

JESA INVESTMENT & MANAGEMENT CO. LTD.

NEWSLETTER

APRIL 2010

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**NEWS FROM JESA!**
China new face

By Saro Capozzoli, Founder and GM of JESA Investment & Management Co., Ltd

At the end of March we have sent a document that explained the new taxation landscape that the Representative Offices in China will have to face in the near future.

Circular nr 18 is the second regulation about Representative Office issued by the government from the beginning of 2010.

Early this year another regulation modified the registration procedure and controls over the license renewal. The latest instead regulates tax calculation method, which will be detailed in next months, and seriously undermines the profitability of this kind of structure.

Taking as example these two new regulations issued in the first three months of 2010, the Chinese Government is officially identifying and taking actions against the improper use of this kind of investment vehicles.

This demonstrates that China is deepening the investigation of the activities carried out by foreign investors that were already much more scrutinized than the Chinese Companies.

For a while, China seemed to be mainly interested in pulling toward itself foreign investments and leaving them a relative freedom, or at least a wide range of action. Now China is becoming more and more a normal country, interested in protecting its local companies, local income and taxes.

That being so, we do invite foreign companies with a stable presence in China to verify their fiscal position and the compliance with all regulations, also related to HR.

Jesa is available to evaluate together with the foreign companies other options, such as the upgrading of the Representative Office to a Foreign Invested Commercial Enterprise either for trading or only for services. A deeper evaluation of the activities can in fact demonstrate that the investment might be very similar to the one for a representative office.

ITALIAN VERSION

Alla fine di Marzo abbiamo inviato un comunicato relativo a novita' circa il trattamento fiscale che gli Uffici di Rappresentanza dovranno a breve affrontare.

La Circolare nr 18 e' il secondo regolamento che concerne questo tipo di struttura emanato dall'inizio del 2010.

All'inizio di quest'anno infatti era stato emanato un regolamento che imporra' procedure piu' complesse in fase di registrazione e controlli piu' approfonditi in fase di rinnovo della licenza. L'ultima circolare emessa regola invece il metodo di calcolo delle tasse, i cui dettagli attuativi verranno specificati nei prossimi mesi, e potrebbe seriamente mettere in discussione la profittabilita' di tale struttura.

Prendendo ad esempio i due regolamenti emessi nei primi tre mesi del 2010, il Governo Cinese sta ufficialmente iniziando a

prendere provvedimenti nei confronti dell'utilizzo improprio di questo veicolo di investimento. Questo dimostra che la Cina sta inasprendo il controllo delle attivita' condotte da societa' straniere che gia' erano sottoposte a controlli maggiori rispetto a quelle cinesi.

Per un certo periodo il Governo Cinese e' sembrato interessato solo ad attirare investimenti stranieri lasciando agli stessi una relativa liberta' di azione. Ora la Cina sta diventando sempre piu' una nazione normale, interessata quindi alla tutela delle proprie imprese, del proprio reddito e delle proprie tasse.

Alla luce di questo, invitiamo le imprese straniere con stabile presenza in Cina a verificare la loro posizione fiscale e il rispetto dei regolamenti, anche relativi alle risorse umane.

Jesa e' disponibile ad aiutare le imprese straniere nella valutazione delle opzioni disponibili, quali ad esempio la trasformazione dell'Ufficio di Rappresentanza in Foreign Invested Commercial Enterprise sia per attivita' di trading che limitatamente all'erogazione di servizi. Una piu' attenta valutazione delle attivita' potrebbe infatti dimostrare che altre tipologie di investimenti potrebbero avere impatto molto simile a quello dell'Ufficio di Rappresentanza.

Joint (ad)Venture

Several analysts in China are currently experiencing and predicting a new era for Equity Joint Venture in the country. Though JV obviously never left China, there has been a post-recession resurgence. First of all it is worth pointing out that with the exception of some market sectors, China is now remarkably open to foreign investment, and in the past years WOFEs (Wholly Owned Foreign Enterprise) have become the most common vehicle for foreign investments, partially due to investors' concerns about stories of failed Equity Joint Venture (EJV). In the past, those companies that did JV in China did so for very specific and China-particular reasons, while the "new" JVs have a cost saving scope. It is not that crazy, considering that a foreign investor today, might choose a joint venture with an existing Chinese factory, rather than spend the money to build a factory from scratch. The reasons for this are pretty obvious: many Western economies and, as a consequence, many Western companies have less money and, even more important, less access to credit.

