to come and entertain yourself. We call it the world's adult guilty pleasure. Now, it may be a bit "over the top," but it's fun and enjoyable. And it's successful. We want to create a similar sense and feel along our Cotai Strip in Macao.

Initially, we'll work with the tour operators that we're currently working with at the Sands. We will broaden that base dramatically. Under the CEPA (Closer Economic Partnership Arrangement between the mainland, Hong Kong, and Macao) the FIT [free independent traveler] program is expanding, and more and more Chinese are allowed to come to Macao directly, so we'll have to employ some broad-based advertising. If we seize the imagination of the people in the top 10 cities of China, we will have more visitors than our strip can handle. But the key thing is to execute the concept well, take good care of the customer, and word-of-mouth will take care of the rest.

CBR: This would all be much further down the road, but do you see Venetian moving into the mainland at all?

Weidner: We would certainly consider further investment in the region as our non-gaming businesses develop. However, I would point out that our Macao developments are not only focused on China. If we do this thing right, it will draw people from [all over the Asian] region and all over the world. The 2008 Olympics will broaden the region's visitor base, and those visitors are also an important target market for us. The Disney theme park opens in Hong Kong in 2005, we open 2007, the bridge connecting Hong Kong and Macao opens 2009, 2010—that combination ought to make for a real world-class, multi-day stay destination drawing visitors from all over the world. 完

Greetings FROM CHINA

Super 8 in China

The US economy hotel chain offers China travelers a new lodging option

Paula M. Miller

CENDANT HOTEL GROUP RECENTLY OPENED ITS FIRST SUPER 8 IN CHINA. Previously only located in the United States and Canada, Super 8—the world's largest franchise economy lodging chain by number of hotels—is now targeting Chinese domestic tourists. Will the budget chain capture the nation's rapidly growing middle-class market?

First links in a chain

Cendant Hotel Group (parent company not only of Super 8 but also of the AmeriHost Inn, Days Inn, Howard Johnson, Knights Inn, Ramada, Travelodge, and Wingate Inn hotel chains) is not new to China. The first Ramada hotel in China opened in 1993. Howard Johnson and Days Inn chains entered China next—opening in 1998 and 1999, respectively. Cendant Hotel Group's master franchisees in China plan to develop roughly 14 Days Inn, 15 Ramada, and 21 Howard Johnson hotels in the next 18 months.

Super 8 opened its first China hotel in Beijing in June 2004. The chain has since expanded to five other locations and plans to expand to 38 major cities in China by mid-2006. The chain aims to start in first-tier cities such as Beijing, Chongqing, Guangzhou, and Shanghai and second-tier cities such as Dalian, Liaoning; Chengdu, Sichuan; Hangzhou, Zhejiang; Harbin, Heilongjiang; and Xiamen, Fujian. The chain then plans to expand to smaller cities and major highway locations.

Paula M. Miller is assistant editor of the *CBR*.

Customer base

Reas Kondraschow, senior vice president and managing director of Cendant Hotel Group International, noted in a recent interview that Cendant is now able to offer travelers lodging at all price levels in China. Howard Johnson hotels are in the top tier, with a 5-star rating in China, and are generally frequented by senior executives. Ramada properties range from 3.5 to 5 stars and, depending on whether the hotel is a Ramada Plaza or Ramada Hotel, house senior or mid-level executives. Mid-level executives also often stay at Days Inn hotels, which range from 3 to 3.5 stars. Super 8 hotels range from 2.5 to 3 stars. Super 8 expects most of its guests to be Chinese business travelers, group tours, and budget travelers, and in the short run, that most Super 8 guests will be Chinese. The chain also expects budget travelers from Australia, Japan, and South Korea, as well as backpackers from many countries.

Mitchell A. Presnick, president and chief executive officer of Super 8 Hotels (China) Co. Ltd.,

"Super 8 customers in China tend to be at least 50 percent business travelers, in contrast to in the United States, where two-thirds of Super 8 customers are leisure travelers."

Cendant Hotel Group

elaborated: "Super 8's target customers are Chinese middle-class business and leisure travelers who appreciate good value and international levels of quality and service. Currently, most Super 8 customers arrive by plane or train. However, we expect more and more car travelers in the future, consistent with China's high growth rates in road networks and car sales. Super 8 customers in China tend to be at least 50 percent business travelers, in contrast to in the United States, where two-thirds of Super 8 customers are leisure travelers."

A master franchise operation

Cendant picked China as Super 8's third country of expansion because it found an investor/developer that fit all of its master franchisee criteria. Kondraschow explained, "We selected Tian Rui Hotel Corp., based in Hong Kong, to be our master franchisee partner because it matched Cendant's requirements for capital and marketplace knowledge." Tian Rui Hotel Corp., in which Presnick is an investor, is the master license holder of Super 8 Hotels in mainland China, Hong Kong, and Macao. "Presnick was involved in the development of several major American brands in the PRC and wanted to expand the Super 8 brand to China because the nation needs quality economy hotels and because more Chinese are traveling by car and seeking value accommodations." (Super 8s are traditionally motels.) He added, "Also, as many people know, the number 8 is considered lucky in China. For all these reasons, Super 8 seemed like a good fit."

Under the master franchisee agreement, Tian Rui acts as franchisor in China and will develop the brand and franchise system there. (In contrast, Super 8 Motels, Inc., a subsidiary of Cendant Hotel Group, handles its own franchises in the United States and Canada.) Meanwhile, US franchisor Super 8 Motels, Inc. provides its trademarks and international sales and reservation services. Kondraschow explained, "It's an ideal relationship—Tian Rui brings the local knowledge and Super 8 brings the international trademark. . . . Cendant was one of the first hotel companies to set up in China on a franchise basis; Ramada was its earliest brand. Most competing hotels went into China as manager agree-

ments. But in the hotel industry, franchising is a viable alternative." (Franchises have existed in China for more than a decade, but in the early years frequently suffered from legal ambiguity and quality control problems. Now, with several years of experience in China and clearer laws, franchising is a more attractive business model.)

Adapting an established model

Super 8's goal is for all Super 8 franchises to maintain the same high international standards, whether in China or North America. But hotel layout and design may vary by location—for example, in room size or parking lot space. According to Kondraschow, Cendant encourages master franchisees to reproduce the US product, but also to tailor the hotels a bit to suit each region's language and characteristics. In China, hotels can be more elaborate than in the United States—not only because Super 8s are slightly more upscale in China than they are in the United States but because materials are cheaper in China. However, the brand owner must be sure a hotel does not become so upscale that it breaks out of its planned market tier. "Super 8s in China will not become 3- or 4-star hotels, but we can enhance their product quality," said Kondraschow.

Marketing will also take a slightly different tack in China. Super 8 will emphasize that it is a new company in China that provides a new product for a market segment that did not exist before. And it will place Chinese-language advertisements in the local markets via billboards, newspapers, and travel agencies.

"Super" challenges in China?

According to Presnick, Super 8 has not experienced major marketing or World Trade Organi-

Continued on page 44

Cendant Hotel Group in China

Note: Properties accurate as of February 2005.
Source: Cendant Hotel Group

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(Left to right) Morgan Stanley Managing Director and Chief Economist Stephen S. Roach; guests at Gala dinner; USCBC Chair and UPS Chairman and CEO Michael L. Eskew and PRC Ambassador Yang Jiechi

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A GUIDE TO PROVIDING MEDIA AND CONTENT TO CHINA'S VAST MOBILE PHONE MARKET

Spread Your Content Far and Wide

Paul W. Boltz and Charles C. Comey

Statistics from the mobile phone market in China are staggering: more than 334 million users by the end of 2004, double-digit growth rates projected for the foreseeable future, and billions of dollars in revenue for the principal mobile phone operators in China. This unprecedented explosion in mobile activity has spawned a vibrant "thumb culture" of mobile phone users. For these users, the mobile phone is not just a device for speaking to people, but a complete communication and entertainment center for playing games; downloading news, music, and cartoons; participating in fan clubs; and engaging in a whole host of other activities. The thumb culture is visible everywhere in China, and the sight of people busily typing messages or playing games on their phones is as common as the sight of people speaking into them.

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is managing partner in the Shanghai office of Morrison & Foerster LLP.

Several trends are converging to heighten the appetite for premium branded content among mobile users, from the growing affluence of China's coastal provinces and the rapid adoption of more advanced phone technologies to more discriminating consumer tastes in entertainment. In fact, media giants such as MTV Networks, Sony Corp., and Time Warner Inc. have already entered the market. But the market for wireless value-added services in China is idiosyncratic and subject to constant technological and regulatory change. International media and content companies thus need to grasp clearly the practices and pitfalls of this market before entering it so they can understand how to place their content, how to select local partners, and how to structure their contracts with local partners.

The growing importance of content

As the wireless market in China continues to expand to less-developed and poorer provinces, an increasing portion of new subscribers have relatively low incomes. These subscribers yield lower levels of average revenue per user because they primarily use pre-paid services. In addition, China's wireless market is becoming increasingly

China Mobile and China Unicom rely almost entirely upon third-party service providers to drive their network traffic, supply attractive services, and increase revenue from these services.

competitive, with nonroaming, single-city networks springing up in cities across China. In fact, China Telecom and China Netcom, which are better known for their large fixed-line networks in China, together claim to have more than 60 million users on their limited mobility networks, with millions of new users joining every quarter. As a result of these pressures on the traditional voice-related businesses of the mobile operators, wireless value-added services have become an increasingly important market development tool for China Mobile and China Unicom and the privately owned service providers that support them.

Norson Telecom Consulting, an independent research firm, estimates that total revenues generated by wireless value-added service providers in China will grow from about $565 million in 2003 to around $1.9 billion in 2008, representing a compound annual growth rate of 27 percent. The eastern and southern provinces of China, more developed than their neighbors, are key drivers of this revenue growth. Mobile customers in those provinces have used wireless value-added services for years and have high expectations for the content of the services they purchase. Finally, China's low personal computer and Internet penetration rates have created an entertainment vacuum that mobile services are in a position to fill.

Working with mobile operators

China Mobile and China Unicom together control most of the mobile phone market in China. Following the successful model established previously in Japan and South Korea, China Mobile and China Unicom rely almost entirely upon third-party service providers to drive their network traffic, supply attractive services, and increase revenue from these services. In turn, the mobile operators focus on the operation and technical enhancement of their networks while monitoring service providers' offerings for prohibited content such as pornography and political and religious discourse. For their part, wireless value-added service providers in China rely on the two mobile operators for the network distribution of their content and services, billing and collection, and remittance of revenues.

When first setting up, a third-party service provider will obtain the requisite value-added telecom licenses from the Chinese government and seek permission from mobile operators to offer its services through their networks. The mobile operators, particularly China Mobile, have highly decentralized organizational structures. As a result, service providers usually sign separate contracts with national, provincial, and local offices of the mobile operators. The mobile operators then work with service providers to determine a package of services and its pricing. Prices for the most basic services, such as the download of a single ringtone or screensaver, can be $0.01 per use or less, while subscriptions for more advanced services, such as a sophisticated "game arcade," can cost several dollars per month.

Approved services appear on service menus accessed through mobile phones and on websites operated by the mobile operators. When a mobile user selects a service, the third-party service provider delivers it over the mobile operator's network, and the charge for the service appears on the user's next phone bill.

