

# Jesa Consulting Ltd.

## NEWSLETTER

October 2007

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## What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia). Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 engineers following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue. Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia. We also perform HR audit and investment analysis (trouble-shot analysis) to verify performances in support to enterprises already established in China.

## China's new employment contract law

On June 29th, 2007 the Employment Contract Law of the People's Republic of China (hereinafter referred to as "ECL") was adopted at the 28th Session of the Standing Committee of the 10th National People's Congress, and it will come into force as of January 1st, 2008. On one hand, the ECL will better protect workers' interests and rights; on the other hand, it will, undoubtedly, provide challenges to human resource management of employers. The following comparison chart highlights the ECL's changes to current law that in the future will have the greatest impact on Chinese companies' employment policies.

Comments are also provided regarding the impact of some important changes. We invite

the reader to contact Jesa for further details about this issue.

### Issue No. 1: Fixed Term vs Open Term Contract

#### Current regulation

No limitation on the number of fixed-term consecutive contracts is provided. Employee can demand open-term contract in limited circumstances. No severance payable upon expiration of fixed term contract.

#### ECL

After an employee has completed two fixed-term contracts, an open-term contract should be concluded in certain circumstances. Upon expiration of a fixed-term contract, severance is generally payable. An employer must pay double salary if it insists on a fixed-term contract when the employee is entitled to an open-term contract.

#### Comments

There are two possible interpretations in regards to the two fixed-term contracts rule. Sources close to the NPC indicate that an open-term contract should only be concluded if both employer and employee agree that they wish to continue the employment relationship after the conclusion of the second term. However, the ECL can be interpreted to give the employee the unilateral right to demand an open-term contract at the end of the second term.

### Issue No. 2: Probation period

#### Current regulation

Maximum allowed probationary period depends on length of contract term.

#### ECL

Allowable probationary periods are slightly shortened. During probationary period, wage may not fall below certain threshold.

#### Comments

Even during the probationary period, no "at-will" termination is allowed.

## Issue No. 2: Non-Compete Restrictions

### Current regulation

Non-compete agreements shall last no more than three years following termination. Compensation must be paid in consideration for non-compete restriction. However, no details are mentioned regarding the timing of payment.

### ECL

Non-compete agreements shall last no more than two years following termination. Compensation must be paid in monthly instalments during the post-termination of non-compete period.

### Comments

ECL clarifies that wages paid during active employment are not a sufficient compensation, but does not clarify how much must be paid to make non-compete enforceable. Local regulations may apply. Compared with Labour Law, the ECL introduces principles of justice and good faith. Therefore, under the ECL, besides employers' obligation of informing of the job, employees shall guarantee the authenticity of their resume and tell their true ability regarding the job to be engaged in. For example, workers shall bear the consequences caused by lack of information or false information about themselves provided to employers

### Possible solutions for employers are:

- I to review and check carefully the information about workers in an earnest manners;
  - I to try to know workers' true ability regarding the job to be engaged in during the interviews or recruitment examination by means of asking professional questions concerning the job;
  - I to ask workers to provide a declaration before recruitment;
  - I to render the right rules of the company;
  - I to claim remedies for the void labour contracts.
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## Outsourcing in China: problems and opportunities

By Saro Capozzoli

Poisoned pet food, defected pneumatic tires, toxic toothpaste and toys, computer and telephone batteries that explode... what is happening in Chinese factories? The fact to have become the "world workshop" puts also to China the ethic and ineludible problem of security and respect of international standards.

Every year, we meet tens of businessmen who complain about the same problems: Non constancy of quality standards, unreliability of many Chinese manufacturers that disregard the initial and agreed requirements, not only from a quality and security point of view, but also from the point of view of the time schedule respect. Without considering, in this venue, the nonchalance with which intellectual property is considered (this issue will be investigated in the next newsletter).

When I was visiting factories in the first '90s, I become aware of the enormous potential for European entrepreneurs that China had in terms of costs and industrial rationalization. I visited German, French and Dutch companies but, unfortunately, did not see any Italians. In those years, in Chinese structures, already existed the great motivation to do better and more, but perhaps it was the distance (Romania was much more closer and easily manageable by the average Italian businessmen) or cultural differences (not only in linguistic terms) that led up Italians to definitively "discover" China in the last 3 years only.

The actual Chinese industrial structure evolved, within few years, from a governmental and monolithic structure (that emerged after 500 years of closedown to the outside world), with companies that were not following the logic of a market economy (not aimed to create profits but only to employ as much people as possible without an apparent industrial logic), to a socialist market economy where private enterprises and a new form of "socialist capitalism" are the ones we see today. What we

see now in China was born only 25 years ago; it is difficult, indeed, to find companies structured as their Western counterparts and with the same business culture.

The Chinese industry has always been characterized by extreme competitiveness and challenges with the consequence to see profitability and profit margins eroded. Thus, it is not surprising that many companies keep 1-3% margins in order to obtain orders and to maintain the business alive. This fact makes the relationship between the company and its client very complicated both for the company and for the client that receives products different from the order's requirements or of a lower quality due to the attempt to erode margins as much as possible. Another big problem is the high turnover of staff, that sometimes reaches about 25-30% per year, and that creates difficulties in the relationship with Chinese companies from a managerial point of view. In fact, most of qualitative problems are due to non transfer of the competences necessary to manage productions and markets.

Another problem is the Chinese companies' low loyalty to the client, due to the excessive demand in the market coming from all over the world that makes it possible to acquire new clients in the numerous industrial fairs. This issue must be taken into consideration too.

