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Chazen International Study Tour Report

Business and the Legal Environment: Lessons from China

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A Note from the Authors

The authors are MBA students at Columbia Business School. In August 2005, they participated in a study tour to China that was organized in concert with the School's Jerome A. Chazen Institute of International Business and directed by Kenneth Ayotte, assistant professor of finance and economics. The information about the companies discussed in this paper is primarily drawn from the authors' interactions during this trip with company representatives.

Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During study tours students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Recent destinations include China, France, India, Japan, Russia and Scandinavia.

Introduction

With its impressive economic growth, China presents foreign investors with enormous opportunities, not only as a location for low-cost production but also as a rapidly developing market for their products. Since the late 1970s, when the Chinese government began its transition toward a more market-oriented economy, changes in labor skill levels and incomes have been dramatic. Per capita GDP has more than quadrupled over the past 20 years, and the rapid expansion of opportunities has led to an explosion in foreign direct investment by multinational firms.

Nonetheless, seizing business opportunities in China presents unique challenges. China's underdeveloped legal system—specifically, the uncertainty regarding protection of property and contractual rights—requires foreign entrants to develop strategies for managing these hazards effectively. On a trip organized in concert with Columbia Business School's Jerome A. Chazen Institute of International Business, 33 Columbia MBA students had the opportunity to visit China in August 2005 to learn directly from foreign investors the difficulties of doing business in China's developing legal environment.

We present below three key themes—regulations and bureaucracy, intellectual property rights and corporate financial policy—that emerged during our company visits. During each visit, we probed, with variations, a common question: “How does China's developing legal environment influence the way you do business?”

What we conclude is that an awareness of these challenges is essential to doing business in China. Ignorance of these realities can lead to failure, notwithstanding a business strategy that would produce successful results in the United States. In some cases, we found that a working knowledge of the realities of the Chinese system can provide a crucial advantage over competitors. Finally, very few executives at the companies that hosted us expressed optimism that the legal protections we take for granted in the United States would be realized in China anytime in the near future; thus, effective strategies for doing business in an uncertain legal environment will continue to be crucial in the years to come.

With this in mind, we present some of the unique insights we acquired.

Regulations and Bureaucracy

In Beijing, we toured a hospital facility owned by Chindex International, Inc., a provider of state-of-the-art medical equipment, over-the-counter health care products and medical services through privately owned for-profit hospitals. These hospitals cater primarily to expatriates and wealthy Chinese, who pay for services in advance in cash.

The company's CEO, Roberta Lipson, MBA '77, detailed some of the enormous logistical complications involved in opening Chindex's new hospital in Shanghai—for example, more than 150 “stamps” of approval were required to open the new hospital. Lipson also noted that so many legal gray areas exist that it is not always clear which types of approval are required for any given project. Often, it is not obvious to the applicants or to the regulators themselves who has the authority to grant or deny approvals. Lipson emphasized the necessity of developing good relationships with government officials. For Chindex, this was facilitated by the company's long-standing presence in China and its experience in sidestepping these potential roadblocks.

Interestingly, though, Lipson saw these regulatory requirements and burdensome red tape not just as a cost but also as a benefit to Chindex. The necessity of these relationships, she explained, creates a barrier to entry that reinforces Chindex's first-mover advantage in the medical services market. While rival firms

have also recognized the unmet demand for high-quality medical services in China, the fixed cost of developing these relationships, and the expertise required to navigate a minefield of regulations, has held potential competitors at bay.

In Tianjin, a port city of 10 million people about 85 miles southeast of Beijing, we toured the headquarters of the Tianjin Investment Bureau and saw the effect of regulation from the government's perspective. Throughout China, local governments are competing to attract investments from international companies by setting up special economic development zones, which provide tax relief and other incentives to attract foreign direct investment.

When evaluating a prospective production site, multinationals have several locations to choose from, both inside and outside China. Thus, local government bureaus competing to attract businesses are eager to provide the most appealing environment possible. Sometimes they find that the central government, which maintains control over approval of large foreign investments, is a hindrance to their start-up efforts. In particular, officials at the Tianjin Investment Bureau expressed some frustration over a potential \$1 billion investment in Tianjin that was rejected by an environmental regulatory body of the central government. We found it interesting to note that "government" in China should not be seen as a single-minded monolith. Different, and sometimes conflicting, objectives persist between local governments striving to attract investment and the central government seeking to prevent perceived negative consequences of foreign investment in China.