Given their dominant market positions, the mobile operators have significant negotiating leverage over third-party service providers and largely dictate the terms of their cooperative agreements. Recognizing that they are dependent on service providers to continuously create new, innovative services and drive revenue growth, the mobile operators have been willing to give service providers the majority of the revenue generated by their services, typically 80 to 90 percent of the gross revenue. In many cases, this percentage can change if the service provider fails to satisfy various performance criteria, such as revenue, number of users, and

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number of customer complaints. Poor performance by a service provider can also lead to it being denied access to part or all of a mobile operator's network. In addition, service providers are usually charged network transmission fees for each message sent by them to the ultimate enduser according to a formula. (Rumored changes in the basic revenue sharing percentages have not yet materialized, but remain a distinct possibility as the mobile operators seek additional revenue to fund future network infrastructure upgrades.)

It is widely anticipated that other parties such as fixed-line operators China Telecom and China Netcom will also be granted licenses to operate full-fledged mobile networks in China. This should further heighten competition in the wireless value-added services market, but it is difficult to predict what effect, if any, the entry of new operators will have on the revenue-sharing model described above. Moreover, observers speculate that the current or new mobile operators could introduce their own portfolio of self-developed services, which could radically alter this market.

Options for content delivery

The predominant wireless value-added service in China is currently short messaging services (SMS) that allow users to send and receive simple text messages over their mobile phones. Users can also play basic games and download ringtones and icons for the screens of their mobile phones through SMS. SMS is offered through China Mobile's and China Unicom's second-generation (2G) mobile telecom networks.

In the past year, the use of services offered over the advanced second-generation (2.5G) mobile telecom networks in China has grown dramatically. Services offered over the higher-capacity 2.5G networks are more sophisticated and offer users higher quality graphics and richer content and interactivity, commanding a premium price over the more established SMS-based services. Thus, Chinese service providers are moving upmarket with premium branded content from international partners to fully utilize the capabilities of 2.5G services and differentiate themselves from their competitors. The more common 2.5G services include games, information services such as news updates, community forums and dating services, animated cartoons, and sophisticated ringtones and icons. Even more advanced services will be possible once the Chinese government grants licenses for third-generation (3G) mobile telecom networks.

The third major category of wireless value-added services is interactive voice response services (IVRS), which allow users to listen to songs, jokes, stories, and other audio content. Users can also use IVRS to send such audio content, along with personal messages, to the mobile phones of their friends.

Service providers in China have shown great ingenuity in integrating all kinds of content into wireless value-added services. Thus far, the primary categories of branded content that have proved successful with Chinese mobile users include:

- Music, particularly Japanese and South Korean pop music, which can be used in services such as customized ringtones and IVRS and can also act as a driver for other services such as chat rooms that are centered on particular artists. BMG, EMI, Sony Music, and many other major record labels have licensed their song libraries to service providers for a wide range of services.
- Imported game technology, as well as branded content such as famous Western cartoon characters, which is incorporated into a locally developed game. One example of using branded content in a game is Time Warner's licensing of some of its Cartoon Network characters, including *Tom & Jerry* and the *Power Puff Girls*, for inclusion into what has become a well-known line of 2G and 2.5G games in China.
- News and entertainment-related information, such as daily news updates or announcements about upcoming concert schedules of particular pop stars.

Wireless Service Providers

Several hundred service providers operate in China, and they generally fall into three categories:

- **Nationwide Internet portal operators**, which have expanded into the wireless area. The main players in this category are Nasdaq-listed companies NetEase, SINA, Sohu, and TOM Online, an affiliate of Internet portal operator Tom Group.
- **"Pure play" service providers**, which focus exclusively on offering a wide range of wireless value-added services. These providers include Nasdaq-listed companies Hurray!, KongZhong, and Linktone, as well as privately held companies such as MTone Wireless.
- **Niche service providers**, which focus on a particular market segment or application. This category includes TENCENT, which is listed on the Hong Kong Stock Exchange and specializes in a type of wireless service known as instant messaging.

Given the fragmentation in this industry and the recent customer service initiatives by China Mobile and China Unicom, many smaller service providers are under increasing pressure. This has contributed to a recent increase in mergers and acquisitions in the industry, which is likely to continue at least through 2005.

—Paul W. Boltz and Charles C. Comey

- Pictures, which includes everything from pastoral scenes to photos of hot pop stars.
- Serial stories and cartoons that users can read (or, in the case of the newly launched "mobile novels," listen to).

Careful thought should be given to whether multiple local partners, licensed on a non-exclusive basis, should be used.

Practical pointers

Although a number of major international media and content companies have already entered the Chinese wireless value-added services market, a consistent approach to entering this market has yet to emerge. In fact, many entrants have crafted arrangements that fail to reflect market conditions or do not fully maximize available opportunities. The following are practical pointers to avoid such problems:

- **Partner with a local service provider**

China Mobile and China Unicom prefer to work with domestically incorporated and owned service providers. Even Nasdaq-listed service providers such as Hurray! Holding Co. Ltd. and Linktone Ltd. have had to use domestic affiliates, which are owned by Chinese individuals and controlled by the listed company through a series of contracts, as vehicles to sign contracts with China Mobile and China Unicom and provide services to their users. Thus, international media and content companies must, in essence, funnel their content through one or more local service providers.

Mobile operators have recently been more rigorous in enforcing customer service policies and, on occasion, have prohibited offending service providers from offering certain services for a

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SOFT SELL: China Learns to Lobby

Scott Kennedy

CHINA'S SOFTWARE INDUSTRY HAS BEEN growing annually at more than 30 percent since the mid-1990s. Though it is often compared unfavorably to its Indian cousin, China's software sector has woven itself into the nation's economy and urban society. As domestic firms have emerged and the world's leading software developers have set up shop in China, they have begun to interact intensively with the PRC central government and local authorities over policies that affect their interests. For software companies operating in the PRC, as is the case with firms in other industries, public policy is business.

The majority of the software industry's economic characteristics—high knowledge intensity, low economies of scale, predominance of domestic and foreign private companies, and the importance of inter-firm cooperation—clearly extend to matters of public policy. The high-tech nature of software means that firms have expertise that government cadres generally lack but need to make decisions that affect the industry. Small size and the predominance of private firms mean that most software companies do not have voices loud enough to be heard on their own and do not have natural allies in government to support them. The emphasis on cooperation in business creates an incentive for joint activism in trying to promote common public-policy objectives. The extent of domestic-foreign interaction on the business side of software reduces conflicts of interest among these firms on policy issues, facilitating truly industry-wide, concerted efforts on relevant policies.

Software industry vs. VAT

The PRC government's tax receipts as a percentage of GDP dwindled substantially in the 1980s and early 1990s, dropping from 31.2 percent of China's GDP in 1978 to 12.6 percent in 1993. To stem this tide and shift a greater proportion of tax receipts to the central government, in 1994 the government introduced a major overhaul of the tax system. One important component was the implementation of a 17 percent value-added tax (VAT) on the sale of all goods. Though perhaps an important innovation from a national perspective, the tax placed a unique burden on software developers because of how it was calculated. The seller of a good was charged 17 percent of the difference between the sale price and the cost of inputs. Though not specified in the regulation, in practice only material inputs are counted as part of production costs. Given that the cost of producing software is primarily creativity, an intangible asset, the effective VAT that software developers

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Adapted from *The Business of Lobbying in China* by Scott Kennedy, published February 28, 2005 by Harvard University Press. Copyright ©2005 by the President and Fellows of Harvard College. Used by permission. All rights reserved.

How software companies in China united to lower value-added tax rates

have paid is far greater than that for ordinary manufacturers.

China's software industry in the early 1990s was young and certainly could not derail such a sweeping change of the tax code. Aside from particular relief given to foreign-invested firms, the government initially made a point not to provide preferential treatment to any industries.

Despite the government's declaration, the software industry began to mobilize in opposition. This was an issue that united all software firms, state-owned and private, domestic and foreign. Over the following years, medium- and large-sized software firms of all ownership stripes complained vociferously to various parts of the national government, principally the Ministry of Information Industry (MII), the Ministry of Science and Technology (MOST, known as the Science and Technology Commission until March 1998), the Ministry of Finance, and the State Administration of Taxation (SAT). China's first software association—the China Software Industry Association (CSIA), regional associations, and at least one issue-specific association (the Accounting and Business Management Sub-Association) organized meetings with these government agencies, met with officials on their own, and wrote numerous reports. They collectively argued that the tax was unfair to an industry that was supposedly critical to China's modernization and that because of the industry's small size, an exemption or reduction would not have a significant impact on the government's revenue stream.

As the years passed, the industry believed that SAT would never relent. By late 1998, software firms and associations saw tax relief as a distant and fading hope, leaving some to complain that the dialogue with the government was superficial. Some also grumbled about the lack of association initiative.

But to almost everyone's surprise, in June 1999 the tax agency notified associations that it had decided that software firms in Beijing would have their VAT slashed from 17 percent to 6 percent. Six months later the tax break took effect nationally.

The larger software firms deserve a great deal of the credit for finally persuading the government to enact the tax reduction. Without their regular criticism, there would have been no incentive for the government to make changes. Officials at MII and MOST, which also represented the industry in discussions within the government, emphasized that firms protested regularly, spurring ministry activism on behalf of the firms. In addition to the regular interaction with ministries, two industry leaders, Wang Wenjing of the financial software producer UFSoft and Wang Xuan of the publishing software maker Founder Group, used their positions in the National People's Congress to call for greater government support of high technology, including software. Even though they lacked the authority to enact changes themselves, they raised the visibility of the issue.

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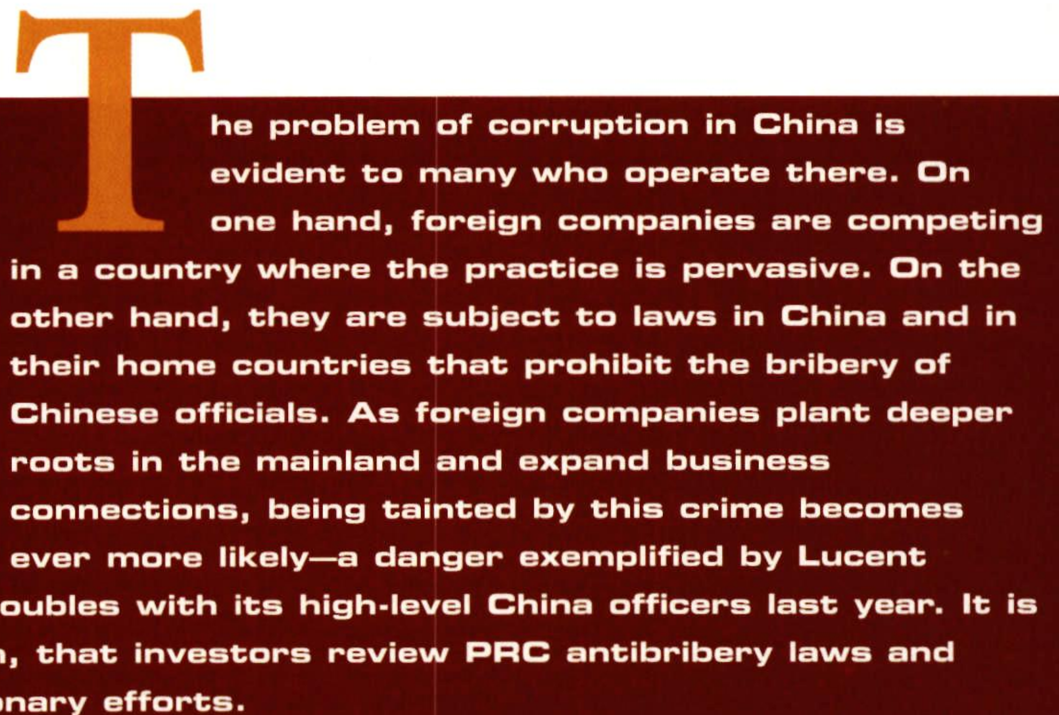
Complying with PRC Antibribery Laws

A clarification of China's criminal and commercial antibribery statutes

Laetitia Tjoa, Ouyang Jianyu, and Like Pykstra



The problem of corruption in China is evident to many who operate there. On one hand, foreign companies are competing in a country where the practice is pervasive. On the other hand, they are subject to laws in China and in their home countries that prohibit the bribery of Chinese officials. As foreign companies plant deeper roots in the mainland and expand business connections, being tainted by this crime becomes ever more likely—a danger exemplified by Lucent Technologies' troubles with its high-level China officers last year. It is imperative, then, that investors review PRC antibribery laws and renew precautionary efforts.

