Revival Investments

Building wealth with China.

Edwin Way
China's Political Economy
December 15, 2009

Executive Summary:

The most significant risks faced by foreign investors in China flow from the opacity of Chinese lawmaking and the fragmented enforcement of central government regulations governing the economy. This characteristic of the Chinese economic environment suggests that a winning strategy for foreign investors focuses on a multi-sector approach that minimizes the risk of policy shocks from the center. At the same time it is worthwhile to invest in a long-term relationship with a business-friendly regional government. Three high growth sectors that merit investment include high-end apparel, dental equipment manufacturing and land-to-land domestic freight services. While other foreign companies are investing in these sectors, a differentiated strategy offers the best chance for sustained high returns.

China's economic rise offers foreign investors the opportunity for sustained, long-term profits in an otherwise uncertain global economic environment. At the same time, the Chinese market involves a number of serious potential risks for foreign investors. This proposal outlines one strategy for investment in China, setting up a venture capital firm *Revival Investments* (Revival) to oversee a ten-year, $1 billion investment in the high growth sectors of high-end apparel, dental device and equipment production, and domestic land-to-land commercial freight.

The proposal will first consider the merits of investment in these three sectors, before examining three other sectors that while superficially appealing carry hidden, serious risks. It will then address the impact of Chinese government policies on the investment environment as well as political risks that are particularly relevant for any foreign-invested enterprises. The final section will lay out in detail how Revival will allocate its capital over its first ten years, and consider specific strategies for addressing the risks and challenges outlined in the first portion of the paper.

Economic Risks

While China can be a very challenging market for foreign investment, it was nevertheless the number one destination of foreign direct investment in 2008, and it has a number of strengths[1]. Foremost among these is a government that has shown both the commitment and the ability to promote macroeconomic stability. While in the early reform period China suffered severe bouts of inflation and a period of economic retrenchment after the Tiananmen incident, over the last decade the Chinese central government has succeeded at simultaneously expanding the economy at a double-digit annual growth rate while keeping inflation low[2]. At the same time, the Chinese government succeeded in reducing the share of non-performing loans in the Chinese state banking system to close to 2% in 2008[3]. It also has reformed many inefficient State Owned Enterprises, privatizing some through insider management buyouts, while managing the potentially destabilizing consequences of massive layoffs.

In spite of the glitz of its coastal cities, China is still classified as a lower-middle income country by the United Nations. Its middle class is still relatively small and spread out over a continental sized country[4]. However, the Chinese

[1] "China Country Profile" (London: Economic Intelligence Unit, 2009), p. 5.
[2] Ibid, p. 25.
[3] "Country Finance: China 2009" (New York: Economist Intelligence Unit, August, 2009), p. 14.
[4] Arthur Kroeber, "RMB/USD Peg: Goodbye and Good Riddance," *China Notes*, July 21, 2005.

middle class is growing rapidly and as one analyst with Goldman Sachs recently suggested, by 2027 China 's per capita GDP will have passed $10,000 (in 2005 terms) and it "will probably be considered a developed country"[5].

How can foreign investors take advantage of the rise of China's middle class? Three sectors that stand out for their medium and long-term potential are high-end apparel, dental equipment and domestic land-to-land business transportation services. These three sectors can enable investors to take advantage of China's developing economy while also benefiting from specific Chinese government policies.

Chinese consumers are spending an increasing amount of their budget on clothing, and national statistics indicate that among the top ten percent of urban households spending on clothing almost doubled between 2001 and 2007[6]. High-end fashion has attracted a large number of major foreign luxury fashion houses that have set up boutiques in China's major coastal cities. The wealthiest Chinese prefer foreign to domestic brands; an industry report produced by Master Card in 2007 indicated that the two most popular brands are Chanel and Giorgio Armani[7]. As one young Chinese manager put it: "France for me is elegance: good fashion and wines."[8]

There is strong evidence that a revolution in fashion may be around the corner as elites both East and West race to embrace more Chinese elements in their clothing style. A similar revolution in American sportswear in the 1960's and 1970's helped launch Nike from a small startup in 1972 to a global behemoth with $19 billion in revenue in 2009[9]. In January 2009, Giogio Armani's Paris Couture week was in some ways dominated by Chinese design elements; his men's collection featured simple button-less Mao jackets while his women's collection included "pagoda style" skirts and lotus blossom prints. In December 2009, Chanel organized its first fashion show in Shanghai, which was dominated by Chinese-inspired design elements heavy in red and jade[10].

