Less Risky Business

For SMEs doing business in China, proper research is critical

By Peter Humphrey

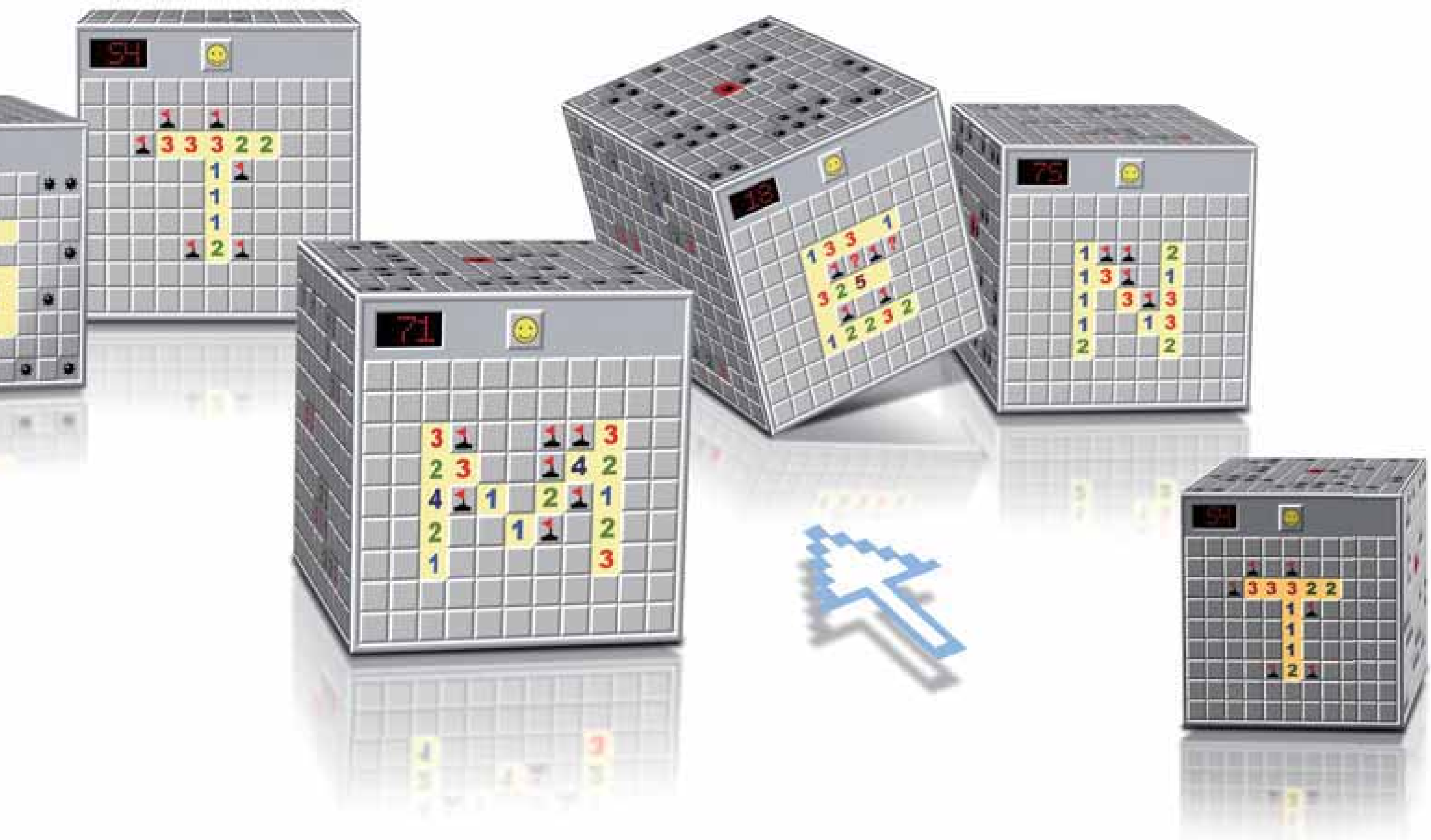
China is booming, so it is no surprise that many foreign companies see the country as a bright spot in their quest for sustained growth and profitability. Some of the small- and medium-sized enterprises (SMEs) that have arrived in recent years have been successful, but many have turned out to be a bit like lambs sent to the slaughter. The troubles that many smaller firms (and larger ones, for that matter) encounter stem from being ill-prepared for business in China and unfamiliar with the risks, not to mention a lack of capital sufficient to cope with major problems or business crises.