Laetitia Tjoa (tjoal@coudert.com), **Ouyang Jianyu**, and **Like Pykstra** are partner, associate, and legal trainee, respectively, in the Beijing office of Coudert Brothers LLP.

PRC antibribery law is a complex system. It is composed of two major parts, both of which apply to domestic and foreign entities equally. One part handles criminal offenses, which carry heavier punishments and are further split into two categories: the bribery of state functionaries and state-related units, and bribery as an economic crime. The other part covers commercial bribery—a type of unfair competition practice prohibited by the PRC Law Against Unfair Competition and the Interim Rules on Prohibition of Commercial Bribery. These two parts of the antibribery regime are not coordinated; they both overlap and fail to address some gray areas.

Foreign companies in China must also follow international laws and conventions. Two of the most important are the US Foreign Corrupt Practices Act (FCPA) and the Organization for Economic Cooperation and Development's (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Both prohibit the bribery of foreign officials. All companies registered in the United States are subject to the FCPA, and 35 nations—including all 30 member countries of the OECD—have ratified the OECD Convention and, by doing so, have obligated themselves to pass domestic legislation criminalizing bribery of foreign officials.

Bribing the state

The PRC Criminal Code defines one type of criminal bribery as bribery of state functionaries (*guojia gongzuo renyuan*) or state-related units

(*guojia jiguan, guoyou gongsi, qiye, shiye danwei,* and *renmin tuanti*). This includes people who perform public services in the legislative, administrative, or judicial branches or the military; people who perform public services in state-owned enterprises (SOEs), institutions, or civil organizations; people assigned by the government or SOEs to non-state-owned enterprises, institutions, or civil organizations to perform public services (such as the deputy general manager of a joint venture who is sent by an SOE); and people who perform public services according to law, such as local representatives to the National People's Congress.

Thus, the term "state functionaries" applies not only to government officials, but also to the directors, managers, supervisors, accountants, and even the cashiers that work for SOEs. Not included, however, are SOE employees who perform labor services or technical services without government-related functions, such as computer engineers. The FCPA and OECD Convention offer slightly different definitions for foreign officials; they include officials and employees of public international organizations such as the International Monetary Fund.

The PRC Criminal Code also prohibits bribes to state-related units including legislative, administrative, and judicial offices and the military; SOEs and state-owned institutions such as universities and hospitals; and civil associations and federations such as the China Association for Science and Technology and the All-China Federation of Industry and Commerce. This provision would, for example, prohibit a pharmaceutical company from paying a hospital (a state-owned institution) to encourage sales of the company's drugs—a practice nevertheless common in China.

Intent is also a key hallmark of criminal bribery in China. The intent of bribes must be to seek improper benefits in the form of "illegal benefits" or "illegal assistance or preferential treatment" from state functionaries or state-related units. Thus, a company cannot give money or property to a Customs inspector, for instance, to obtain smuggling profits ("illegal benefit") or to a Beijing Olympics official to act in favor of the briber by handling a bid evaluation unlawfully ("illegal preferential treatment"). Notably, the PRC Criminal Code does not require that the briber actually gain any benefit or preferential treatment, but only that intent be present. The FCPA and the OECD Convention also require intent as an integral element of an act of criminal bribery.

Intent, however, becomes irrelevant if giving money or property to state functionaries and state-related units while "doing business" is expressly prohibited by other laws. (Though courts have discretion to decide what constitutes "doing business," this usually includes government procurement, contract signing, and construction project bidding, among other activities.) For example, PRC law explicitly prohibits a supplier from giving bribes to a buyer when obtaining or bidding for a government procurement contract. The legislative perspective here may be that, when contracts are on the table, gifts of money or property can only be aimed at improper benefit. If not expressly prohibited by other laws, then intent is considered when determining whether gift-giving constitutes bribery.

PRC antibribery law is composed of two major parts, both of which apply to domestic and foreign entities equally.

Criminal amounts of money and property

Under the PRC Criminal Code, bribes involve money and property. But "money and property" is an undefined term over which there has been controversy. Prior cases show that cash, stocks, securities, and in-kind gifts are considered "money and property," but incentives such as sex or school admission for relatives are not. There has also been longstanding debate among academics about whether quantifiable incentives such as meals, travel, and tuition payment should be considered bribes. Though these were not included when the PRC Criminal Code was amended in 1997, certain PRC courts have recognized such incentives as forms of bribery.

According to the PRC Criminal Code, the bribes must actually be delivered to constitute a crime of bribery. Promising or offering to pay does not constitute a crime. The PRC code thus differs from the FCPA and the OECD Convention, which both state that an offer or promise to pay can constitute a crime even if no actual payment is made.

The Supreme People's Procuratorate has also adopted value thresholds for criminal bribery. For an individual who bribes state functionaries or state-related units, the value of the bribes must be ¥10,000 ($1,208) or above; for a unit, the value must be ¥200,000 ($24,154) or above. Nonetheless, even if the value of the bribes is less than the above figures, an act of bribery will also be considered criminal if one of the following criteria is met:

- The purpose of the bribe was to gain illegal benefit (bribes for "illegal assistance or preferential treatment" do not qualify);
- Bribes were paid to three or more state functionaries or three or more state-related units;
- Bribes were paid to Chinese Communist

"Money and property" is an undefined term over which there has been controversy.

Party (CCP) leaders or government leaders, including judicial officials or officials that execute law; or CCP or government offices, including judicial or law-enforcement offices; or

- The bribe caused severe damage to national or social interests.

For example, a bribe of ¥8,000 ($966) paid by an individual to the chief executive of an SOE may not constitute a crime of bribery (although it may constitute commercial bribery, as discussed later). But such payment becomes a crime of bribery if it is paid to a judge.

There is one exception under the PRC Criminal Code that exempts an individual from criminal indictment for offering bribes to state functionaries: An individual shall not be held guilty if the bribes are given because of blackmail by state functionaries *and* no improper benefit has been gained. Regardless of duress, however, an individual will face criminal charges if he or she has gained improper benefit from bribes.

As mentioned before, the PRC Criminal Code also covers bribery as an economic crime. A separate section of the code prohibits any individual or unit from giving money and property to the staff members of *non-state owned enterprises* to gain improper benefits. The code also sets monetary thresholds for this crime: individuals who have paid a bribe of ¥10,000 or above, and units that have paid ¥200,000 or above, may be indicted.

The wages of criminal bribery

For an individual, criminal sentences range from short-term criminal detention to life imprisonment. A fine or confiscation of property may be imposed simultaneously. Guilty units face fines, and people directly in charge and other people directly responsible for the crime will face sentences under the criteria for individuals. Penalties for officials who accept bribes are much more severe.

An act of bribery is also subject to other laws and regulations. For instance, under the PRC legal regime of bidding or government procurement, if a briber wins the bid or procurement contract by giving bribes, the bid or contract will be invalid.

Tilting the playing field

Commercial bribery, as opposed to criminal bribery, is defined as business operators giving money or property or resorting to other means to sell or purchase goods and services. As mentioned above, bribery as an economic crime is also addressed in the PRC Criminal Code. Here, the two parts of the PRC antibribery system overlap, and the major difference is the magnitude of the crime. For example, a bidder's monetary gift to a project owner with an aim to win a public tender will constitute commercial bribery, unless the act is serious enough to trigger criminal offense charges, in which case it would then be treated as criminal bribery. In such circumstances, penalties both for commercial and criminal bribery would apply: in addition to criminal punishment, the bid would be declared void. The State Administration of Industry and Commerce (SAIC) has jurisdiction over acts of commercial bribery.

Commercial bribery is committed by businesses: any legal person, economic organization, or individual that sells goods or services for profit, regardless of whether it is domestic or foreign. Bribes given by employees to sell or purchase goods and services for the business will be attributed to the business.

Commercial bribes are defined more broadly—in the sense of what is forbidden—than criminal bribes. As in the PRC Criminal Code, gifts of money and property are prohibited, but "other means" to secure business are also covered. This includes any money or property given in the name of expenses for promotion, advertising, sponsorship, research, labor services, consultation, commissions, or reimbursement of various expenses. Other benefits, such as inappropriate travel under the pretext of an investigation tour or training course, are also forbidden. The law does not go so far as to include benefits that are difficult to measure in cash value, such as sex or school admission, into the commercial bribery definition.

Kickbacks, although common in China, are also explicitly banned. For commercial bribery, kickbacks are defined as a percentage of the commodity price given to a bribee in the form of cash, property, or other means without clear record in the business operator's legally established financial account, which includes omitting account entries, shifting payments to other accounts, or forging accounts. The law also prohibits a business operator from giving supplementary cash or in-kind gifts to its business partners in transactions.

The commercial antibribery laws have limited scope. To constitute an act of commercial bribery, the briber must have a business purpose—to sell or purchase goods or services. This creates gray areas that are not addressed by either the PRC criminal regime or commercial bribery system. For example, an act of bribery not constituting a crime under the PRC Criminal Code can also escape charges of commercial bribery if it is not associated with the sale or purchase of goods or services. For instance, a foreign investor may give ¥4,000 ($483) to a local official to facilitate approval procedures. This act does not constitute a crime nor does it contravene rules against commercial bribery because it neither reaches the value threshold (¥10,000) nor has any business purpose related to the sale or purchase of goods or services.

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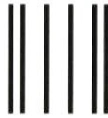

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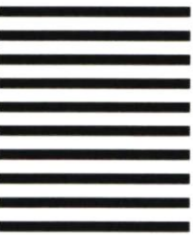

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There are two exceptions to commercial bribery. One exception is that businesses are allowed to give discounts to their partners or give commissions to intermediaries if such discounts or commissions are recorded in their financial accounts. A note of caution is necessary, though, as proper recording of transactions does not automatically protect the payer from all charges of commercial bribery. SAIC has pursued charges of commercial bribery against businesses on the grounds that the discounts or commissions (despite being recorded) made the business environment less fair. The second exception allows for advertisement gifts of small value to be given in accordance with commercial practice.

For commercial bribery, violators must pay a ¥10,000–¥200,000 fine, depending on the seriousness of the offense, and relinquish all illegal income generated from the bribery.

Complying with the law

Despite the similarities between the PRC antibribery law and the FCPA and OECD Convention, anyone operating in China will notice that the PRC antibribery law has been neither strictly nor consistently enforced. For example, in 2003, Peng Muyu, the past head of Yunnan's former Department of Foreign Trade and Economic Cooperation, was tried and sentenced for accepting bribes from a shareholder of a large multinational retail company's China subsidiary. However, this company was left unharmed, and, in fact, was not even investigated by the People's Procuratorate regarding its involvement. Another example is the recent, widely publicized Lucent case. Although Lucent filed a report to the relevant US authority according to the FCPA for improper acts in China and four of its top executives in its Chinese operations were removed, the PRC government chose not to investigate Lucent's China division.