At the same time, investment and promotion of distinctively Chinese fashion at this point may allow investors to reap the profits associated with first mover advantage. Chinese fashion designer and clothing companies are still largely geared to promoting Western designs. As one Chinese designer put it, "Heavily Chinese designs are not trendy and can hardly be accepted by international fashion circles". This tendency to mimic the West is reflected in the names of leading Chinese apparel companies that draw on Western, especially French imagery such as Septwolves, Luyi 13

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[5] This would still leave China far behind the United States in terms of per capita income, which the report estimated would reach $61,000 by 2027. "BRICS and Beyond" (New York: Goldman Sachs Global Economics Group, 2007), p. 55.
[6] *China Statistical Yearbook 2008*. (Beijing: China Statistics Press, 2008), p. 247.
[7] Susan Fenton. "Chinese nouveau riche go gaga over haute couture." *The Toronto Star,* June 1, 2008.
[8] Ibid.
[9] "Company Overview." Nike World. <http://www.nikebiz.com/company_overview/> Accessed December 1, 2009.
[10] "China goes from Mao to Wow." *The Sunday Telegraph,*. December 6, 2009.

(路易十三), La Cima, Polomeisdo, or feature European style coats of arms such as EMEBT. Over time, the economic vitality of China may lead Chinese to more enthusiastically embrace their traditions, and may lead more foreigners to incorporate Chinese elements into their wardrobe.

A second promising industry for foreign investment is in dental and orthodontic equipment. As the Chinese population ages it will require increased dental care, this factor combined with an increasingly image-conscious and wealthy society will propel demand for dental services and long-term demand for dental (and eventually) orthodontic devices. Dietary changes have led to increased dental problems for many Chinese. In a 2001 study, 46% of 12 year old children in Chinese urban areas were found to have caries while the incidence in rural areas was 31%[11]. A more recent study found that fully 68% of Chinese between the ages of 35-44 brushed fewer than two times a day and only 5% used flouridated toothpaste[12].

The market for dental products in China is expected to grow rapidly, capping $3 billion by 2012 according to analysis by the market research firm Freedonia. American firms have benefited greatly from the growth in the Chinese dental market. Between 2002 and 2006 Chinese imports of dental products grew at an annual rate of 13.5% reaching $47.7 million in 2006.[13] One American company that capitalized on the growing demand for dental equipment is Milestone Scientific Inc, which in November 2009 received an order for 12,000 Single Tooth Anesthesia Systems by the China National Medicines Corporation (Sinopharm), which is China's largest distributor of pharmaceuticals and importer of medical devices[14]. This purchase indicates both the scale of Chinese customers' purchasing power, and their understandable desire to purchase the best and most effective technology. The STA system is one of the most advanced methods for delivering localized anesthesia with a minimum of pain[15]. In addition to initial sales, large orders can generate longer-term revenue streams through servicing and equipment replacement.

Another multinational dental equipment producer that has benefited from the growth in China's oral care industry is the German firm Sirona. In 2004 it established production facilities in Foshan acquiring the HTC Hipo

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[11] Harold Lin and Edward Schwartz. "Oral health and dental care in modern-day China." *Community Dentistry and Oral Epidemiology*, February 2001, pp 319-28.
[12] Zhu Li, Paul Peterson, Wang Haiyan, Bian Junyong, Zhang Bin. "Oral health knowledge, attitudes and behaviour of adults in China." *International Dental Journal*, Winter 2005, pp 231-241.
[13] "China's Emerging Markets: Opportunities in the Dental and Dental Lab Industry." US Commercial Service, US Department of Commerce, 2006. <http://www.export.gov/china/ATC/Snapshot_Dental.pdf> Accessed December 10, 2009.
[14] "China National Medicines Corporation issues Milestone purchase order for 12,000 STA systems." *PR Newswire,* November 2, 2009.
[15] Ibid.

group, a producer of integrated treatment centers located in the Pearl River Delta[16]. Sirona has since used the production facilities in Foshan to export to other Asian and African markets as well as China[17]. Another Western company, Belgium-based Remedent, recently established a high-end oral clinic in Beijing that provides customers with the full range of cosmetic dental services in a "luxurious and comfortable environment."[18] In addition, in January 2009. Remedent established a laboratory and production facility for its teeth veneers, known under the trademark "GlamSmile."[19]

While investments in high end apparel and dental equipment manufacturing benefit from the increasing wealth of Chinese consumers, long distance business to business commercial delivery services are a sector that is ripe for investment given recent Chinese government policies, namely massive infrastructure investments and the opening up of the industry to foreign investment. Beginning in 2005, the Chinese government opened up land to land trucking service to wholly-owned foreign investment, and the American trucking firm Schneider international was the first multinational to be authorized to provide business-to-business land transportation services[20]. In 2008, a year after Schneider bought up a Chinese trucking firm in Tianjin, another American transportation firm YRC Worldwide formed a joint venture with China's second largest air freight forwarder, Shanghai-based Jin Jiang International Industrial Investment Co[21]. YRC followed up this acquisition with the purchase of another Shanghai-based firm, Jiayu Logistics Limited, which specialized in land-to-land delivery[22].