SMEs entering China need to have nerves of steel and deep pockets. If they do not have significant financial backing, then at least they need to factor some risk management costs into their budget calculations. Many try to save money by avoiding potentially expensive due diligence or corporate background checks, only to suffer huge losses as a consequence of white-collar crime. In China these can easily be significant enough to make an SME go bust.

Business risks that SMEs face in China too often revolve around suppliers, distributors, employees, partners, intellectual property protection, bogus contracts and other scams. Navigating this minefield of risks can be an immense challenge for a smaller company. Yet it can be done, and proper preparation can mean the difference between success and failure.

SUCCESSES AND DIFFICULTIES: TEST CASES

In one recent case I reviewed, a European family-owned agricultural materials processing business had to shut part of its operation in northeast China because of fraud by its local joint venture (JV) partner. The foreign SME had conducted no due diligence and had not performed proper audits. They relied entirely on the word and trust of their partner—until it was too late and they fell victim to a classic scam. The partner had set up a parallel business and siphoned money from the JV into his own firm. When the Europeans realized this and began to investigate, the partner scuttled the JV and moved all the machinery to his own firm. The contracts turned out to be ambiguous and unenforceable, and local authori-



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ties did not take the foreign side's complaint seriously.

In contrast, I also worked on behalf of a medium-sized American firm that was seeking a significant stake in a dye-casting plant in northern China. The American SME conducted extensive research. First they hired lawyers for legal due diligence, then conducted financial due diligence with accountants, and finally (and very wisely) conducted deep background checks using investigators.

The legal and financial due diligence found the all-too-common problems over land title, irregular accounting practices and the firm's questionable origins, as it was created by stripping out state assets. But by and large, it was all *par for the course*, right? At that point, maybe.

However, the investigators made a crucial discovery: the local firm had bought new land nine kilometers away from the main operation, and had already begun building a plant there and shifting managers to it in secret. There were plans to poach all the best staff from the old plant, leaving behind only the weaker employees for the foreign investor. Clearly, the capital infusion from the US investor would be used to fund a new plant that would compete directly with the so-called JV. In the end this extra due diligence clearly saved the American firm a lot of time and money.

The lesson? Simply that some careful research and additional upfront investment of time and money can save a lot of aggravation and pay enormous dividends in the end. But to maximize such an investment, one needs to know what to look for and where to look. There are many different business structures possible in China, each with its own unique potential pitfalls. Here are a few of the most common types of business relationships, and an outline of how to ensure you are working with upstanding companies whose interests are aligned with yours.

SUPPLIERS & DISTRIBUTORS

So-called "vendor checks" on suppliers and distributors are a routine measure in America and are easy to execute. In China, more footwork is required, through site visits and interviews. Despite the extra time required, these steps are critical to avoid potential problems. Employees or partners can insert phantom vendors into your supply chain, skimming profits. Similar issues can arise on the distribution side of the chain. A phantom distributor in your sales chain can be personally owned, or controlled through a proxy, by someone in your company.

To avoid this you need to include background checks in your vendor qualification process. Here are some of the critical steps to take to vet the vendor:

- ☑ Research the vendor's public profile (look for any signs of scandal).
- ☑ Check whether the vendor physically exists.
- ☑ Verify its operating address.
- ☑ Check the business license.
- ☑ Verify corporate registration.
- ☑ Learn who the shareholders are.
- ☑ Check for family ties to your own staff.
- ☑ Obtain credit information and financial data.
- ☑ Inquire into business practices,

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including bribery issues.
- ☑ Check for any litigation history, conflicts with authorities, or CSR violations.

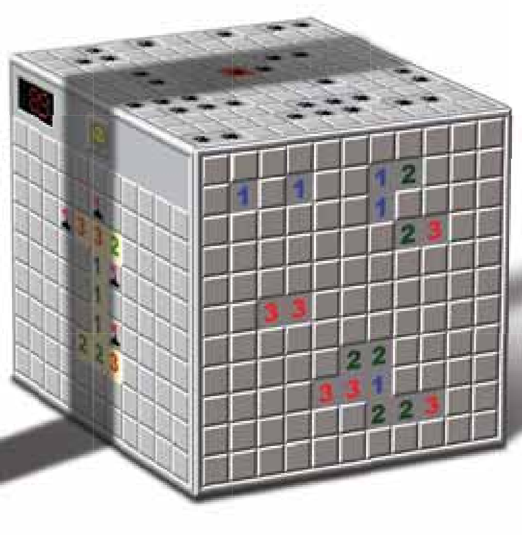
You should also set up a whistle-blowing channel so that staff, vendors, customers, distributors, and anyone else involved in your business chain can confidentially report unethical conduct.