Yet the Chinese government has expressed its determination to strengthen antibribery efforts. At the end of 2003, the CCP issued provisional regulations on internal party controls, and China signed the United Nations Convention Against Corruption. A brief checklist of items that may assist multinational corporations in complying with the PRC antibribery system follows.

- **Compliance program** Developing a formal, written compliance program has many advantages, one of which is to make the company and its employees more aware of the relevant laws, thus helping to avoid violations.
- **Training programs for employees** Employees should receive periodic training on PRC antibribery law compliance; the training should use hypothetical cases that they may actually face.
- **Documenting tasks** Foreign companies in China should carefully define and accurately document the role and responsibilities of employees, with periodic reviews to ensure compliance.
- **Thorough due diligence of Chinese partners** Because many Chinese enterprises may be accustomed to giving bribes to obtain business, foreign investors should check Chinese partners to find out whether they use bribery.

Proceeding carefully

To stay clear of PRC and home-country antibribery laws, foreign companies should consult their legal advisors and act with extreme prudence when giving any benefits to state functionaries. This should even be true of language in contracts that offer non-monetary benefits to government officials. For example, Chinese subsidiaries of foreign companies have been known to include provisions in contracts for sending government officials overseas for "training." This usually does not trigger bribery claims under the PRC Criminal Code as no money or property is directly offered (although it may elicit charges of commercial bribery under the broader definition of commercial bribes). Complying with FCPA stipulations is another matter, though it can still be done if certain criteria are met. Companies must have clear, legitimate reasons for conducting the training overseas, such as a lack of comparable programs in China, as well as for sending these particular individuals (for example, engineers sent for scientific training). Also, the business purpose and the absence of corrupt intentions must be clear.

Operating successfully in China requires a great deal of localization, but foreign companies—when it comes to the practice of bribery—cannot afford to "do as the Romans do," or even turn a blind eye, as they need to comply with both local- and home-country corruption laws.

In observing local antibribery laws, foreign companies are advised to take note of some important characteristics of the PRC system: certain payments to units, as opposed to individuals, are also covered by the PRC definition of bribery; and acts of commercial bribery by local employees will be attributed to the company even if management was unaware of the practices.

The confluence of China's increasing efforts to reduce corruption within its borders and renewed focus on the practices of foreign companies operating in China brought on by recent FCPA-related cases means that companies must be especially careful to avoid the appearance of impropriety. Foreign companies must ensure that their PRC subsidiaries step up risk management so that they can offer more than just a plea of ignorance. 完

Bribes given by employees to sell or purchase goods and services for the business will be attributed to the business.

Spread Your Content Far and Wide

Continued from page 31

fixed period. Accordingly, careful thought should be given to whether multiple local partners, licensed on a non-exclusive basis, should be used. Naturally, no international media or content company wants to be in the position of signing an exclusive content license with a service provider and then discover that its new partner has been banned from a mobile operator's network for violating customer service policies.

- **Consider more than just market share when evaluating local partners**

With several hundred service providers in China, identifying and choosing the right partners can be an overwhelming task. While the market share of a service provider is clearly an important factor, international media and content providers should also answer several other important questions.

For example, does the service provider have a presence in both 2G and 2.5G services and offer a portfolio of services broad enough to maximize the content? The nature of wireless value-added services enables service providers to offer the same content through a variety of services and technology platforms. For example, the music or images of a famous pop star could be used for SMS ringtones and icons; sophisticated 2.5G animated cartoons, games, and fan clubs; and customized IVRS audio downloads to reach the widest possible audience. Thus, a service provider that covers the 2G and 2.5G markets and has experience offering multiple kinds of services could be in a better position to place a company's content than a more narrowly focused service provider.

International content providers should also ask whether the service provider has ties to both China Mobile and China Unicom. Dependence on a single operator not only excludes the provider's services from a significant portion of the market, but as mentioned above, makes the provider especially vulnerable to penalties such as service suspensions.

Another factor in the choice is the service provider's skill in localizing and customizing content. This means more than just translating content into Chinese. Rather, it is a complex task of incorporating content into a service that is specifically designed for the small screens and dial-pads of mobile phones, so that, for example, games play smoothly despite the tightly packed keypads. In addition, Chinese mobile users tend to be young and highly fashion-conscious, so localization and customization must be done with an eye to what young Chinese consider hip and trendy.

Finally, is the service provider committed to observing contracts and maintaining accurate records? The quality of the management of service providers in China varies enormously. Some firms boast highly experienced, international management teams, while other companies are simple start-ups operated by local managers who are only familiar with the province in which their companies operate.

- **Define the appropriate scope of cooperation with local partners**

Some international content providers enter into narrow cooperation or license agreements with a local partner for the provision of a single, fixed type of service. For example, the content provider may license the image of a pop star for inclusion in a particular 2.5G picture download service.

This approach may make sense if the content provider is still testing the waters or if the local partner has a niche strength. On the other hand, the one constant in China's market for wireless services is rapid change in technologies and mobile users' tastes. Consequently, cooperation or license agreements should be flexible enough to allow services to evolve along with the market. Moreover, to maximize the potential user base, the parties should consider how the content could be used across multiple 2G and 2.5G services.

- **Prepare agreements consistent with the Chinese market**

International media and content companies often use their standard, off-the-shelf cooperation or license agreements when partnering with local service providers. Because of the peculiarities of the Chinese market, generic agreements usually do not work and can lead to delays, confusion, and disagreement among the parties. One common challenge is the terms governing revenue sharing arrangements. For example, service providers have little or no visibility into the mobile operators' networks and often cannot tell which services were actually delivered and paid for. As a result, service providers typically depend heavily on the information contained in monthly statements of revenue provided by the mobile operators, which means that contractual provisions that tie revenue sharing to the service provider's own internal records need to be carefully framed.

Another common problem with boilerplate cooperation or license agreements is that they often fail to account for the multi-layered organizational structures of Chinese mobile operators. In China, each provincial and local office of the mobile operators has its own policies and procedures. Thus, a clause that requires the service provider to charge the same price to all users in China will cause problems since the provincial and local offices of the mobile operators often make independent pricing decisions.

The one constant in China's market for wireless services is rapid change in technologies and mobile users' tastes.

● **Protect intellectual property**

Protection of intellectual property is a perennial concern in China. Fortunately, unlike CDs and DVDs which can be reproduced relatively easily, mobile phone content is confined to the phone itself unless the mobile operator allows the user to forward it to other mobile phones. China Mobile and China Unicom have also taken it upon themselves to monitor their service providers and users closely to ensure that there is no unauthorized use of third-party intellectual property. Cases of mobile operators punishing service providers for including stolen content in services have been reported in the Chinese media. Indeed, the contracts between mobile operators and service providers usually state that mobile operators can terminate the relationship without warning if the service provider is caught infringing other parties' intellectual property rights. In addition, partnering with a service provider that diligently monitors the market for infringement will help media and content companies better protect their intellectual property.

A flexible approach to an ever-changing market

For international media and content companies, answers to the fundamental questions of "which content?", "used in which wireless services?", and "partnering with which service providers?" are likely to change as rapidly as the market itself. This means that long-term success depends on a flexible and well-considered approach to market entry, built on one or more partnerships with domestic service providers that have the range of services, localization know-how, and relationships with the mobile operators to maximize use of the content. 完

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Sales and Investment November 16, 2004–January 15, 2005 Compiled by Doris Grage and John Kemmer

The following tables contain recent press reports of business contracts and negotiations exclusive of those listed in previous issues. For the most part, the accuracy of these reports is not independently confirmed by the *CBR*. Contracts denominated in foreign currencies are converted into US dollars at the most recent monthly rate quoted in the International Monetary Fund's International Financial Statistics.

Firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in the *CBR* by sending the information to the attention of the editor.

Advertising, Marketing & Public Relations

OTHER

Visa International (US)/Lenovo Group Ltd. (Beijing)
Formed partnership to market credit card products jointly prior to the Beijing 2008 Olympic Games. 12/04.

Automotive

INVESTMENTS IN CHINA

Nippon Yusen Kabushiki Kaisha (Japan)/ANJI Automotive Logistics Co. Ltd., a subsidiary of Shanghai Automotive Industry Corp.
Formed joint venture, NYKANJI, to provide land transport services for cars produced in China. (Japan: 49%-PRC:51%). $5 million. 12/04.

DaimlerChrysler AG (Germany)/Beijing Automotive Industry Shareholding Co. Ltd.
Formed joint venture to manufacture Mercedes-Benz E- and C-Class sedans in Beijing. 11/04.

DaimlerChrysler AG (Germany), China Motor Corp. (Taiwan)/Fujian Motor Industry Group
Formed joint venture to manufacture Daimler Chrysler's Sprinter, Viano, and Vito vans in Fuzhou, Fujian. 11/04.

OTHER

China Automotive Systems, Inc. (Hubei)
Signed technology licensing agreement with Korea Delphi Automotive Systems Corp. to manufacture and export its M150/M200 model automotive steering systems for use in GM Daewoo Auto & Technology Co.'s Matiz vehicle. 01/05.

Inveco Ltd., the truck unit of Fiat SpA (Italy)/Shanghai Automotive Industry Corp.
Signed contract to develop commercial vehicle partnership. 12/04.

Aviation/Aerospace

CHINA'S EXPORTS

Shenyang Aircraft Corp., National Aero-Technology Import and Export Corp. (Beijing)
Won contract to manufacture cargo doors for France's Airbus SAS. $40 million. 12/04.

CHINA'S IMPORTS

Airbus SAS (France)
Received order from China Aviation Supplies Import & Export Group Corp. for 23 A320 planes. $1.2 billion. 12/04.

Banking & Finance

INVESTMENTS IN CHINA

Lehman Brothers Holdings Inc. (US)/China Huarong Asset Management Corp. (Beijing)
Formed joint venture, Leihua Asset Management Co., to dispose of $240 million in nonperforming loans held by Huarong. 12/04.

The Goldman Sachs Group, Inc. (US)/Beijing Gao Hua Securities Co. Ltd.
Formed joint venture, Goldman Sachs Gao Hua Securities Co. Ltd., to underwrite locally listed A-share stock deals, RMB-denominated corporate bonds, and offer domestic financial advisory services. (US:33%-PRC:67%). $130 million. 11/04.

Standard Chartered Plc (UK)
Signed agreement to take a 19.99% stake in Tianjin-based Bohai Bank. 11/04.

OTHER

Credit Suisse First Boston LLC (US)
Purchased $290 million in nonperforming loans from China Orient Asset Management Corp. 12/04.