According to the China Federation of Logistics and Purchasing (CFLP) there are as many as 2.7 million land-to-land transportation companies operating in China, with the overwhelming majority being small family-owned businesses. Many of the larger firms are in need of capital for expansion and now is a good period to take advantage of industry consolidation. The government has reportedly increased enforcement of its weight restrictions, and the long term rise in fuel costs will pressure smaller companies with narrower margins out of the industry[23]. Because of

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[16] "Sirona strengthens its position in the Chinese dental market." Sirona company website, November 16, 2004. <http://www.sirona.com/ecomaXL/index.php?site=SIRONACOM_press_china_foshan> Accessed December 5, 2009.
[17] "Successful year for dental company Sirona." Sirona company website, September 30, 2005. <http://www.sirona.com/ecomaXL/index.php?site=SIRONA_COM_press_successful_year_for_sirona> Accessed December 5, 2009.
[18] Remedent company website. <http://www.remedent.com/company.html#bejing> Accessed December 5, 2009.
[19] Ibid.
[20] Lara Sowinski, "Driving Further into China." *World Trade*. October 2006, pp. 34-35.
[21] "*Meiguo changtu huoyun qiye jinjun Zhongguo.* [American Long haul companies are marching into China.]" 360.doc. <http://lib.360doc.com/06/1026/16/267_241342.shtml>. Accessed December 8, 2009.
[22] Sowinski, "Driving Further into China", p. 35.
[23] Lee Perkins. "Schneider shows the way forward in China." *International Freighting Weekly*, June 30, 2008.

provincial bottlenecks, as many as 37% of trucks were running at below capacity in 2008[24]. Logistics and transportation costs are the equivalent of between 18-21% of the Chinese gross domestic product in 2008, double the level for the United States[25].

There are some alternative industries that may be appealing to some investors, but which on balance present more downside risks and fewer long-term profit opportunities than the investments suggested in this proposal. Three such industries that have attracted interest among Western venture capitalists are software, beer, and brokerage and stock market related financial services. These three industries are faced with some of the same problems of intellectual property rights infringement and a fragmented and capricious regulatory environment that complicate investments in high-end apparel, dental equipment production, and commercial freight services. However there are additional risks associated with the software, beer and types of financial services that warrant caution when considering investments in these sectors.

The software sector may attract some investors given its continued growth and Chinese government tax policies that favor investment in the industry. Foreign companies enjoy a two-year tax holiday and a fifty percent reduction in tax rates for the first three years of company profitability[26]. Nevertheless, given the pervasiveness of software piracy China is an extremely challenging market for software companies. The rate of piracy was estimated by analysts with the Economist Intelligence Unit to be 82% in 2007, with losses due to piracy estimated at $6.7 billion[27].

While intellectual property infringement is a potential risk for investments in the apparel industry and in dental equipment production, it is relatively easier to limit the negative impacts of China's weak intellectual property rights regimes on investments in these two industries. As some experienced Western businessmen have noted, foreign companies that focus on business-to-business markets and produce a differentiated, high quality product have less to fear from IPR infringement[28]. Moreover, in a society with growing legal consciousness and more legal remedies, dentists and orthodontists face serious risks if the quality of their services are endangered by the use of substandard products that endanger the health of their clients. In terms of the high-end apparel industry, the costs of the garments will be high relative to the costs of production, which some might worry could potentially invite the production of

[24] Lee, "Schneider shows the way forward in China" June 30, 2008.
[25] Ibid.
[26] "Country Finance: China 2009", p. 14.
[27] "Country Commerce: China 2009" (New York: Economist Intelligence Unit, August, 2009), p. 5.
[28] Jack Perkowski, *Managing the Dragon: How I'm Building a Billion-Dollar Business in China* (New York: Crown Business, 2008), pp. 246-249.

knockoffs and copying as with the software industry. However, unlike in software, high-prices are actually viewed positively by high-end consumers looking for a status symbol.

The Chinese beer industry has attracted investments from most of the world's leading beer companies, and high growth in beer consumption as well as continued fragmentation in the industry would appear to make it a good sector for foreign investors seeking to benefit from consolidation. There are special risks associated with the beer industry that are less prominent with long-haul trucking, dental products or high-end apparel. Beer companies not only face competition from domestic and foreign beer producers, but are also vulnerable to shifts in consumer tastes. Chinese wine consumption has risen rapidly particularly among high-end urban consumers, and traditional Chinese white alcohol has also become a more popular beverage at the lavish feasts that are a part of Chinese political and business culture[29]. Moreover, beer companies that extrapolate from current trends should consider that while per capita Chinese beer consumption is still significantly lower than levels in the West, it is rapidly approaching or has even passed the level of beer consumption in Taiwan and Hong Kong[30]. It is conceivable that Chinese consumption could stabilize at these lower levels, especially given the presence of many alternative alcoholic beverages. In some respects, this aspect of the beer industry may have parallels with the competition long-haul trucking faces from railroad and waterway transportation services. Nevertheless, the rise of inter-modal trucking combining the use of rail, water and highway transportation suggests that these three forms of transport should be seen as complementary rather than strictly competitive.