PARTNERS

By some estimates, the failure rate for JVs in many parts of the globe is higher than 70 percent, including among domestic JVs in the USA. Yet in China, a country where foreigners can face such great cross-cultural challenges, the odds can be even worse. At the same time, thorough research ahead of time can exponentially increase your odds of success.

It too often seems that companies that adopt best practices at home, such as background checks on new employees, abandon these practices in China, where they are probably needed more. They do this partly because of the cultural barriers and the challenge of gathering information here. Also, very often somebody has persuaded them that checks are not necessary because they "already know the partners" and are over-confident in them.

Firms also easily buy into "good connections," or trust SME partners simply because they speak good English and understand Western business culture. SMEs too often believe their problems are solved when they find someone who seems reliable, even without proper vetting. This false trust puts the SME in a highly vulnerable position, subject to problems like account manipulation and establishing related businesses to siphon resources.



There are numerous signs about a potential partner that should raise red flags. SMEs should check public profiles and any history of scandals, professional credentials and qualifications, employment histories, and criminal record or litigation history. Even character, integrity, lifestyle, sources of wealth, family connections and reputation are all legitimate and necessary areas of investigation. All of these things can be researched in China, so why not look into them?

At a minimum, companies should buy a credit report on any potential partner company. However, since these reports contain data obtained openly from the target, they need to be viewed with a grain of salt. You should ask your counterparty to complete a detailed questionnaire about their business. If they resist, it could be the sign of a problem.

After receiving the answers, you should conduct discreet third party inquiries to verify the information and dig out the real story about your prospective partner. In addition to the checklist above, it is important to look at the status of any previous international deals or co-investments as a guideline for what to expect.

Once your business is operational, it should be closely monitored. It is important to have your own personnel overseeing things, and be sure to take a hands-on role. Contracts should include strict covenants on confidentiality, non-disclosure, intellectual property, conflicts of interest, non-compete, non-solicitation, anti-bribery and compliance with all applicable laws in order to protect the SME against errant behavior. The more checks you have in place, the more likely you are to avoid, or at least limit, problems.

IP PROTECTION

Big corporations have big budgets and can afford to spend millions of dollars on anti-counterfeit work to protect their intellectual property. Smaller companies can often be big losers if they have not taken protective measures. At a minimum, SMEs should register all their patents, trademarks, copyright, designs, and similar intellectual property in China under Chinese law. This means taking qualified legal advice from a reputable law firm and then filing the IP properly with a bona fide patent and trademark agent.

Do not rely on your newfound JV partner or recently hired key executive in China to do this for you. Do it independently. This is a must before you enter the market. Local filing of IP is essential if you have a dispute to settle here. It is not enough to have filed in Boston or Miami or Wichita. You have to do it in China, too.

When you are up and running, you must take steps internally to monitor your operations and your people to prevent leaks or obtain early warning signs of a theft of intellectual property. Include strong IP protection clauses in all of your contracts, including your staff, vendors, partners and other third parties. Fighting an IP dispute is tough in China, so you need very professional contracts.

PREPARATION IS KEY

Sometimes SMEs are hesitant to hire professionals to execute the kind of due diligence required to succeed in China, but this is a strategic mistake for the business. Even those SMEs without a budget to hire outside help can take a few inexpensive steps to reduce risks. For example, they should at a minimum ask the Chinese side to provide:

- ☑ a business license copy (a copy, not just a translation)
- ☑ a copy of their shareholder registration
- ☑ a copy of both sides of their business card (English and Chinese)
- ☑ their website address
- ☑ their email addresses
- ☑ their operational address in Chinese and English
- ☑ their registered address in Chinese and English
- ☑ Chinese ID and/or passport numbers or copies
- ☑ copy of the ID and/or passport of the responsible person ("legal representative")
- ☑ operational bank account number and bank address in Chinese and English

These are not unreasonable requests. Legitimate companies will oblige, and if a firm is unwilling to provide these items, you have the right to be suspicious. These are all verifiable items that can be checked through independent inquiries on the ground in China and online. Through the right channels you can determine the validity of the information, obtain copies of documents to verify what you've been given, and conduct additional inquiries to get a sense of whether your potential partner is legitimate. Only with careful due diligence can you expect to have successful business dealings in China.

Peter Humphrey is the founder and managing director of ChinaWhys, an advisory firm promoting business ethics and transparency in China. Fluent in Chinese, he has dealt with business issues in China and other developing markets for 30 years. Contact him at: peter.humphrey@chinawhys.com