Abbreviations used throughout text: **ABC:** Agricultural Bank of China; **ADB:** Asian Development Bank; **ASEAN:** Association of Southeast Asian Nations; **AVIC I and II:** China Aviation Industry Corp. I and II; **BOC:** Bank of China; **CAAC:** General Administration of Civil Aviation of China; **CATV:** cable television; **CBRC:** China Banking Regulatory Commision; **CCB:** China Construction Bank; **CCTV:** China Central Television; **CDB:** China Development Bank; **CDMA:** code division multiple access; **CEIEC:** China National Electronics Import and Export Corp.; **China Mobile:** China Mobile Communications Corp.; **China Netcom:** China Netcom Corp. Ltd.; **China Railcom:** China Railway Communications Co., Ltd.; **China Telecom:** China Telecommunications Group Corp.; **China Unicom:** China United Telecommunications Corp.; **CIRC:** China Insurance Regulatory Commission; **CITIC:** China International Trust and Investment Corp.; **CITS:** China International Travel Service; **CNOOC:** China National Offshore Oil Corp.; **CNPC:** China National Petroleum & Gas Corp.; **COFCO:** China National Cereals, Oils, and Foodstuffs Import and Export Corp.; **COSCO:** China Ocean Shipping Co.; **CSRC:** China Securities Regulatory Commission; **DSL:** digital subscriber line; **ETDZ:** economic and technological development zone; **GSM:** global system for mobile communication; **ICBC:** Industrial and Commercial Bank of China; **IT:** information technology; **LNG:** liquified natural gas; **MII:** Ministry of Information Industry; **MOFCOM:** Ministry of Commerce; **MOU:** memorandum of understanding; **NA:** not available; **NDRC:** National Development and Reform Commission; **NORINCO:** China North Industries Corp.; **PAS:** personal access system; **PBOC:** People's Bank of China; **PetroChina:** PetroChina Co., Ltd.; **RMB:** renminbi; **SARFT:** State Administration of Radio, Film, and Television; **SEZ:** special economic zone; **SINOPEC:** China National Petrochemical Corp.; **SINOTRANS:** China National Foreign Trade Transportation Corp.; **UNDP:** United Nations Development Program; **SME:** small and medium-sized enterprise; **WFOE:** wholly foreign-owned enterprise

International Finance Corp. (US)
Provided financing package to Jiangxi Chenming Paper Co. to promote high standards in environmental practices and community development. $72.9 million. 12/04.

Chemicals, Petrochemicals & Related Equipment

CHINA'S IMPORTS

L'Air Liquide SA (France)
Will provide air separation unit to Yunnan Tianan Chemical Co., Ltd. $39 million. 12/04.

L'Air Liquide SA (France)
Will install air inspection unit in SINOPEC Shanghai Petrochemical Co., Ltd.'s new plant. $18 million. 12/04.

INVESTMENTS IN CHINA

The BOC Group plc (UK)/Maanshan Iron & Steel Co. Ltd. (Anhui)
Formed joint venture, Maanshan BOC-Ma Steel Gases Co., to produce oxygen, nitrogen, and argon to meet Maanshan's industrial gases demand. (UK:50%-PRC:50%). $100 million. 01/05.

Plymouth Rubber Co., Inc. (US)/Hebei Huaxia Group
Agreed to form joint venture, Plymouth Yongle Tape (Shanghai) Co., Ltd. to manufacture PVC vinyl adhesive tape in China. 12/04.

Stepan Co. (US)/SINOPEC, Jinling Petrochemical Co. (Jiangsu)
Formed joint venture in Nanjing to manufacture aromatic polyester polyols for the domestic market. 12/04.

SK Corp. (South Korea)/SINOPEC
Agreed to form joint venture, Shanghai Gaoqiao-SK Solvent Co. Ltd., to produce environmentally friendly solvent products. (South Korea:50%-PRC:50%). $15 million. 11/04.

Distribution, Logistics & Related Services

INVESTMENTS IN CHINA

ComfortDelGro (China) Pte., Ltd., a subsidiary of ComfortDelGro Corp., Ltd. (Singapore)/Sichuan Chengdu Long-Distance Bus (Group) Co.
Formed joint venture, Chengdu ComfortDelGro Chang Yun Transportation Co., Ltd., to provide long-distance bus services, taxi operation, and automotive repair and maintenance. (Singapore:60%-PRC:40%). $20 million. 12/04.

ProLogis (US)/Shanghai Lingang Economic Development Group, Co., Ltd.
Formed joint venture to develop a logistics park in Lingang, Shanghai. (US:50%-PRC:50%). $29.8 million. 12/04.

UPS (US)
Signed agreement with Sinotrans Ltd. to take direct control of its international express operations in Shanghai, Guangzhou, Shenzhen, Tianjin, and Qingdao, Shandong. $100 million. 12/04.

SK Corp. (South Korea)/Zhejiang Province Highway Materials Co. Ltd.
Formed joint venture to operate and manage an asphalt distribution facility in Zhejiang. (South Korea:51%-PRC:49%). $6 million. 11/04.

Electronics, Hardware & Software

CHINA'S INVESTMENTS ABROAD

Lenovo Group Ltd. (Beijing)
Purchased IBM Corp.'s personal computer business. $1.75 billion. 12/04.

INVESTMENTS IN CHINA

IBM International Holdings, BV, a unit of IBM Corp. (US)/China Great Wall Computer Shenzhen Co. Ltd.
Formed joint venture, International Systems Technology Co., in Guangdong to manufacture servers for the Asia-Pacific region. (US:80%-PRC:20%). 12/04.

Infocus Corp. (US)/TCL Corp. (Guangdong)
Signed agreement to form joint venture, South Mountain Technologies, for the development, manufacture, and sale of rear and front-image projection engines and projectors. (US:50%-PRC:50%). $20 million. 12/04.

Dassault Systèmes SA (France)/CAXA (Beijing)
Agreed to develop and market product lifecycle management solutions in China. 11/04.

Thomson (France)
Will acquire 8% stake in Shenzhen-based Konka Group Co. Ltd. and cooperate on producing television components and mobile devices. 11/04.

OTHER

Microsoft Corp. (US)
Formed global strategic cooperation partnership with Langchao Group, a Shandong-based IT firm. 01/05.

Energy & Electric Power

CHINA'S IMPORTS

Korea Electric Power Corp. (South Korea)
Won contract from the Henan provincial government to build two electricity generators in Jiaozhou, Henan. $210 million. 12/04.

Honeywell International Inc. (US)
Won contract from Shanxilujin Wangqu Power Generation Co. Ltd. to automate a new power plant in Shanxi. $10 million. 11/04.

INVESTMENTS IN CHINA

Siemens AG (Germany)/Shanghai Electric Group Co. Ltd.
Formed joint venture to manufacture gas turbines for Chinese power plants. (Germany:51%-PRC:49%). $71 million. 11/04.

OTHER

Emerson Electric Co. (US)/Standardization Administration of China
Will cooperate to formulate and implement energy-efficiency standards in China. 12/04.

Environmental Equipment & Technology

CHINA'S IMPORTS

Vestas Wind Systems A/S (Denmark)
Won contract from Jiangsu Unipower Wind Power Co., Ltd. to provide 50 wind turbines for the Rudong Wind Power Concession project. $80 million. 01/05.

Food & Food Processing

INVESTMENTS IN CHINA

Danisco A/S (Denmark)/Henan Tangyin Yuxin Co. Ltd.
Formed joint venture, Danisco Sweeteners (Anyang) Co. Ltd., to produce artificial sweeteners for domestic and international markets. 11/04.

Kirin Brewery Co. Ltd. (Japan)
Acquired 25% stake in Dalian Daxue Brewery in Liaoning. $36 million. 11/04.

Infrastructure

INVESTMENTS IN CHINA

Shell China Holding BV, Shell (China) Ltd., subsidiaries of Royal Dutch/Shell Group (the Netherlands)
Acquired 75% stake in Shanghai Pioneer Road Service Co., an asphalt manufacturer and paving services provider.

Insurance

INVESTMENTS IN CHINA

The Carlyle Group
Agreed to purchase 25% stake in China Pacific Life Insurance Co., Ltd., a subsidiary of Shanghai-based China Pacific Insurance (Group) Co., Ltd. $400 million. 12/04.

Internet/E-Commerce

CHINA'S IMPORTS

Array Networks Inc. (US)
Selected by Beijing-based Aerospace Information Corp. Ltd. to provide secure, remote-access network-protection technology. 11/04.

CHINA'S INVESTMENTS ABROAD

Network for Electronic Transfers Singapore Pte., Ltd.
Acquired 51% stake in Shanghai Commercial High and New Technology Development Co., Ltd., a stored-value credit card manufacturing business. 12/04.

Shanda Interactive Entertainment Ltd. (Shanghai)
Signed agreement to take a 29% stake in South Korea's Actoz Soft Co. Ltd., an online games firm. $91.7 million. 11/04.

Light Industry/Manufacturing

INVESTMENTS IN CHINA

RUBA General Trading Co., Ltd. (Pakistan)/SVA (Group) Co., Ltd. (Shanghai)
Formed joint venture, SVA-RUBA Molded Products Co., Ltd., to produce plastic products and molds for color TVs, washing machines, automobiles, and other items in Lahore, Pakistan. $20 million. 12/04.

Dometic Group (Sweden)
Will open facility in Suzhou, Jiangsu, to manufacture hotel minibars for sale in China. 11/04.

Machinery & Machine Tools

CHINA'S IMPORTS

ABB Ltd. (Switzerland)
Won contract from Anhui-based Huainan Mining Group Co. Ltd. to supply mine hoist equipment for eight of the group's coal mines. $24 million. 11/04.

INVESTMENTS IN CHINA

TTS Marine Cranes, a division of TTS Marine ASA (Norway)/Dalian New Shipbuilding Heavy Industry Co. Ltd. (Liaoning)
Formed joint venture for the production and sale of cranes for ships built at Chinese shipyards. 01/05.

Caterpillar Inc. (US)
Signed agreement to acquire stake in Shandong SEM Machinery Co. Ltd., a wheel loader manufacturer. 12/04.

Smiths Group plc (UK)
Acquired Tianjin Timing Seals Co. Ltd., a gas-sealing products manufacturer. $4.8 million. 12/04.

Siegerland Bremsen Emde Gmbh & Co. (Germany)
Established Sibre Brake (Tianjin) Co., Ltd. to produce advanced industrial brakes, couplings, and reducers for harbors, steel works, power stations, and coal mines. 11/04.

Media, Publishing & Entertainment

CHINA'S IMPORTS

IMAX Corp. (Canada)
Signed agreement with Chongqing Land Property Group to build three IMAX theatres in Chongqing. 01/05.

INVESTMENTS IN CHINA

MIH Holdings, a subsidiary of Naspers Ltd. (South Africa)
Bought 9.9% stake in Beijing Media Corp. Ltd. 12/04.

Medical Equipment & Devices

INVESTMENTS IN CHINA

Hutchison Whampoa (China) Ltd. (Hong Kong)/Guangzhou Baiyunshan Pharmaceutical Co. Ltd. (Guangdong)
Formed joint venture, Baiyunshan Hutchison TCM Co. Ltd., to research and develop, produce, and market traditional Chinese medicines. (Hong Kong:50%-PRC:50%). 12/04.

Metals, Minerals & Mining

INVESTMENTS IN CHINA

Mittal Steel Co. NV (the Netherlands)
Agreed to purchase a 37.17% stake in Hunan Valin Iron & Steel Group Co. $314 million. 01/05.

WMC Resources Ltd. (Australia)/Jinchuan Group Ltd. (Gansu)
Formed joint venture to mine for nickel and copper in Gansu and other western provinces. (Australia:50%-PRC:50%). $6 million. 11/04.

OTHER

Royal Dutch/Shell Group (the Netherlands)/Bureau of Geological Exploration and Mineral Development of Jilin Province
Formed joint venture to conduct oil shale research studies in Jilin. $30 million. 12/04.

Petroleum, Natural Gas & Related Equipment

CHINA'S EXPORTS

CNPC (Beijing)
Won contract from Mozambique-based SARL-INPETRO to build nine oil product storage tanks in Mozambique. $22 million. 12/04.

OTHER

CNOOC Myanmar, Ltd., a unit of CNOOC, China Huanqiu Contracting and Engineering Corp. (Beijing)/Golden Aaron Pte. Ltd (Singapore)
Jointly signed contract with Myanmar Oil and Gas Enterprise to explore for oil and gas off Myanmar's coast. 12/04.

Pharmaceuticals

INVESTMENTS IN CHINA

CITIC Capital Markets Holdings Ltd. (Hong Kong)
Will acquire 22.5% stake in Harbin Pharmaceutical Group (Holdings). $100 million. 12/04.