Turning to financial services, recent analysis by Goldman Sachs suggests that Chinese stock markets are poised to experience a long-term boom given Chinese demographic changes[31]. Over the next decade and a half the share of the Chinese population between the ages of 40 and 59 (the peak ages for income earning and saving) will grow substantially, while the portion of Chinese over 60 (an age group that withdraws savings) will grow steadily but more slowly. While this change should translate into greater demand for investment in Chinese stock markets, it would be unwise to invest in the brokerage industry or other forms of stock market-related financial services companies, even

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[29] Audrina Gan, "Corporate: Spirits maker Trump Dragon plans expansion" *The Singapore Edge,* October 20, 2008.
[30] In 2004 Chinese per capita beer consumption was estimated at 22.1 litres per person, compared with 109 liters per person Australia and 81.6 liters in the US. Beer consumption in Taiwan in 2008 was 22.5 liters a person, while in Hong Kong beer consumption in 2003 was reportedly 29 liters per person. Chris Shanahan, "All eyes on the China market" *Canberra Times*, April 29, 2009. "Taiwan Beer," *The China Post*, December 18, 2008. <http://www.chinapost.com.tw/supplement/2008/12/18/188303/Taiwan-Beer.htm> Accessed December 7, 2009. "China's beer market: still room for investment" AP-Food Technology, August 6, 2004. <http://www.ap-foodtechnology.com/Industry-drivers/China-s-beer-market-still-room-for-investment>. Accessed December 7, 2009.
[31] "BRICs and Beyond, 2007" (New York: Goldman Sachs Global Economics Group, 2007)., pp 61-63.

though the Chinese government has loosened restrictions on foreign investment in these areas[32]. China has yet to develop a reliable credit ratings industry, with existing companies accused of inflating their company evaluations[33]. In addition, the high volatility of the Chinese stock market increases the political risks faced by foreign investors. A dramatic stock-market downturn, like that which occurred in the early part of this decade could pose special problems for foreign financial services firms. The Chinese government is intensely concerned about preserving stability, and a stock-market downturn is precisely the kind of event that could produce threatening mass dissatisfaction, especially if the numbers of Chinese invested in the market continues to grow. It might prove very attractive for the central and local government to redirect popular anger against shadowy foreign banks and related brokerage and financial services firms, launching media campaigns as well as corruption or malpractice investigations of these firms or targeting them with new restrictions.

Policy Risks

Chinese government policy has a direct impact on the daily operation of businesses across the country, and shifts in government policy are sometimes difficult to anticipate. The greatest policy risks for foreign investors stem from the opacity of the Chinese policy-making process. Government regulations may be passed one day and scheduled to go into effect the very next day. This was recently illustrated by the decision of the China Securities Regulatory Commission (CSRC) which drafted new rules on initial public offerings June 10, 2009 that went into effect on June 11[34]. While there is strong evidence that rule-making is now subject to greater influence from companies and societal groups, suggesting limited progress towards a more open and democratic system of government, from the prospective of investors this trend may actually be deleterious. To the extent that government is open to greater influence by one's competitors, companies have to invest more resources into government relations and developing defensive lobbying strategies. This section will consider two recent policy changes that highlight potential risks, as well as considering the problems associated with Beijing's inability to rein in corruption.

China's Anti-monopoly Law (AML) may affect foreign investment, even those investments that don't appear a priori to risk the creation of monopolies. This uncertainty stems from a lack of clarity over how the Chinese Ministry of Finance and Commerce (which is charged with approving Mergers and Acquisitions) defines a monopolistic position in

[32] "Country Commerce Report: China 2009" p. 17.
[33] Scott Kennedy, "China's Emerging Credit Rating Industry: The Official Foundations of Private Authority," The China Quarterly (March 2008), pp. 65-83.
[34] "Country Finance: China 2009" p. 3.

a given market (Bachrack 2009: 22). It appears that MOFCOM uses industrial policy goals not directly related to more technical definitions of monopoly when deciding monopoly cases as is evidenced by its rejection of Coca-cola's purchase of Huiyuan[35]. It is also not clear what paperwork is required when applying to MOFCOM and delays may frustrate companies' attempts to expand[36]. There are only three explained decisions, but interestingly all three involved Western or Japanese companies, suggesting that the law may differentially impact foreign investors. While it is unlikely that Revival and its merging partners would have the revenue streams globally (combined $1.5 bn.) or in China ($290 million) to be subject to the AML, the AML allows the Chinese Ministry of Finance and Commerce (MOFCOM) to investigate companies that fall below this threshold. To avoid any possible complications, the company will thus follow a practice of voluntarily informing MOFCOM of any domestic acquisitions regardless of size[37].