Intellectual Property Rights

As many American companies strive to maintain strategic competitiveness in the global marketplace, outsourcing to China has become almost commonplace. But one of the main issues holding back additional foreign investment in China is perceived weakness in the enforcement of intellectual property rights (IPRs). More than any other aspect of China's legal environment that came up in our discussions, the lack of effective IPR enforcement was cited as a crucial weakness.

Overall, we found that those American companies who are doing business successfully in China mitigate IPR problems through self-protective strategies of guarding sensitive technology and information. They do not place much faith in the formal legal sector to defend their rights. Tianjin Investment Bureau officials conceded the difficulty of IPR problems. In response to these concerns, they offer foreign companies the prospect of IPR enforcement through relationships with local police teams. Nevertheless, the officials acknowledged that formal enforcement mechanisms are at an early stage of development.

Moreover, where the formal legal system is perceived to be ineffective, cultural norms in China also contribute to IPR vulnerability. According to an experienced China-based consultant at Booz Allen Hamilton, the Chinese mindset and culture are such that copying existing products and selling them more cheaply just "makes perfect sense" and represents Chinese pragmatism at work.

Of course, concern with IPR tends to vary across industries. Most notably, for consumer-goods and technology manufacturers, protection of proprietary information is an ongoing concern of major importance. Both of the management-consulting firms we visited, Booz Allen Hamilton and Bain, advise their clients who are invested in China to carefully implement protection strategies regarding critical IP areas and to avoid bringing particularly sensitive technology inside China altogether.

Indeed, the consultants told us they often face IPR challenges with respect to their firm's proprietary information. Since many Chinese companies are eager to learn best business practices and management

techniques, client presentations are often treated as executive learning opportunities and are attended by entire management teams as opposed to key executives. As a result, some consultants have reported finding copies of client presentations for sale on the Internet.

One way to mitigate IP risk is to decide whether to manufacture in-house or to outsource. Like many mobile-phone manufacturers who make advanced phones in China, Motorola only manufactures within its own facilities, as opposed to hiring a Chinese contract manufacturer. Motorola has also instituted internal strategies to combat weak IPR enforcement by trying to instill employee loyalty and discourage IPR abuses by making protection of sensitive information a part of the company culture and rules. As we toured Motorola's manufacturing facility in Tianjin, we passed by a large sign, strategically placed near the factory floor, explicitly stating that employees are not to discuss or share technological information outside the workplace.

Jack Perkowski of Asimco shared with us further insights regarding intellectual property issues. Asimco was, at one time, one of the largest foreign investors in China and is now the largest China-based auto components supplier in the world. Perkowski emphasized that companies should selectively choose which products to manufacture within China in order to avoid IPR problems. He noted that high-margin/low-tech products such as Callaway golf clubs or Mont Blanc pens are particularly vulnerable to counterfeiters. In the United States, retailers can be held legally responsible for selling counterfeit goods; this provides protection for easily copied branded products when the manufacturers of counterfeit goods themselves are difficult to track down. China has yet to develop such protections, and as a result clusters of small vendors selling counterfeit goods proliferate. Within his company, Perkowski has been careful to keep certain processes and operations totally outside Chinese borders, and he prefers to obtain new technology by acquiring companies within the United States.

Though avoidance is a common strategy for proprietary technology, American companies that have found success in China know the importance of developing relationships with the right government officials and agencies. With respect to IPR, determining which agency to turn to when a violation occurs depends on the circumstances. For example, if counterfeit goods are being exported, the customs agency should be contacted. If a distributor is carrying counterfeit goods, then the Administration for Industry and Commerce (AIC) is the responsible government agency.

This point about relationships is noteworthy because several of our company hosts emphasized that in Chinese business culture relationships and contacts matter much more than the letter of the law in enforcing property and contractual rights. Perkowski, in particular, mentioned that Americans often have trouble understanding this fundamental difference in Chinese business culture.