Warburg Pincus LLC (US)
Will acquire 22.5% stake in Harbin Pharmaceutical Group (Holdings). $100 million. 12/04.

Ports & Shipping

INVESTMENTS IN CHINA

Hutchison Whampoa Ltd. (Hong Kong)/Shenzhen Yantian Port Holdings Co., Ltd.
Formed joint venture, Hutchison Whampoa Yantian Port Investment Co., to operate three berths in Yantian Port. (Hong Kong:41.67%-PRC:58.33%). $30 million. 12/04.

Kalmar Industries AB (Sweden)
Invested in a new assembly plant in Shanghai's Lingang New City Industrial Zone. $10 million. 11/04.

Rail

CHINA'S IMPORTS

Siemens Transportation Systems, a unit of Siemens AG (Germany)
Won contract from Ministry of Railways to supply 180 electric double locomotives for heavy freight transport. $470 million. 12/04.

Raw Materials

INVESTMENTS IN CHINA

Cementerie del Tirreno SpA (Italy)
Acquired a white cement production plant in Shanghai. $7.5 million. 11/04.

Real Estate & Land

INVESTMENTS IN CHINA

Chevalier International Holdings Ltd. (Hong Kong)/Shenzhen Golden Peak Investment Development Co.
Formed property development joint venture. (Hong Kong:46%-PRC:54%). $15.1 million. 01/05.

Research & Development

INVESTMENTS IN CHINA

Invitrogen Corp. (US)
Signed agreement to acquire privately held Shanghai-based Bio Asia, a provider of research products in China. $8 million. 12/04.

OTHER

J.D. Power and Associates (US)
Opened an office in Shanghai to expand its Asia Pacific operations in customer satisfaction research. 01/05.

Retail/Wholesale

INVESTMENTS IN CHINA

CapitaLand Ltd. (Singapore)
Agreed to purchase two shopping malls from Beijing Hualian Group. $210 million. 01/05.

Ito-Yokado Co., Ltd., York-Benimaru Co., Ltd. (Japan)/Beijing Wangfujing Department Store Group Co., Ltd.
Formed supermarket joint venture, Beijing Wangfujing Yokado Commercial Co., Ltd. (Japan:60%-PRC:40%). $24 million. 12/04.

BP plc (UK)/Petrochina Co. Ltd., a subsidiary of SINOPEC (Beijing)
Formed joint venture, BP Petrochina Petroleum Co., to operate gas stations in Guangdong. (UK:49%-PRC:51%). $566 million. 11/04.

Kingfisher plc (UK)
Acquired five hypermarket stores from PriceSmart, Inc. $13.5 million. 11/04.

OTHER

Exel Oyj (Finland)/China Institute of Sports Science (Beijing)
Formed joint venture to import and sell sports products in China. 12/04.

Telecommunications

CHINA'S EXPORTS

ZTE Corp. (Shenzhen)
Won contract to construct nationwide CDMA network in Algeria. 01/05.

Huawei Technologies Co. Ltd. (Shenzhen)
Selected by Dutch mobile operator Telfort BV to deliver and install a nationwide, third-generation wireless network in the Netherlands. 12/04.

Huawei Technologies Co. Ltd. (Shenzhen)
Won contract from Compañía Anónima Nacional Teléfonos de Venezuela to upgrade its national backbone network. $7 million. 12/04.

ZTE Corp. (Shenzhen)
Won contract from Office des Postes et Télécommunications to provide a complete GSM network in Benin. 12/04.

ZTE Corp. (Shenzhen)
Won contract from Transam Comunicaciones SA to provide GSM network system to Santiago, Chile. 12/04.

CHINA'S IMPORTS

Compagnie Financière Alcatel SA (France)
Won contract from China Telecom to establish an optical backbone network from Shanghai to Guangzhou, and from Shanghai to Xuzhou, Jiangsu. 01/05.

AsiaInfo Holdings Inc. (US)
Signed contract with China Mobile to upgrade its business operation support systems in Gansu and Shanghai. 12/04.

Compagnie Financière Alcatel SA (France)
Won contract from the Guangdong Provincial Radio, Film, and Television Bureau to convert its TV broadcast and backbone transmission network from analog to digital. 12/04.

Compagnie Financière Alcatel SA (France)
Won contract from China Telecom to provide Internet routing gear to support its communications systems. 12/04.

LM Ericsson AB (Sweden)
Won contract from China Mobile to expand its GSM network in Guangdong. $805 million. 12/04.

LM Ericsson AB (Sweden)
Won contract from China Mobile to expand its GSM network in Hebei. $50 million. 12/04.

Siemens AG (Germany)
Signed agreement with China's Ministry of Railways to equip the railway between Jinan and Qingdao, Shandong with a wireless communication platform. 12/04.

LM Ericsson AB (Sweden)
Won CDMA2000 infrastructure expansion contracts from China Unicom in Jiangsu, Yunnan, Heilongjiang, and Liaoning. $90 million. 11/04.

Nokia Corp. (Finland)
Selected by China Mobile to expand its GSM network in Henan. $200 million. 11/04.

Nokia Corp. (Finland)
Selected by Guangdong's Guangzhou Metro Corp. to provide digital radio communications service for its metro line in Guangzhou. 11/04.

Siemens Information and Communications, a unit of Siemens AG (Germany)
Received order from China Mobile to expand its GSM and GPRS networks in Anhui. $60 million. 11/04.

INVESTMENTS IN CHINA

Actis Capital LLP (UK)
Invested in Shanghai-based YuHua TelTech Ltd., a leading mobile phone design company. $12 million. 01/05.

Intel Corp. (US)/ZTE Corp. (Shenzhen)
Agreed to jointly develop and deliver global broadband wireless solutions using WiMAX technology. 01/05.

NEC Corp. (Japan)
Signed agreement to purchase a 2.13% stake in Wuhan NEC Mobile Communications Co., Ltd. from Wuhan East Lake High Technology Group Co., Ltd. $1.4 million. 12/04.

PalmSource, Inc. (US)
Signed agreement to acquire Nanjing-based China MobileSoft Ltd., a Chinese mobile phone software company. 12/04.

Skylogic, the Italy-based subsidiary of Eutelsat SA (France)/China Satellite Communication Corp. (Beijing)
Signed agreement for two-way satellite communications between Chinese and Italian businesses and other users. 12/04.

Tourism & Hotels

CHINA'S IMPORTS

Pegasus Solutions, Inc. (US)
Signed electronic distribution agreement to provide Shanghai's Ctrip.com International, Ltd. with access to its online distribution database of live inventory at hotels worldwide, including rates, images, and tour bookings. 12/04.

Super 8 in China

Continued from page 26

zation-related hurdles in China, but other issues have arisen. For example, the chain must focus on implementing detailed operating processes to ensure service consistency. Presnick said, "Although we already provide detailed standards for operation and hotel conversion, our hotel owners have asked us to provide more common-look features in our design plans than we originally anticipated. There have been many requests for a standardized 'Super 8 Model.' Some franchisees have asked us to insist on certain Super 8 hotel-style features and other hardware similarities. In addition to the hardware and safety requirements, which are fairly stringent, and the branding requirements and 'Superline' board [which details contact information for Super 8 hotels across the country], we have now added a 'Super 8 Picture Wall' to the design requirements for all Super 8s in China." The wall includes photos of important moments in the brand's history, such as "Super 8 Day on August 8, 1988."

But what about Super 8's competition? The economy hotel sector is just getting started, according to Presnick. Super 8 was among the first foreign economy hotel chains to enter the China market, he explains, but there have since been several other entrants, including Green Tree Inn, a foreign-funded chain (founded by American Pacific Homes, Inc.). Local Chinese-owned economy hotel chains include Home Inn, Motel 168, and Jinjiang Inn. Presnick added, "We have worked to capture the benefits of first-mover advantage, which has in turn helped to create a good degree of visibility for the brand. During the first eight months of operation, the market has responded well to our value proposition."

With their modest price and Western standards, today's urban Super 8s are doing well in China. Someday, will fatigued Chinese travelers on long road trips scout out Super 8 motels off stretches of highway? Only time will tell. 完

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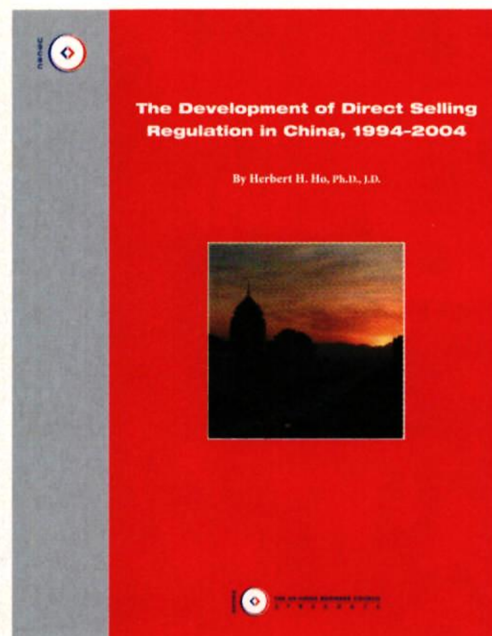

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MA05

Under the *Hood*

James A. C. Sinclair

CHINA'S AUTO SECTOR GROWTH HAS CAPTURED THE world's attention. In 2003, the nation's total auto output grew 35 percent to 4.4 million and passenger car output grew an astonishing 83 percent to 2 million. And despite a slowdown in auto sales growth to 15 percent in 2004, automakers remain committed to their strategic positions, with General Motors Corp. (GM), Volkswagen AG (VW), Ford Motor Co., and Toyota Motor Corp. planning to invest a total of more than $12 billion over the next five years.

As global automakers have scrambled to enter the China market, so have their component suppliers. Roughly 800 foreign auto component suppliers currently operate in mainland China, and these include most of the top 50 multinationals. Aktiebolaget SKF of Sweden; Cummins, Inc., Delphi Corp., Eaton Corp., ITT Industries, Inc., and Visteon Corp. of the United States; Denso Corp. of Japan; and Robert Bosch GmbH, Siemens VDO AG, and ZF Friedrichshafen AG of Germany, to name a few, all have several production facilities in China.

Despite the impressive growth of the sector, the presence of major foreign manufacturers, and the shift of auto sector practices and expectations toward more international norms, operational risks for foreign auto component suppliers remain substantial. Auto component suppliers that are not already present in China must carefully consider their market entry strategies, and suppliers that already have a presence must determine the best way to move forward.

James A. C. Sinclair
is senior consultant and head of Strategy at InterChina Consulting, Shanghai.

Auto component suppliers in China ride a fast but rough road

Dennis Chen

In need of a tune-up

Despite the rapid growth and influx of foreign investment, China's auto component sector remains poorly structured, relatively protected, and technically weak. The sector suffers from several problems:

- **Too many automakers**

The auto component sector's problems begin with China's automakers. At the end of 2004, there were 33 passenger car manufacturers in China, with an average output of only 70,000 units per manufacturer. Even joint venture (JV) automakers have relatively limited capacities of 100,000 to 250,000 units, and only Shanghai VW, a JV between the Shanghai Automotive Industry Corp. and VW, has a capacity of more than 300,000. (More sizeable US or EU plants average 300,000–400,000 units per year.) Plants are scattered across China: Beijing; Changchun, Jilin; Chongqing; Fuzhou, Fujian; Guangzhou; Nanjing, Jiangsu; Ningbo, Zhejiang; Shanghai; Shenyang, Liaoning; Tianjin; Wuhan, Hubei; and Wuhu, Anhui.