Chinese labor costs may continue to rise as a result of the passage of a new Labour Contract Law by the National People's Congress in 2007. In the words of one scholar, the law was "abrasively" opposed by many foreign firms on the grounds that it risked raising their labor costs and introduced complications into the ability of firms to lay off employees[38]. The law imposed some requirements on companies without specifying what kinds of penalties they might face for non-compliance[39]. In particular it is more difficult now to terminate fixed contract employees in the past, although casual workers who are not bound by a contract are more easily dismissed[40]. Non-full term engagement labor by law can only work a maximum of 4 hours per day and 24 hours per week[41]. One area of potential confusion relates to whether or not new entities inherit the employment contracts of previous firms. One reading of the current law seems to suggest that they do, which sets China's labor system apart from those in North America and Europe[42].

According to the Economist Intelligence Unit, the Chinese government is considering revising the nation's trademark law and draft amendments have been available for input by the public since 2007[43]. The proposed changes would move China towards strengthening its protection of trademarks, reducing the time for the Trademark office to

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[35] Matthew Bachrack, "Merger Control under China's Antimonopoly Law: The First Year," *China Business Review*, July-August 2009, pp. 18-22.
[36] Bachrack, "Merger Control under China's Antimonopoly Law: The First Year,", p. 22.
[37] Bachrack, "Merger Control under China's Antimonopoly Law: The First Year," p. 22.
[38] Sean Cooney, Sarah Bidulph, Li Kungang and Ying Zhu. "China's new labour contract law: responding to the growing complexity of labour relations in the PRC." *University of New South Wales Law Journal,* December 2008, p. 792.
[39] Cooney, "China's new labour contract law", p. 803.
[40] Cooney, "China's new labour contract law", p. 797.
[41] Cooney, "China's new labour contract law", p. 797.
[42] Cooney, "China's new labour contract law", p. 794.
[43] "Country Finance: China 2009" p. 55.

review applications from the current three years to one year. At the same time, there is a proposal to raise the maximum fine for trademark infringement from RMB 100,000 to RMB 1 million.

In addition, foreign invested enterprises may be harmfully impacted by Chinese government procurement policies. When it acceded to the WTO, the Chinese government did not sign onto the Government Agreement on Procurement and Chinese law gives preference to domestic producers. This is potentially important in the dental equipment market, given Chinese moves toward a more universal system of health insurance. Most Chinese dentists operate through hospitals and so dental equipment could be adversely affected by preferential Chinese government policies, though possible policies to address this problem will be discussed in more detail in the final section.

In addition to these risks, foreign investors should also consider possible shifts in the Chinese currency regime as a possible risk factor. In the context of economic retrenchment, Western governments may put more pressure on the Chinese government to allow the Chinese yuan to appreciate. Chinese policymakers themselves have indicated dissatisfaction with the current international monetary system, and it is likely given its increased productivity and the need to increase domestic demand that the Chinese government will allow its currency to appreciate. This would decrease the profits of firms oriented towards export markets and for domestic firms this could also increase competition from imports.

Political Risks

While the opacity of the policymaking process is the most significant policy risk faced by foreign investors, the most important political risk associated with Chinese investment stems from the country's pervasive corruption. Attempts to rein in corruption have been largely unsuccessful and companies run the risk of finding themselves in the dilemma of being encouraged to bribe local officials while at the same time risking sanctions for violating the country's anti-corruption laws[44].

An additional political risk to foreign investors is that they may find themselves the victims of political disputes between their home governments and the Chinese government. This potential risk was highlighted by the boycotts against Japanese and French companies that occurred respectively in 2005 and 2008. In April of 2005 several Chinese websites began circulating petitions to oppose Japan's membership on the Security Council. The petitions garnered as many as 20 million signatories, and snowballed into a boycott of Japanese products. The China Chain Store

[44] Andrew Wedeman, “Anticorruption Campaigns and the Intensification of Corruption in China,” *Journal of Contemporary China*, February 2005, pp. 93-116.