Whatever, the constant cost and raw materials increase remains the principal problem that makes it difficult to maintain the finished products price constant for a long period of time. Examples of this issue are copper, that quadrupled its cost in only two years, or the case of steel.

**After more than 10 years of industrial experience in China, Jesa's suggestions are the following:**

- Do not reduce the price to the minimum; a "win to win" logic preferable because it permits to leave the supplier free and to bring it to your own side. It happens frequently that if a more profitable order arrives, our order is put aside with

unpleasant consequences. The illusion to have gained a good price leaving the Chinese counterpart in the dilemma of how to respect its obligation at the agreed price may lead to problems with no remedies. In fact, it must be remembered that very often Chinese managers say "yes" with the hope to find a way to extract profits from the agreement (economizing on materials, weights, specifications, prolonging processing times, sub-contracting the mandate, etc.);

- To keep in mind that raw materials price in China, because very often it does not follow the international market (this is the case of copper, brass and of certain plastics). It is always better to proceed with a price analysis that considers the effective processing costs trying to point out potential hidden costs;
- To find more than one person of reference in a factory in order to avoid the risks due to turnover. It often happens to discuss a project with a manager who is quickly substituted with a person who does not know anything about agreement and production;
- To organize frequent meetings with suppliers;
- To not delay or avoid payments: A payment delay, even if of one week, can lead to the loss of a good supplier. In China a not declared rating list of client exists. A client that delays agreed payments risks to lose its credibility and favorable conditions in the subsequent orders;
- To verify and qualify the partner Chinese company, not relying only on what shown in fair. Very often, traders are able to hide behind a sample of fake manufacturers and problems emerge when products are defected or when the time comes to discuss about technicalities. It is recommendable to audit also the sub-suppliers web. In fact, the companies we are dealing with, even if they are manufacturer, frequently rely on sub-suppliers that need to be identified and qualified. There is always a risk that they are changed by the manufacturer of reference on

the basis of the convenience of the moment, and this can affect quality;

- Certifications must be controlled and verified; do not trust photocopies, very often faked.

Finally, Jesa suggests to:

- Not adlib, but plan activities and productions;
- Use adequate instruments of control;
- Focus on articles with greater purchasing volumes. If possible, create purchasing groups (consortiums) in order to give to the supplier less orders but with bigger volumes, in spite of fragment them not keeping continuity; in this case, in fact, prices and conditions must be negotiated every time;
- Create a structure in China, such as a purchasing centre that might also become a warehouse;
- Organize quality control without relying completely on the same Chinese suppliers, avoiding conflicts of interests.

Jesa is obviously available for all those companies that desire to locate their production in China or that are already present in the country but that want to verify their supply chain and, eventually, to improve conditions and to verify the situation periodically.

This article is available also in Italian. Please contact Jesa for further details.

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## The growth of Chinese Firms in the West

It is more and more common in the last years to get to know about Chinese companies that try to enter in the European market, and Italy is included in their aim. It is an example the historical motorcycle constructor Benelli, part of Merloni Group, that after almost ultimate negotiations with the Russian magnate Nikolai Smolenski of John Galt Ltd., decided to conclude the cession of the company to the Chinese Qianjiang Group Co Ltd in September 2005.

The point in this case seems to have been the group's availability of capital, that declared to be interested in a further investment in Pesaro.

The Chinese firm, greater manufacturer of motors in China, appealed to its capacity to warrant the labour conditions settled by Benelli, among which the guarantee of occupational levels, the maintenance of the brand and of the productive site in Pesaro. It is passing through the consent of labour unions and employees that the president of the Group, Ling Hua Zhang, managed to get in touch with this market. In the HR division the Qianjiang Group found also the greatest difficulty, tied mainly to the application of the Bossi-Fini law (n° 189 about immigration) to its Chinese managers. "A kilometre long travel starts with a small step", it is in this way that the Chinese multinational Haier, founded in 1984 a Qingdao, thought to reach the occidental market.

The internationalization strategy is completely different from the Qianjiang Group's one, but the ambition is equally big: challenge the European company of household appliances and consumer electronics, positioning among the first six brands within 2010.

A point in Haier favour is the rate of product innovation and design, aligned with the western requirement.

Also the experience built up in the commercialization in a so wide country like the Chinese one, makes this company high qualified for the competition with the European giants.

The great strategies put in existence by the Chinese multinationals with the aim to reach the occidental market, have to run against the intrinsic structure of themselves.

The government-controlled model in fact, weights down any attempt of expansion, keeping the enterprise anchored to the endless procedure of the Chinese head office.

It is mainly the lack of decisional autonomy of European branches that prevent them the

possibility to join the market through both cultural and commercial approach.

It could be stated that the shadow of Chinese companies for the moment has slowed down, but is certainly not avoided. It will not be hard for companies in fast development to fill up these gaps and to obtain results that will warn the occidental companies.

It cannot be denied the merit of a successful case like the one of Lenovo Group, founded in 1984 in Beijing from a group of engineers, whom objective to make China enter in a new age of innovation has been reached and widened with the desire to become one of the greatest producers of personal computer in the world. Lenovo now is the third producer in the world, thanks to its strategy of penetration that has mainly seen the acquisition of IBM PCD in order to guarantee an high-technology level, the hiring of local high qualified staff in order to be able to boast a talented team of research & development and the participation in the civil society in order to make the brand know thorough the world.

This is the right tactic to face the developed western world.

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