- **Too many component suppliers**

Though the automaker sector is fragmented, the auto component sector is even worse. According to official statistics, China had 4,833 auto component suppliers by the end of 2004 with combined revenues of ¥382 billion ($46.1 billion).

- **Scattered supply bases**

Chinese automakers have encouraged auto component suppliers to locate nearby to maintain self-sufficiency. Thus, auto component suppliers are as scattered around the country as auto firms. Sustained by local and group protectionism, the cluster pattern is likely to continue because of the need for just-in-time supply deliveries. JV automakers in particular now require some components to be delivered to their factories several times per day, and because of inefficiencies in China's logistics infrastructure, this is only possible if the component supplier has a factory or warehouse near its client's assembly lines.

- **Small-scale operations duplicate efforts**

Because of the scattered supply base, dozens of auto component suppliers manufacture the same components in China. For example, automakers can choose from among 27 manufacturers of shock absorbers and 23 manufacturers of steering gears. Many component suppliers in China thus operate below capacity and have been unable to achieve large production scales or efficient economies of scale. Consider that Toyoda Gosei Co., Ltd., a component supplier ranked 50th in the world, had net sales in 2001 greater than the combined total of China's top 10 auto component suppliers.

- **Supply chain lacks clear hierarchy**

The auto component sector in China also lacks the hierarchy (the clearly structured tiers of the auto component value chain that start with raw material producers and end with automakers) that is the backbone of the global auto industry. Tier 1 suppliers (which primarily

Case Study: Auto Components in Yongkang, Zhejiang

Yongkang, Zhejiang, is a major producer of auto components for the aftermarket in China and overseas. The city hosts roughly 10,000 manufacturers, and most makers offer products that are more attractive for their price than their quality. These manufacturers keep costs low using a range of methods:

- Using labor-intensive rather than capital-intensive production methods;
- Hiring temporary workers at ¥3–5 ($0.36–$0.60) per hour without any insurance or benefits;
- Running workshops that are small, rundown, and without climate control;
- Operating at night when electricity rates are discounted;
- Sourcing the cheapest raw materials available, including scrap metal; and
- "Shutting down" and re-registering to enjoy the tax holidays of "new" companies.

Many of these manufacturers do not even have a company nameplate at the front gate of their factories.

—James A. C. Sinclair

JV automakers are ramping up pressure on auto component supply chains in China, with almost all the automakers implementing price reduction requirements of 3 to 10 percent per year, and subjecting the auto component suppliers to an unprecedented margin squeeze.

sell to automakers) and Tier 2 suppliers (which primarily sell to Tier 1 suppliers) are not clearly distinguishable, and therefore automakers have to deal with both Tier 1 and Tier 2 suppliers, often amounting to several hundred in number. Supply chain management clearly costs automakers in China a lot of time and money.

- **Protectionism persists**

Although local content requirements have officially been abolished, the new Automotive Industry Development Policy, which took effect June 2004, appears to push indirectly for localization; Customs can now impose higher import duties on knock-down kits if automakers fail to meet the new policy's vague requirements of "complete vehicle characteristics."

Moreover, the culture of protectionism still prevails in the auto sector—at the national, provincial, and local levels. Since around 70 percent of Chinese auto component suppliers remain fully or partially owned by Chinese automakers, local protectionism has also combined with a culture of group protectionism. For products other than those strictly controlled by the foreign partner, protectionism has led to local or subsidiary suppliers securing orders despite the fact that they offer inferior components at higher prices. Some Chinese automakers declare that, everything being equal, they first select the group member, then the supplier located closest to their assembly lines, then finally suppliers outside of their network. But "everything being equal" is just a smokescreen. Even among JVs, protectionism remains strong—and can even be strongest at older JV automakers such as Shanghai VW and First Auto Works VW. Chinese partners will often select an inefficient local Chinese supplier that is a member of their group rather than an efficient supplier outside of the group. Indeed, the Chinese party and the foreign party often have different objectives for establishing and managing their supply chains.

- **Entrenchment blocks market entry and expansion of new firms**

The entrenchment of local and group suppliers has been exacerbated by the strong role that personal relationships play within the supply chain. Because automakers have several departments involved in supplier selection (such as product development, quality control, and purchasing departments), auto component suppliers must establish and maintain multiple personal relationships with each automaker. Supplier selection is a resource-intensive process, often involving underhanded dealings, and has acted as a barrier to market entry and expansion. While homologation (certification that confirms a product met required standards) in other markets, such as US or European markets, has allowed some foreign auto component suppliers to sell to JV automakers, the level of entrenchment makes it difficult for many newcomers to break into the market.

- **Technological weakness**

Chinese auto component suppliers have been slow to invest in product development. Though they are adept at making prototypes based on blueprints or physical samples, most real product development remains in the hands of foreign auto component suppliers. JV automakers still must import components for newly introduced car models (such as the Audi A6, the BMW 3 and 5 series, and the Buick Regal) while the Chinese auto component suppliers play catch-up, and they will need to do so until the components become locally available.

- **Counterfeiting**

Finally, many of the foreign auto component suppliers in China are facing a serious problem with intellectual property rights (IPR) infringement. According to a survey conducted by the Taiwan newspaper *Commercial Times*, 56 percent of all vehicles in China contain counterfeit components. One US auto company believes exports from China of counterfeit components for its cars may exceed $200 million per year. In raids of counterfeiting factories, the company

has found fake transmission fluid, oil filters, and brake liners—all made of absurdly poor substitute materials. Though IPR infringement is widespread in China, it has a particularly large impact on the auto sector because of the sector's increasingly competitive price pressures, income loss through lost sales, and smaller economies of scale. Though the PRC central government has indicated that it will crack down more heavily on IPR infringers, provincial and municipal governments remain reluctant to close counterfeiters down, and seized goods are often returned to the market rather than destroyed.

Slowdown exposes weaknesses

Compared with the remarkable growth during 2003, sales growth in China's auto market slowed significantly in 2004, with sales of passenger cars growing only 15 percent, to 2.33 million vehicles. The central government instituted a number of macroeconomic measures that are partly responsible for the reduced pace, but the slowdown is also a reasonable market correction, shifting the explosive auto sales growth of the last two years toward a more sustainable pace.

Automakers in China have had to balance the risk of temporary overcapacity with the risk of losing potential sales, and overcapacity is the greater concern now. Automaker plant utilization dropped from 96 percent in 2003 to around 75 percent in 2004 and was even lower in plants that produce older models. In addition, automaker inventory levels more than doubled from 2003 to 2004. In this period of imbalance, the auto sector reached a crunch point, bringing sector weaknesses to the forefront.

Trends will upend the status quo

Now that players in China's auto sector have begun to understand the significance of these weaknesses better, there are signs that the auto component sector may be gradually streamlining in response.

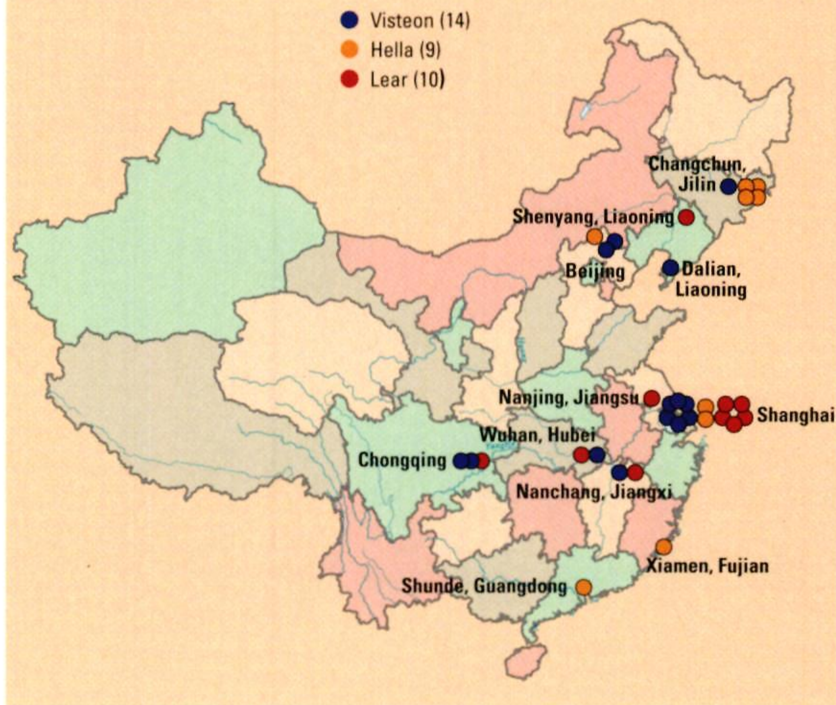
From protectionism to competition

With a slowdown in passenger car sales and increasingly fierce competition in the sector, Chinese automakers can no longer afford to protect subsidiary or local suppliers. Thus, most of the major component subsidiaries are being restructured as independent companies charged with supplying the whole sector, thus exposing them to outside competition. Although intragroup trade may still account for most of their transactions, even these transactions are slowly becoming more market-oriented.

One Supplier, Multiple Plants

Many foreign auto component suppliers have set up multiple operations in China, with multinational corporations like Hella KgaA Hueck & Co., Lear Corp., and Visteon Corp. running about a dozen entities across the nation. Even smaller foreign auto component suppliers tend to run several entities that produce the same component in different locations.

—James A. C. Sinclair



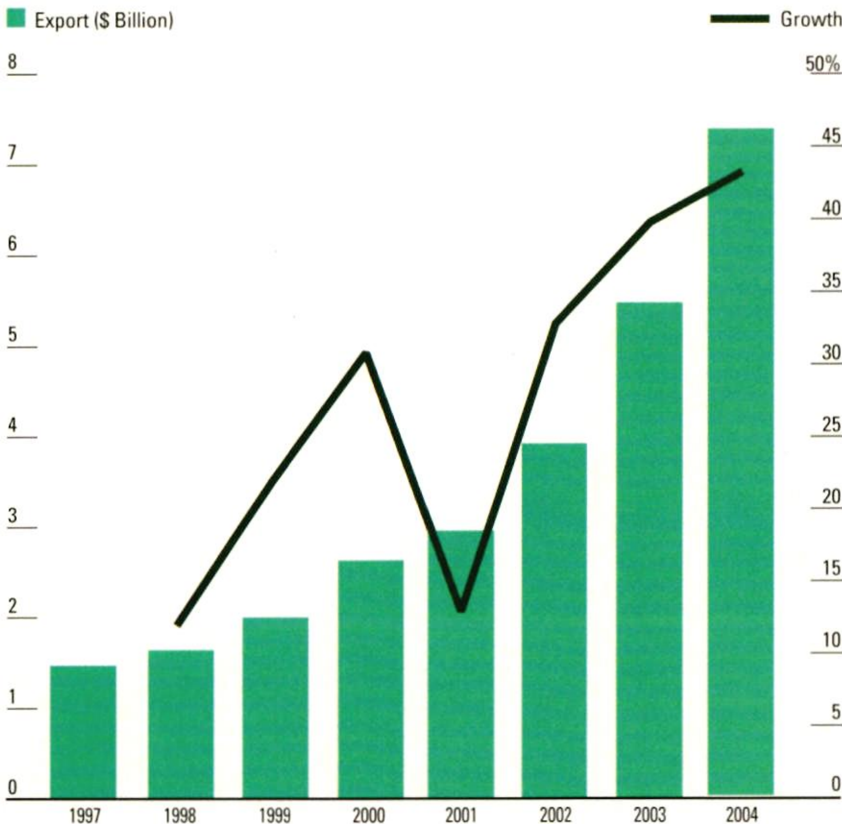
Cost pressures spark efficiency

The auto industry's large fixed costs and current overcapacity have forced automakers and component suppliers to focus on reducing costs. Despite low wages and weak environmental protection requirements, China's auto components have historically been relatively expensive, largely because of inefficient production and high profit margins. Now JV automakers are ramping up pressure on auto component supply chains in China, with almost all the automakers implementing price reduction requirements of 3 to 10 percent per year, and subjecting the auto component suppliers to an unprecedented margin squeeze.