& Franchise Association urged its members, mostly supermarkets and other retailers to stop selling Japanese products and Japanese beer, coffee and produce were taken off the shelves in more than 2000 stores. Consumer products that were closely associated with Japan and that had a number of domestic and foreign substitutes were especially vulnerable to boycott action. In the anti-Japanese boycotts, Asahi was targeted and boycotts even affected Asahi's Beijing subsidiaries[45]. In 2008 two waves of boycotts appeared to threaten French firms, though these subsided after Chinese authorities explicitly tried to discourage them. In April 2008 Chinese internet activists tried to organize an anti-French boycott after a paralyzed woman carrying the Olympic flame was assaulted in Paris. A second wave rose in December 2008 in response to France's perceived support of the Dalai Lama[46]. As many as 100,000 individuals signed onto an internet petition to boycott French goods and demonstrations were staged in front of the French retailer Carrefour. One poll taken at the time suggested 66% of Chinese would boycott the company while only 6% were willing to say they would not[47]. While the boycotts never materialized, Bernard Arnault, CEO of French luxury-goods maker LVMH publicly distanced his company from the Dalai Lama and told one reporter that it was "shocking to see China attacked" and that he "understood why the Chinese people could be affected by the attacks on their country." [48]

Overall anti-foreign boycotts have been a relatively rare event for foreign companies, although the consequences would be clearly serious. On the other hand, the risks associated with massive nationwide political upheaval on the scale of the collapse of the Soviet Union would be truly devastating, but the likelihood of this occurring appears minimal. While some commentators argue that the Chinese political system is not as stable as it may on the surface appear, it is important to note that the Chinese central government has remained largely stable since the events of 1989 and it has undergone two peaceful leadership transitions[49].

Action Plan

Given the complexities and challenges of the Chinese market outlined in the previous sections, what specific business strategies should be deployed to maximize profit and help minimize potential risks? This section will outline

[45] "Chinese boycott of Japanese gods escalates." *BBC Worldwide Monitoring Service*, April 2, 2005.
[46] "Internet Users Urge Boycott of France." *Business Daily Update,* December 5, 2008.
[47] "China aims to calm 'patriotic zeal' amid calls to boycott foreign business." *The International Herald Tribune,* April 19, 2008.
[48] Adam Sage, "Arnault offers support to China after consumers threaten boycott of LVMH" *The Times of London*. Adam Sage, April 18, 2008.
[49] Minxin Pei, "China's Governance Crisis," *Foreign Affairs*, September/October 2002, pp 130-146; Alice Miller, "The Problem of Hu Jintao's Successor," *China Leadership Monitor*, Fall 2006.

in some detail the sectors and approach to be taken by Revival Investments, and the rationale motivating our investments in the high-end garment business, long-haul trucking, and dental equipment production.

Because China is still rapidly developing and some sectors have yet to take off, it may be unrealistic to expect easy profits in the first few years of operation. Recall that China's consuming class is still relatively small, and that high volume products today such as beverages, also tend to have lower margins and more limited profit potential. Revival Investments seeks to begin building the foundations of companies that can take advantage of China's shift towards becoming a more middle-class society. In order to become a market leader, and reap the benefits of first-mover advantage as the Chinese market matures it is important to start laying the groundwork today. Moreover, to capitalize on China's economic transformation over the longer term, it is important to focus on the Chinese domestic market rather than using China as a base for exports. Over a 10-15 year time horizon it is very likely that the Chinese currency will appreciate in value, hurting export markets and exposing certain tradable goods to greater competition from imports.

Some of the unique aspects of the Chinese political-economic system argue for an investment approach that is multi-sectoral but focused on a single region. National government regulation can have a dramatic impact on the ability of foreign enterprises to engage in particular sectors, and unfortunately given the number of party, economic and bureaucratic interests involved it is difficult for a single company, no matter how large, to reliably depend on its ability to steer national government policy. As a result, to reduce the risks of dramatic regulatory change, Revival Investments will fund companies across three sectors. At the same time, because government-business relations tend to be more clientalistic at the local level there is more scope for a single relatively large company to impact its treatment in a given location[50]. Enforcement of government regulations is largely carried out by local agencies, which while frequently nominally tied to ministries and agencies of the central government in fact are often dependent on local governments for their budget and personnel[51]. For reasons to be outlined below, Revival Investments will follow a "Yangztee river" strategy with its base of operations in Sichuan but also with a presence in Shanghai.

Yangtzee River Strategy

The center of operations for Revival Investments will be in the capital of Sichuan province, Chengdu. Basing operations in Sichuan allows the company to benefit from the central government's "Develop the West" strategy, which

[50] Scott Kennedy, *The Business of Lobbying in China* (Harvard University Press, 2008).
[51] Andrew Mertha *The Politics of Piracy: Intellectual Property in Contemporary China*. (Cornell University Press, 2005).

was initiated at the 16th party Congress in 2002 and involved extensive new infrastructure investments in twelve Western and central provinces including Sichuan[52]. The "Develop the West" strategy also offered foreign companies tax breaks for investing in the specified provinces. Although these tax breaks are scheduled to end in 2010, the continued income inequality and renewed ethnic violence in Xinjiang and Tibet (which borders Sichuan) may lead the government to extend these tax provisions into the future. Sichuan is also an attractive location for the production of garments, given that wages tend to be lower in the province than in more developed parts of Eastern China. While transportation costs are higher, this has become less of a problem since the opening up of neighboring Chongqing to ocean-going vessels as a result of the Three-Gorges dam project.