Whatever is the reason why a foreign investor enters in an EJV with a Chinese partner, it is important to take into consideration pros and cons, threats and advantages. Many mistakes wait for the foreign investors at the doorstep of the investment. These could put the investor in a very tough position, till he/she fully regrets the day of the EJV agreement.

One of the first mistakes comes immediately and we call it "marry the first date" mistake. Entering in an EJV with

suppliers or clients only because the commercial relationship has been lasting for years, without any problems and difficulties, unfortunately has proved not to be the wisest solution. The foreign investor can never know who actually the Chinese partner is, no matter how many visits to China, meetings and dinners. They are just the top of the iceberg of a much more complicated situation that has to be understood from the beginning.

The detailed characteristics of the partner, and the real value of the company must be ascertained through a precise and professional due diligence. The due diligence should be conducted by a third and external professional company that can directly dispatch on-site staff to conduct a complete assessment of the company's accounting books and legal documents.

Legal Due Diligence is a complex issue when comes to JV in China and is therefore a prerequisite to determine where the managerial operation are in the existing company and what needs to be changed and improved to comply with the increasing attention of the authorities toward the new entity. During the legal due diligence it is necessary to verify that the current business scope is compatible and that the Business License is duly valid and renewed. If in the EJV agreement is included the transfer of property right the foreign investor must be aware of different rights in land property in China, granted and allocated. Granted land is definitely owned, allocated means that there is only the right to use. This can

sensibly change the valuation of partner's contribution to the JV equity. Moreover it is advisable to check the partner's background and prior or pending legal problems.

Financial Due Diligence must be carried out through an on field investigation in order to determine the position of the business due to the lacking of a publicly available record system in China that permit viewing of reported accounts. This analysis goes beyond a simple analysis of the books and it is also aimed to provide the investor with a complete picture of the integral honesty of the business and the management system. It is necessary that a foreign investor keeps in mind that Chinese companies are usually not scrutinized as carefully by the tax officer as the foreign companies are. Thus any comments such as "we've always done so" should not be considered.

Aspects like third parties transactions, overheads, receivable, sales and purchasing contracts, and debts have to be carefully investigated and double checked in order to verify the lacking of inflated third parties transactions, or the existence of bad debts that might be transfer to the JV.

Above mentioned tips are only few of the things that should be included in a wise checklist when evaluating the investment with a Chinese partner.

Another very common mistake is mainly done during the negotiation of the investment agreement, when foreign investor believes that having 51% of shares of the new entity will ensure him the control over the activities. We are not

saying that the full control of the JV is the only way to be sure that the JV will be a success. On the contrary it is first of all necessary to understand whether the JV can be successful without foreign investor exercising full control. If so, the equity issue assumes a less significant status.

With regard to the ownership and control, the foreign investor must be aware that a JV is not exactly managed according to common Western models, under which the Board of Director has full control over the company. Since the board is elected by a majority vote of company owners, most foreign investors will strive to obtain a 51% ownership interest in the EJV. As majority owner, the investor then assumes he has the right to elect the entire board, and thus effectively control the company. After winning the percentage ownership, as a concession, the foreign investor will frequently allow the local partner to appoint the representative director and the company general manager. Unintentionally, this cedes effective power. As a result, the investor's struggle for board control is meaningless. In order to exercise effective control over a joint venture in China, investors must avoid this mistake. It is necessary to have control over the day-to-day management of the joint venture company.

In order to avoid such a mistake and to maintain control over the joint venture it is necessary to keep in mind that:

- | The side that appoints the representative director has significant power over the operations. It is advisable to keep the power to appoint and remove the JV's representative

away from Chinese partner rights;

- | The General Manager is employed entirely under the discretion of the representative director. Avoiding the appointment of the same person both as legal representative and GM is strongly advised.
- | The person who controls the seals of the company can make binding contract on behalf of the company and to deal with company's banks. The control over the company's seals is very important to ensure the daily control over the company.

The Chinese partner will surely complain that the most efficient and manageable way is for him to be in charge of the daily management of the company. Moreover he will claim that he will not be able to use its *guanxi* and political connection if this person is not the legal representative and GM of the company. Well all above should warn the Foreign investor about the potential problem it can be faced. Anyway one of the most irreparable mistakes is done when the investor grants the Chinese partner the control as a matter of convenience.