Technological upgrades

JV automakers are actively encouraging suppliers to develop and upgrade the local supply base. On the one hand, this requires JV automakers to drag foreign component suppliers to China to establish local operations. On the other hand, it means supporting Chinese component suppliers by subsidizing their upfront tooling expenses for critical components. JV

Figure 1: China's Auto Component Exports



Sources: *China Automotive Industry Yearbook;* PRC General Administration of Customs

automakers are not just motivated by the potential for a cheaper supply base, but by the need for local product development as they start to redesign models specifically for the China market. The consequence for foreign component suppliers is that simply transferring production operations to China is no longer enough. (For example, in the redesign of the Buick Regal for the China market, GM worked with Visteon's local team on the development of the new dashboard module.)

Consolidation and sector cleanup

To meet these expectations and still make profits, the auto component sector must consolidate and restructure. A fight for survival lies ahead that will shake out weaker players, drive forward mergers and acquisitions, and result in fewer but stronger auto component suppliers. These suppliers will seek greater economies of scale, which are needed to sustain price competitiveness, resources to invest in product development, and ultimately long-term relationships with the automakers. Restructuring will also lead to more efficient auto component supply chains; strong sub-assemblers (producers of assembled units that make up components) will likely create a more typical first-tier structure in China. Within the next five years, the current 5,000 auto component suppliers will likely shrink to 1,000.

Component exports on the rise

Overseas markets are already feeling the growing strength of China's auto component suppliers. China's auto component exports grew 43 percent in 2004, to $7.38 billion, accounting for more than a fifth of China's total component production. China is strongest in tires, electronics and meters, shock absorbers, wheels and wheel parts, brakes and brake parts, and body parts. Though many of these exports are presently limited to the aftermarket (the market for replacement parts), as Chinese auto component suppliers upgrade technologies and strive for economies of scale, China will increasingly export to global automakers. GM and Ford Motor Co. have already announced that they intend to substantially increase their component purchases from China. (By 2010, GM plans to purchase components worth $10 billion, and Ford plans to purchase $7 billion.) As a result, exports from China will grow at an average of 25 to 30 percent per year over the coming five years.

Chinese suppliers invest overseas

Some of China's auto component suppliers have already gone a step further and made acquisitions overseas. The Wanxiang Group from Hangzhou, Zhejiang, has acquired 10 US auto component suppliers since 1995, looking to gain access to overseas markets. The Greencool Group from Shenzhen announced at the end of 2004 that it had acquired Gates Corp.'s hose plant in France and intends to transfer the technology back to China to begin exports of low-cost, high-quality industrial and auto hoses. More Chinese component suppliers will likely follow in their footsteps.

Difficult questions and operational risks remain

Though these new trends will bring marked improvements in the auto component sector, foreign auto component suppliers that wish to enter the sector still have to make tough decisions.

Relocate to China?

Though most multinational auto component suppliers are already in China, many smaller foreign players have yet to make the move. For some, China is seen as a great opportunity because it can serve as a low-cost production base for exports and because the country is an attractive market in itself. For other companies,

With so many foreign auto component suppliers making the move to China, most of the attractive Chinese partners have already been snapped up.

it is more a question of whether they can afford *not* to come to China. All companies must weigh the risks—especially the auto sales slowdown and expected industry shakeout, in China and around the world.

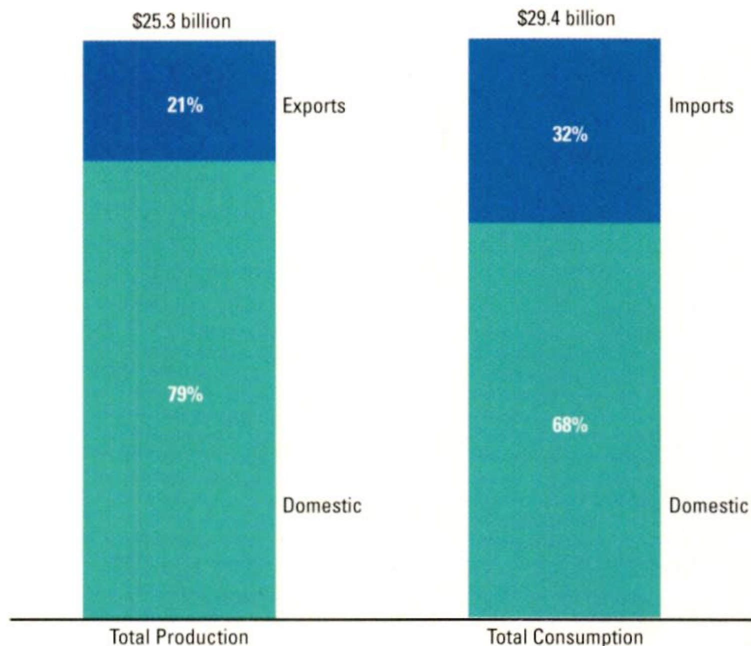
Parameters for market entry

Foreign auto component suppliers that plan to enter China in 2005 will have to develop market entry strategies that can meet many challenges. Suppliers should consider, among other aspects of the market, the importance of homologation and dependence on imports; the competition, including competitors' consolidation levels and export strength; switching costs (customers' willingness to "switch" from existing suppliers in China to new suppliers), including protectionism and entrenchment; technology gaps, such as local quality levels and possible IPR infringements; and suitable partners, including their availability and interest level. Though market-entry strategies are company specific, these parameters may be applied to two variables: the selection of investment vehicle (whether a JV or a wholly foreign-owned enterprise) and sales orientation (whether domestic or foreign sales).

Choosing a JV partner

Despite the gradual weakening of protectionism and entrenchment in China's auto component sector, foreign component suppliers that plan to sell to the domestic market in the short term may still wish to partner with the subsidiary of a Chinese automaker. Such JV partners offer the advantages of market access, knowledge of local practices, and possibly low-cost production. But with so many foreign auto component suppliers making the move to China, most of the attractive Chinese partners have already been snapped up. The remaining firms are likely to offer only small market shares, of 5 percent or less, which hardly compensates for the normal risks associated with JVs.

Figure 2: China's Auto Component Market Structure, 2003



Sources: *China Automotive Industry Yearbook;* PRC General Administration of Customs

Setting up in multiple locations

Since one JV partner can provide access to only one automaker, and because just-in-time supply delivery requires supply bases close to automaker assembly lines, foreign auto component suppliers that intend to expand in China still must establish entities in multiple locations. As market forces gradually make China's auto component sector more market oriented, and as ongoing investment in the logistics sector creates more delivery options, foreign auto component suppliers may start to consolidate their multiple operations and strive for better economies of scale in China.

Inevitable market entry?

This backdrop creates a market brimming with opportunities and risks. Auto component suppliers that are not yet in China will likely feel increasing pressure to make the move. Issues like multiple plant locations will remain significant challenges for smaller auto component suppliers that will have to struggle to achieve economies of scale and make profits, but these companies will likely need to deploy market entry strategies soon and accept a certain level of risk—or consider what their absence from China will mean for their future. 完

SOFT SELL: China Learns to Lobby

Trends in the software sector are indicative of the growing political activism in many industries in China.

Continued from page 33

As significant as larger firms' activism was in raising the stakes of the issue, the software associations shaped the outcome as well. In late 1997, CSIA and the Beijing Software Industry Association (BSIA) met with the Science and Technology Commission and others and persuaded them of the need for the tax break. In the following months, the associations offered alternative plans, including counting 70 percent of a software product's retail price as the input cost or reducing the VAT to 5 percent. Once SAT accepted a 6 percent rate, BSIA came up with the plan of how to determine which firms and which products could be eligible to receive the tax break.

After the policy change was announced, firms praised the associations for their efforts. The failure of other industry associations to help their members, for example in steel and consumer electronics, hurt those organizations' reputations. By contrast, successes such as the reduction in the VAT imbued the software associations with new legitimacy in the eyes of their members, suggesting associations' role in future policy debates would likely rise.

Tax relief on its own would not change the fortunes of the industry as a whole, but it likely has helped most firms to a moderate degree. Not all firms were satisfied with the reduction, arguing that they should be exempted entirely from the VAT. However, in the late summer of 1999, when the tax break applied only in the capital, the number of newly founded software firms in Beijing jumped dramatically, and many existing companies moved to Beijing from other regions. By dint of their actions, firms showed how much they welcomed the change.

The VAT reduction episode and subsequent policy changes suggest that business-government relations in the software sector are structured in a pluralist fashion rather than a corporatist one in which firms' political activism is suppressed by their inclusion in state-controlled associations. Firms that vary in ownership forms and associations, and working in concert and individually, all repeatedly argued for a revision of the tax code, and they did so by focusing on the merits of their position. Although larger firms were the ones with access, large and small companies benefited from the policy change. And so in this instance, the industry as a whole gained from the actions of a few.

But this was not the end. In part spurred by further industry pressure, in June 2000 the national government adopted a broader set of policies, embodied in State Council Document No. 18, to help the industry. It reduced the VAT to 3 percent, supported venture capital investments and stock market listings, permitted direct import-export trading rights, and encouraged government agencies to purchase domestic software.

Despite continued high rates of piracy, China's software industry has grown at a fast pace. Continued expansion combined with active associations should eventually make the industry even more powerful.

The future of political activism in industry

Trends in the software sector are indicative of the growing political activism in many industries in China. Although specific evidence is sometimes hard to find, there are fewer and fewer industry policies that have not been touched by industry. But the level of association development, the depth of direct contact with officialdom, the degree of firms' lobbying aggressiveness, and the level of transparency in the policy process all vary widely across the economic landscape.

One consequence of greater political activism on the part of Chinese industry has been new efforts to push the government to adopt protectionist policies. Though there are instances of such efforts to erect new trade barriers, Chinese firms with international business alliances have on many occasions lobbied on behalf of (and in cooperation with) their foreign partners. Domestic auto and home appliance makers have successfully fought against punitive antidumping charges leveled at foreign steel producers. And one likely reason the government has yet to forcefully implement a "buy-local" software policy is the strong opposition from the many local software developers who cooperate with foreign software companies, for example those who write applications for Microsoft Corp.'s Windows operating system.

The emergence of lobbying in China creates new challenges and opportunities for foreign businesses. Chinese firms are increasingly defending their interests, but the central and local governments are more accessible to foreign industry as well. The most successful foreign firms are taking a multipronged strategy. They lobby officialdom directly, use Chinese and foreign lobbying and public relations firms, and participate in business associations—not just foreign associations but Chinese industry groups as well. Failure to adapt to this new environment will have a major effect on companies' ability to prosper in the future, when business influence is sure to increase. 完

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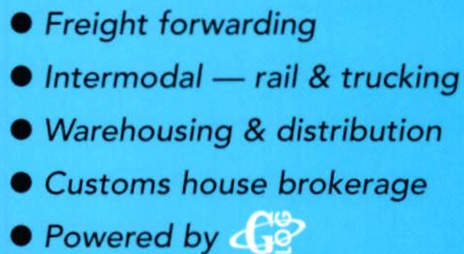

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