At the same time, Revival enterprises will establish a presence in Shanghai. The transportation subsidiary will have an office in Shanghai and will purchase a local Shanghaiese transportation company in the third year of operations to begin offering services to other parts of China while leaving open the possibility of further expansion into the inter-modal transportation market. The fashion subsidiary will also be headquartered in Shanghai, given the city's prestige as a center of modern Chinese culture. The relatively high cost of wages in Shanghai however preclude using the city as a base of production operations. The benefits in terms of transportation costs of outsourcing production to a poorer nearby province such as Anhui, don't outweigh the benefits of co-locating this investment with the dental equipment and trucking investment in Chengdu.

Chengdu, will be the basis of operations for the dental equipment manufacturing operations. Sichuan University's School of Dentistry is one of the most competitive in the country, and the average scores on the national high school graduation exam of its students are third highest after Beijing University's Department of Dentistry and Sun Yat-sen University in Guangzhou[53]. In addition to the resources offered by one of the most selective dental schools in the country, Sichuan is an ideal location given its historic support for patent protection. In the 1990's the Sichuan Patent Bureau was the first to be upgraded to first tier bureau and it had by far the largest staff and budget and was considered the most effective at patent enforcement of China's provincial bureaus[54].

The American Chamber of Commerce in China selected Chengdu as one of ten (out of 280) prime sites for foreign investment, and the city government's commitment to supporting foreign investment is demonstrated by the Mayor's quarterly meetings with Mulitnational corporations based in the city. It has a population of over 12 million and

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[52] "China Country Profile 2009" p. 15.
[53] "*Kouqiang Yixue Zhuanye: Luqu fenshuxian paihangbang* [Dental Specialization: Ranking by admittance scores]" Remen Zhuanye. <http://www.remenzhuanye.com/paihang/PaiHang_3941.html>. Accessed 8 December 2009.
[54] Mertha, *The Politics of Piracy,* p. 95.

over the last ten years its economy tripled, growing an average of 14% a year[55]. In addition, commercial real estate prices have fallen in the city as real estate prices have felt the impact of the global slowdown[56].

High-end apparel: $340 million

The investments in all three sectors will be staggered out over the course of several years as laid out in the table below. Investment in high-end apparel will begin with the purchase of Sichuan-based apparel manufacturers. After an initial period of two years during which the factory management practices of these operations will be closely inspected and relationships with retailers are established, there will follow a period of rapid expansion that involves large-scale investments in advertising and the expansion of brand recognition through product placement. After sustained investments in brand recognition, the firm should be in a position to generate a self-sustaining revenue flow.

Dental Equipment and Device Manufacturing: $300 million

Revival Investments will seek to persuade leading foreign manufacturers of dental devices that have not invested in Chinese production facilities (such as the Swiss company Coltene) to establish a joint venture in Chengdu, purchasing a 70% stake in one of the city's existing medical instruments producers. Possible targets for acquisition include Kangfu and Shifeng whose products have passed ISO 9001 standards. Shifeng is the largest medical device producer in Western China, and they both are established companies that began operating in 1989 and 1993 respectively[57]. After an initial three-year period to establish the quality of production processes, Revival will begin expanding its operations with the goal by the eighth year of expanding into a nationwide supplier of medical devices.

Land-to-Land Commercial Freight: $360 million

American trucking firms are at the moment focusing on providing services for multinationals geared to exporting overseas. They are primarily focused on capturing the market for the transportation of goods from factories to coastal ports for export abroad. Both Con-way freight and JB Hunt Transport Services have formed partnerships with international shipping companies to provide freight services within China as well as in North America to provide

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[55] AmCham China, "American Business in China: 2009 White Paper" p 290.
[56] Ibid, p. 290.
[57] Kangfu company website. <http://www.slkf.cn/newEbiz1/EbizPortalFG/portal/html/Program Show.html?ProgramShow_Program ID=c373e911184012d18f6b5688e7c09531> Accessed December 10, 2009. Shifeng company website. <http://sf.xjshifeng.com/> Accessed December 10, 2009.

retailers a streamlined complete factory-outlet service[58]. This "enclave" strategy is also reflected in Schneider's decision to purchase a Tianjin based company and YRC's decision to purchase a Shanghai based company. In contrast, revival aims to capture the inland market, anticipating rapid growth in inland China as factories relocate from the coastal zones to take advantage of cheaper land and labor inputs. After the initial establishment of offices in Chengdu and Shanghai in the first year of operation and a period during which retailers and potential firms will be investigated for their reliability, in the second, third and fourth years of operation Revival anticipates purchasing leading Chinese freight companies in Sichuan and neighboring provinces. To acquire Chinese freight companies, revival anticipates spending $20-50 million for leading freight companies on a scale comparable to purchases by Schneider and YRC[59].

