HOW TO MANUFACTURE IN CHINA WITHOUT FAILING

By David Kuo

The lure of China is strong for American manufacturers. Even if tariffs on many products are sharply reduced, as was expected, there remain big advantages in manufacturing in the Peoples Republic of China. With a population of 1.2 billion, the country represents a huge and virtually untapped market for U.S. consumer products. Labor is inexpensive by the standards of the United States and competitive with those in many other low-cost countries.

But for American companies that don't already have a presence in China, there are a number of perils and pitfalls that must be negotiated to establish and operate a successful manufacturing plant in that country. As an investment banker who has assisted many U.S. companies in doing business in China, I'd like to offer some suggestions and observations on the cost of labor, form of ownership, plant location, building a plant, staffing a plant, patents and copyrights, and getting paid.

Cost of labor. Wages of most rank-and-file manufacturing workers in China are no more than one-tenth of what their counterparts in the United States earn. But that advantage may diminish somewhat over the next few years, for two reasons.

One is that China is in the midst of designing and implementing a huge social safety net that will combine the functions performed by Social Security, Medicare and Medicaid in the United States. The Chinese system, emulating Social Security, would be financed by contributions from employers and employees alike.

The other factor that should be taken into consideration is that production workers' wages are rising faster in China than they are in the United States. As might be expected, the most rapid growth in labor costs is occurring in metropolitan areas. But any advantage gained by locating a plant in rural areas of China may be offset by another consideration discussed later. Form of ownership. There's nothing to prevent a foreign company from owning 100 percent of a venture it establishes in China. But many companies making their initial foray into China prefer to do so via a joint venture.

Joint ventures are attractive because the government gives them tax breaks. They require a minimum of investment (the foreign company need own only 25 percent of the business), and the Chinese partner often can help negotiate the maze of regulations the government imposes on business.

But a company considering the joint venture option should realize that tax advantages might be revoked. And it should exercise great care in choosing a joint venture partner. An American company doesn't want to get involved with a Chinese company that's not

profitable, or is dominated by executives that came from state-owned companies not concerned with making a profit.

Checking out about the track record of Chinese companies or the background of their executives can be a daunting task. There's no law requiring Chinese companies to report their financial results, and no incentive for them to do so because only a very small percentage of them have access to capital in the public markets.

How, then, can an American company perform the necessary due diligence on a proposed joint venture partner?

Go to the banks. That's where Chinese companies usually go when they need capital. And the banks closely monitor the performance of the companies they lend to, and they are usually well aware of the background of these companies' managers.

Plant location. Because labor costs are lower in the inner provinces of China, American companies may be tempted to build plants in one of these remote areas. Trade delegations often come to the U.S. to promote them, offering inducements such as exemptions from taxes for several years.

These advantages must be weighed against at least two negative factors. Rarely can competent management be found in the inner provinces, and it's difficult and expensive to recruit the necessary expertise from the metropolitan areas in the coastal provinces.

The other downside of locating in the inner provinces is that they don't provide the same degree of legal protection and government cooperation that is enjoyed by companies in the metropolitan areas of the coastal provinces.

The provinces that are most hospitable to American and other foreign companies are those along the coast: Shangdong, Jiangsu, Guangdon and Zhejiang.

A final point about plant location: Foreign companies can't buy land anywhere in China; a plant site must be leased, for terms ranging from fifty to seventy years.

Building a plant. American companies that want to manufacture in foreign countries usually prefer to have their plants build by the contractors they're accustomed to working with. But it may not be economical to bring a major western construction firm into China to build anything less than a large factory.

That leaves a choice of contractors domiciled in mainland China and those based in Taiwan and Hong Kong. The better choice will usually be a contractor from Taiwan or Hong Kong that is licensed to build on the mainland. Some of these companies have good quality control, better technology and can get projects done on time, on budget. Here again, it will pay to do extensive due diligence to find a good contractor.

Plant staffing. There are two big pluses in working with the Chinese labor force. Most employees are willing to put in long hours, and there is no union interference on the scale seen in the United States.

On the negative side, Chinese workers in general have a lack of initiative. Typically, a foreign company finds it must put Chinese workers through a long training process before they are able to do their jobs and learn to come up with solutions to problems on their own.

Getting paid. An American company can make all the right moves in building a plant in China, manufacturing its products and getting them into efficient distribution channels, but all their efforts go for naught if it can't get paid for products sold and delivered.

This hazard is worth addressing because there have been many stories about foreign companies operating in China being "stiffed" by their customers. It would be nice if China had a counterpart of Dun & Bradstreet to check credit ratings, but no such entity exists. What, then, can an American company do to avoid this problem?

First off, American companies must accept as a fact of life that the percentage of their receivables that are not collectible in China will almost always be higher than it is in the United States. One reason for this is that foreign companies have no control over the distribution system in China. (This may change when China is admitted to the World Trade Organization.)

Nonetheless, there is one way to hold uncollectible receivables to a minimum: Check with the banks that are familiar with prospective customers. As noted earlier in the discussion on joint ventures, the banks know the financial condition and the creditworthiness of Chinese better than any other organization in the country. There will always be one or more banks that know any potential customer of a foreign company.

An American company should also differentiate between different types of customers, and be leery of selling to state-owned companies. It's not that these companies deliberately cheat their suppliers; rather, they simply may not be able to pay their bills.

Extreme caution is warranted if a prospective customer is a state-owned manufacturer, because many such companies have obsolete technology and therefore have trouble selling their products.

Patent and copyright protection. China subscribes to international treaties and conventions on patents, copyrights and other intellectual property, and the government is sincere in its vow to catch and prosecute infringers. Still, the country is so huge and the profits to made from infringements so great that some infringement does go on.

This does not mean that American companies should not manufacture any of its proprietary products in China. But they would be well advised to confine the

manufacturing of components containing their core technologies in the United States, and have the less proprietary parts of their products made in China.

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The common denominator in almost all of the areas discussed in this article is the need for guidance by people or entities that know the ropes. Without such contacts, an American company seeking to manufacture in China will almost certainly encounter heavier than necessary expenses, and may actually fail.

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