Investments in China from the viewpoint of foreign chemical companies

Unchallenged *attractiveness*

China's attractiveness for investors appears unchallenged. Political and economic reforms, rapid industrialization, growing stock market capitalization and the opening up of the Chinese market have contributed to making China an attractive option for investors. Meanwhile, China is one of the world's top destinations for foreign direct investments (FDIs) with an overall total of approximately US$ 560 billion at the end of 2004. The Ministry of Commerce estimated that China's FDI dipped slightly to US$ 60.3 billion in 2005, but the figure was later revised to US$ 72.4 billion after the financial sector was taken into account. From January to July 2006 FDI totaled US$ 32.7 billion. Industry, especially the manufacturing sector, continues to absorb more than 70% of foreign investment in China. Another interesting fact is that during the last years import and export values of foreign-funded companies accounted for about 60% of the country's total trade volume.

A large number of chemical producers from Europe, North America and Japan are currently investing in China. These companies want to establish a presence in China in order to participate in its rapid growth. Since around 60% of all chemical investments in the country is made by foreigners, the chemicals sector accounted for a significant part of all FDIs in China. This could lead to the conclusion that the chemicals industry is the most important investor in the Chinese economy at present and the exceptional significance of the Chinese chemicals sector (10% of GDP) is bound to increase even more near-term.

Investing in chemical production

Chemical products that are manufactured abroad and then exported to China are relatively expensive because of the high wage, production and transport costs involved. The result is a competitive disadvantage compared with chemicals manufactured in China. Another factor is that the exporting of chemicals to China in some cases attracts steep import taxes, although China is to progressively remove these to meet its agreements with the WTO. However, market participants have reported that Chinese customs officials are using arbitrary methods to overvalue their goods and thereby maintain the same tax take despite the formally reduced rates. There are also widespread "non tariff barriers" in China. These take the form of apparently arbitrarily imposed requirements on individual exporters, such as e.g. minimum quotas, that make it harder to sell chemical products in China. Therefore, there is a clear need for foreign chemical companies to produce and invest in China.

China's easing restrictions on foreign investment and improved transparency of investment policies to conform with the WTO rules, have reduced the need for foreign investors to find a local partner.

A wholly foreign-owned enterprise (WFOE) involves the most freedom and control of all operations, but it also requires the most investment and therefore the most risk. Using the support of local experts is recommended, as foreign investors may need more time and energy to develop their businesses – additionally, there is often the government-imposed requirement for foreign chemical companies to operate through joint ventures. Locals are better able to function within the local regulatory and business environment. Therefore, to gain market access in China, a foreign investor normally chooses to invest in an equity joint ven-

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ture or cooperative joint venture. But this means that the Chinese partners acquire the foreign companies' know-how. Since the foreign chemical companies have to put up almost all the capital for the joint venture, the financing of the project is secure. The Chinese chemical companies enjoy strong cash flows that they are then free to reinvest, e.g. in their own 100%-owned manufacturing. In this way foreign chemical companies are helping to build strong Chinese chemical companies at their own expense and creating new competition. Therefore, chemical companies active in China should neither underestimate the domestic nor the foreign competition in China.

Foreign investment in China has been largely focused on building new facilities, but this will change. The Chinese Government has published new regulations on foreign investors' mergers and acquisitions (M&As) with Chinese companies, allowing share-swaps in M&As between them; this new method is expected to become a way of investing in the country. M&As accounted for over 80% of total global FDI and will play a much more important role in the future in China. Therefore, foreign investors' M&As in China are on the rise and the trend is expected to continue.

Photo: BASF

Recently, BASF, Huntsman and their Chinese partners – Shanghai Hua Yi (Group Company), Sinopec Shanghai Gao Qiao Petrochemical Corporation and Shanghai Chloro-Alkali Chemical Co. Ltd. – officially opened their integrated isocyanates complex at the Shanghai Chemical Industry Park, China. The project involved a total capital expenditure of $ 1 billion, and was completed as scheduled in mid-2006.

R&D facilities of foreign chemical companies

China is very open to foreign investments, especially in science and technology, and has established a significant amount of investment zones offering in most cases special tax incentives as well as suitable infrastructure. For example, there are 56 economic and technological development zones where local authorities can approve foreign investment with a value of up to US$ 30 million and can guide local investment via locally made regulations. Furthermore, there are 53 high-tech industrial development zones established to transform achievements of science and technology into production. The most prominent examples are the Zhangjiang High-Tech Park in Shanghai and the Zhongguancun Science and Technology Park in Haidian District of Beijing.

Previously, foreign chemical companies mainly used China as a base for production plants. But the strategy with production in China and R&D abroad is changing towards fully integrated operations from R&D and production to marketing and sales in China. Nowadays, many foreign chemical companies have their own R&D operations while these companies focused on setting up R&D alliances with Chinese organizations in the early to mid-nineties. Given the importance of the Chinese market, it is expected that an increasing number of chemical companies are likely to set up own R&D activities in China in the near future. At present, the focus is still on regional R&D service centres to gain a foothold in the Chinese market. But also "real" R&D in China is increasingly being seen as attractive. Examples are numerous: Novozymes has been present in China with R&D since 1997 when they opened an R&D centre in the Zhongguancun Science and Technology Park for customized development of enzymes and processes for the Chinese market. In April 2004 Degussa opened a R&D centre in Shanghai, which is designed to integrate China into Degussa's global R&D network and carry out specific product development work. These labs have the newest equipment, giving an indication that a high number of new developments can be expected to come from China in the future. Especially, as many well educated chemists are coming from the universities and, in general, the motivation of personnel and quality of work is high in China. But the main driving force behind establishing own R&D facilities in China is the lower costs. R&D in China is about 60% cheaper than in Western Europe: labour costs are about 70%, labour related costs about 60% and infrastructure about 40% lower. Intellectual property (IP) theft is seen as one of the challenges or even a deterrent when investing in China, but Chinese authorities have enhanced and tightened IP protection. The chance of success for the enforcement of patent rights is now particularly high for a foreign patent holder. ■