Ten year plan for the allocation of investment funds (millions $US)

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
Garments	10	10	60	70	60	40	40	20	20	10
Dental Equipment	5	5	5	10	10	15	25	50	75	100
Commercial Freight	10	60	60	40	40	30	30	30	30	30

Addressing the challenges of China's Political and Economic System

Revival Investments will employ a variety of strategies to minimize the negative impacts of the potential risks associated with the unique challenges of the Chinese business environment. In addition to the strategy of locating in a province with a relatively good record of intellectual property protection, Revival anticipates engaging a Chinese lobbying firm such as Amlink, Bluefocus, or APCO Worldwide, which have experience working with the unique

[58] John Gallagher. "Leveraging China" *Traffic World*, March 12, 2007.

[59] YRC's 65% stake in Jiayu Logistics in 2008 cost the company $44.7 million, and it reported that depending on the progress made by the company it would be willing to spend an additional $39 US million to buy out the remaining shares. Jiayu had 3,000 vehicles, 200 subsidiaries spread throughout Eastern China. The acquisition of Baoyun Logistics by Schneider Logistics, a private, family-run company, was reported to be in the "tens of millions." John Gallagher, "Schneider's Asia Reach" *Traffic World*, November 20, 2006; "YRC Worldwide buys 65% of Shanghai Jiayu Logistics" *China Transportation Watch*, August 27, 2008.

challenges of foreign enterprises in the Chinese system[60]. Although the Chinese political system is dominated by the Communist party, Revival will avoid lobbying party officials and instead seek to influence government bureaucrats primarily by educating them on the long-term benefits Revival can bring the Chinese people. Chinese government officials tend to resent any perceived interference from party leaders, and the attempt to influence party officials could needlessly entangle the company with Chinese factional politics[61]. The cultivating of party officials at the provincial and especially central level could prove counter-productive if the particular party faction associated with the official loses power[62].

In terms of Chinese government procurement policies, the negative impact of Chinese favoritism should be blunted by the fact that the company is locating production in China. Chinese imports of dental products have grown substantially in recent years, and the effectiveness of Chinese discriminatory procurement practices is thus open to question[63]. In the past government efforts to introduce national technical standards that favored domestic producers failed because of the lobbying efforts of an alliance of foreign and domestic firms; similar alliances between Revival and Chinese clients could also help protect the company's market share. In addition, as one scholar has noted, government officials are sometimes reluctant to purchase Chinese products because they will be sanctioned if these sometimes unreliable products impact the quality of government service[64].

Revival will also seek to positively influence media coverage regarding our investments. This may involve the reimbursement of reporters for their time and effort in attending company press conferences, but the amount to be reimbursed will remain under 4,000 RMB. This is consistent with China's Commercial and Criminal Anti-bribery statutes, as the company will not attempt to bribe journalists, as some less scrupulous domestic and foreign enterprises have done[65]. Cultivating good relations with Chinese media are important from both an offensive and defensive standpoint. Foreign medical equipment manufacturers in the past ran into difficulty when they attempted to sell second

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[60] APCO Worldwide and Bluefocus were cited in Kennedy (2009) p. 205 and 217 respectively. See Amlink website, <http://www.amlinkint.com/>, accessed 5 December 2009.
[61] Scott Kennedy, “Comparing Formal and Informal Lobbying Practices in China: The Capital’s Ambivalent Embrace of Capitalists,” *China Information*, Vol. 23, No. 2 (July 2009), pp. 195-222.
[62] Kennedy, “Comparing Formal and Informal Lobbying Practices in China” p 207.
[63] "China's Emerging Markets: Opportunities in the Dental and Dental Lab Industry." (US Commercial Service, US Department of Commerce, 2006), <http://www.export.gov/china/ATC/Snapshot_Dental.pdf> Accessed December 10, 2009.
[64] Yu Zhou, “State and Commercial Enterprises in China’s Technical Standards Strategy,” *China Review*, Vol. 6, No. 1 (Spring 2006), pp. 37-65.
[65] Laetitia Tjoa, “Complying with PRC Antibribery Laws,” China Business Review, March-April 2005; Kennedy, "Comparing Formal and Informal Lobbying Practices in China" p. 211.

hand medical equipment after a media fire-storm (funded by these companies' domestic competitors) portrayed the companies as trying to dump lower quality and even hazardous devices onto the Chinese market[66].

Conclusion

Revival Investments offers a mixed-sector strategy that minimizes the risks of adverse policy shocks from the central government while simultaneously increasing the opportunities for success in three sectors that are poised to grow dramatically as a result of China's economic changes and recent government policy. At the same time, downside risks will be minimized through a strategy of cultivating local government relations while avoiding the risks associated with unscrupulous business practices.

[66] Kennedy, “Comparing Formal and Informal Lobbying Practices in China”, p. 207.