Chinese Internet Consumer: Online retail growth

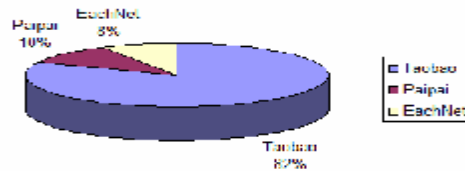
According to the China Internet Network Information Center (CNNIC), China has the world's largest Internet population today. Internet population reached 338 million at the end of 2009 (with an annual growth rate of 28.9%) but the

penetration rate (25% of overall population) is still lagging far behind most of developed countries such as Japan (73%) and USA (72.5%). The online shopping penetration rate reached 24.8%, meaning that one out of four internet users has shopped online in the past 6 months. Nevertheless, online retailing is still nascent in China: online retailing sales value accounted for only 1,18% of the total retail sales of consumer goods in 2008 (with an extraordinary growth of 128.5% in 1 year). Apparel, books, cosmetics and consumer electronics were the most popular items purchased online in 2008. Among the online shoppers young people aged between 18 and 30 are the major consumer group, accounting for the 60% of the total; online retailing is most popular in cities such as Shanghai, Beijing and Guangdong. The online shopping markets are still dominated by C2C marketplaces which account for 93,2% of total sales in 2008. Although accounting for less than 10% of total transaction share, it is believed the B2C will demonstrate better growth potential, mainly because the traditional enterprises and foreign firms now choose this model to enter the Chinese market. "China's B2C e-commerce has entered a stage of rapid development, and we expect to see this fast-paced growth continues during the next few years" says Anthony Chow, President of Newegg China, an American e-retailer.

The competitive landscape

Figure 1 shows the market share of different C2C players: Taobao, the wholly-owned subsidiary of Alibaba Group

dominates the landscape. It has the same business model of Ebay.com (which in China has the name EachNet) but thanks to the free-services-charge strategy (the main source of revenue is advertising) and promoting itself as home-grown Chinese brand was able to reach a market share of 80% in 5 years.



China's B2C online retailing scene is more fragmented. The top ten players have achieved over 80% of the total market share. Prominent players include Taobao Mall, 360 Buy, Joyo Amazon. Even though B2C market accounts for less than 10% of total transaction share, nowadays this market is growing fast and will be the competitive landscape for all those companies which aim to sell their products on line. Major B2C players act as transaction facilitators or operate in a direct-to-customer retailing model. Taobao Mall is a typical transaction facilitator: acting as a matchmaker between individual buyers and sellers, it generates most of its revenues from commission and advertising and it does not engage in the logistics and warehousing of the goods. Many other players, such as DangDang and 360 Buy, operate in a direct-to-customer model and are engaged in managing warehouses and logistics. To

date the first business model proved to be the most successful: Taobao Mall is the market leader with a market share of 20%.

Driving Forces

Logistics, Payment and Policies can be considered the main factors affecting online retailing development.

The logistics costs are relatively high and the poor distribution network can cause geographical barriers for sellers. Compared with C2C, price and quantity are not competitive for B2C. In addition, logistics has always been one of the main issues.

The lack of a safer and efficient payment system to handle credit-card transactions is affecting negatively China's online retail market. To date cash on delivery is still the main payment method for online shopping.

The E-Commerce Development Plan China aims to support the development of e-commerce within three years. However foreign companies which aim to establish and operate e-commerce business must comply with some regulations: for instance, according to the Ministry of Information Industry, foreign companies are subject to license and can only hold a stake of up to 50%.

Opportunities for foreign companies

To date, the major foreign companies in China's B2C market include Amazon, Newegg and M18. Other foreign firms seeking a slice of China's online retail market can be successful in this

attempt but they should first of all fully understand and operate in accordance with Chinese Laws and Regulations; collaboration option should be chosen by those companies not familiar with the Chinese market and the consumers' habits.

A recent success story is Uniqlo, a Japanese clothing retail chain which made its way into the Chinese online shopping market thanks to a partnership with Taobao: while Uniqlo offers a very famous and popular brand in China, Taobao increases its advertising revenues through selling Uniqlo products.

Notice for Italian Tax Payers

Invitation to donate part of the taxes for an association that takes care of medical treatments for immigrants without medical rights in Italy and for the start up of an hospital in Rwanda

Jesa sostiene la causa dei Medici Volontari Italiani ed invita anche voi a donare il 5 per mille.

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MVI è Onlus pertanto l'offerta è deducibile ai sensi dell'art. 13 del D.lgs. 04/12/97 n. 460.

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