Corporate Financial Policy

In comparison with most other industrialized and developing nations, China's ownership structure for foreign entities is strict, with majority ownership and control rights limited in most industries. Specifically, Chinese law prevents foreign investors, despite majority ownership, from exercising full management control in many industries. In certain sectors, such as banking, majority ownership by foreigners is prevented altogether. As part of China's agreement to join the World Trade Organization, ownership and control restrictions are being relaxed gradually, allowing foreign capital providers to obtain formal ownership and control of the companies they fund. In other cases, however, effective control has been established through more informal means.

Asimco's Perkowski told us that when he arrived in Asia in search of investment opportunities, he did not originally intend to focus on the auto parts market. One of the primary reasons he chose that particular sector was the allowance for foreign investors to own a majority stake. The Chinese government had concluded that additional foreign capital in the auto industry would produce dramatic improvement. Ultimately, this allowed Asimco to invest heavily in China with the confidence that its interests would be protected.

In the financial sector, however, majority foreign ownership and control is not yet feasible. In particular, Goldman Sachs's official ownership of its China venture is limited to 33 percent. As part of its contractual agreement with its Chinese partners, however, Goldman has arranged for the eventual transfer of majority ownership as soon as the law permits. In effect, this allows Goldman to maintain de facto control of the Chinese joint venture and implement the firm's distinctive corporate culture in China while remaining within legal boundaries.

Many foreign banks interested in making Chinese investments have found the Goldman structure an interesting way to invest now while maneuvering around certain restrictions. UBS and several other banks have also looked to make direct investments in one of the four major Chinese national banks to gain exposure to the growing financial marketplace in China.

In addition to legal restrictions on foreign equity ownership, debt markets are also affected by China's developing legal environment. Lenders often depend on the availability of good collateral as backing for a loan. This, in turn, requires legal mechanisms that allow for borrowers to identify and pledge assets as collateral and for lenders to seize collateral when borrowers default. Executives at several of the companies we visited noted that these mechanisms were not available in China, which affects the firm's cost of capital—for example, the CFO of Chindex International related to us that hospitals are generally seen as poor credit risks in China. Land is typically leased from the government rather than owned, and hospital equipment cannot be pledged as collateral. This, in turn, makes debt capital more difficult to obtain, and maintaining a solid reputation becomes crucial to raising outside funds.

During our visit to Booz Allen Hamilton's Shanghai office, a discussion of the auto loan market provided perhaps the most interesting example of how business can be affected by the legal environment and how an understanding of this environment can lead to value-enhancing business strategies. In China, the auto finance market is at an early stage of development due to legal restrictions, the lack of centralized credit registries and the lack of an effective mechanism allowing lenders to repossess cars from defaulting borrowers. As a result, the auto market is restricted primarily to buyers who can afford to pay the entire purchase price of the car in cash; for midsize and larger cars, these buyers are at the very top of the country's income distribution.

Consultants at Booz Allen stressed the importance of designing larger cars for the Chinese market with these affluent individuals in mind. They reasoned that buyers wealthy enough to pay the entire purchase price of a car up front likely also could afford to hire a driver. While most design features are focused on satisfying the driver, the consultants argued that larger cars should be designed to provide the amenities and extra legroom in the back seat, where the car buyer is most likely to sit, rather than in the front seat. This example is particularly interesting because it demonstrates how certain financial limitations in China can affect the way companies do business and design products.

Conclusion

Despite the lack of a fully functioning legal system that supports business and capital formation, China's economy continues to grow, seemingly without limit. We saw that competition among local governments may provide some incentive for formal legal protection to improve with time, but most of our hosts expressed skepticism that major improvements in the legal system were on the immediate horizon. For the time being, most of the company executives and other individuals we spoke with thought of deficiencies in the legal environment and investor protection as an incremental cost of doing business that could be managed adequately with the right strategy. These deficiencies are most glaring in the area of intellectual property, with many of our hosts advocating an avoidance of China altogether for the most sensitive and proprietary technologies.

We saw numerous examples of creative solutions to problems and came away with the impression that weaknesses could be turned into strengths with the right relationships, sufficient local knowledge and experience, and the willingness to adapt to China's unique business culture. Ultimately, for many of the businesses we visited in China, the market opportunities and economics of doing business in China outweigh the implicit costs of these legal and structural challenges.