

Considering China... Dealing With Obstacles Today Could Pay Big Dividends Tomorrow

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Why is equipment leasing growth in China, which is home to the world's most dynamic economy, so slow? And, in particular, why have vendor leasing programs failed to become more popular among the world's largest equipment manufacturers now doing business in China?

Although the answers to these questions are complex, they fall broadly into three categories:

- inadequacies in China's legal system,
- capital investment regulations and
- China's under-developed financial market infrastructure.

"China has the 'hardware,' " says Michael Fleming, president of the Equipment Leasing Association (ELA), referring to the gleaming Beijing skyline and Shanghai's massive new port. "It's the 'software' – the legal and financial infrastructure – that needs much more development."

Still, vendor leasing is present in China, and is growing...albeit slowly. Is it something you should consider?

Torrid Economic Growth, But Small Leasing Volumes

The ELA sponsored a business development mission to China in November 2004 to learn more about equipment leasing in China and how it has changed over the last several years. Although some United States and European-based lessors and vendors have established leasing operations in China since the ELA's last business development mission in 1987, the numbers are small.

Consider this anomaly: according to Hunter Xia of the Balloch Group (a business investment advisory firm in Beijing), China now consumes 21 percent of the world's steel production each year, 35 percent of the iron ore, 31 percent of the coal, 25 percent of the aluminum, and a staggering 40 percent of the cement. This consumption is fueling the massive growth of China's construction and manufacturing industries. Statistics from the Asia Development Bank reveal the growth of China's manufacturing, mining and power industries increased 36 percent between 2000 and 2003, to \$529.6 billion annually.

Yet, according to the World Leasing Yearbook 2004, China's 2002 equipment leasing volumes were only an estimated \$2.2 billion, or less than 0.5 percent of estimated worldwide volumes of \$461.6 billion. The U.S. Commercial Service in Beijing notes that China's 2001 gross domestic product of \$1.19 trillion is comparable to that of Italy, yet Italy's equipment leasing volumes are ten times that of China (at \$22.4 billion in 2002, according to the World Leasing Yearbook 2004).

Why has equipment leasing been so slow to take off?

Infrastructure Limitations

China's rapid economic growth has been the direct result of the easing of government regulations and restrictions on business activity. However, "China [still] has the remnants of a planned economy," says the U.S. Commercial Service in Beijing in Contact China, a guidebook for doing business in China. "In many sectors of the business community, the understanding of free enterprise and competition is incomplete...local bureaucrats sometimes keep companies alive by artificial means, even though the firms have not been profitable for years."

The transition from a socialist economy, in which all significant decisions are centrally made, to a market-based economy has occurred at different speeds in different sectors. Unfortunately for lessors, many of the under-developed sectors are in areas that are central to profitable leasing operations. Among them:

1. Enforceability of property rights. Theoretically, China already has made the transition from a collectivist society, in which the state owns all assets, to one of private ownership. In practice, there are still many areas of contention.

The concept of paying for the use of an asset, rather than owning it, is foreign to many Chinese, including many in the judicial system. Some courts have ruled that lessees are only liable for payments while they are in possession of and using an asset and that "hell-or-high-water" clauses are not enforceable.

"The emergence of a body of commercial law, principally including enforceability of property rights, is number one on our list" of requirements before establishing an onshore leasing entity," says Paul A. Larkins, president and CEO of Key Equipment Finance. "We've made a significant investment in researching the Chinese leasing market; we have sent representatives on both the ELA business development mission as well as a recent Colorado governor's trade mission to China. Enforceability of property rights remains an important concern for us."

Lessors on the ELA mission voiced their views on this issue to Hu Jingyan, director general of the Foreign Capital Department of the Ministry of Commerce (MOFCOM). "We think those in the judicial system are reasonably familiar with leasing," he responded, "but it is best not to get into an enforcement situation in the first place. In China, it is very important to know your customers well – probably more so than in other countries."

2. Lack of a true national court system. The power of the regional courts in China cannot be overstated. Chinese policy and legislation may be developed in Beijing, but interpretation and enforcement of law is left to each of the provincial governments and court systems. For lessors, this means that the precedent of

decisions made in Shanghai may have little or no bearing on similar court cases in Xiamen. “For this reason,” notes MOFCOM’s Hu, “we strongly recommend dealing only with reputable companies, and in the larger cities where judges are more familiar with leasing practices.”

With this in mind, most lessors that are in China have focused their operations in the larger cities along the eastern seaboard. Joel Raven, general manager for Asia for General Electric Healthcare Financial Services (GEHFS), says their recently-established onshore operation in China will follow this pattern. “We plan to focus on large, well-established hospitals in the eastern urban centers such as Beijing and Shanghai, at least initially,” states Raven. “These hospitals typically have a large number of beds, high occupancy rates and have been in business for many years – they’re not likely to go out of business.”

3. Availability of accurate credit information. For many years, China’s governmental bureaucrats decided to whom money would be lent, regardless of the financial status of the company or individual. But even prior to the Communists, China’s rich business heritage was built upon underlying personal relationships between businessmen. There was little need for centralized databases of credit information, because businesspeople rarely did business with those they did not know personally.

As a result, the concept of credit bureaus has been slow to take hold in China. This dynamic has given prospective lessors in China cause for significant concern. There are no ratings agencies comparable to Moody’s or Standard and Poor’s in China, and financial statements – particularly among small- and medium-sized companies – are often inadequate, incomplete and unreliable by Western standards. This makes extending credit extremely risky for lessors who may not know their customers well.

Joseph N. Boland, chief credit officer for IBM Corporation, observes that “It’s sometimes difficult to get reliable credit information in the public domain in China, even for some of the larger firms. Transparency of financial statements and the availability of information are both lacking to a considerable extent.” IBM, which established a leasing joint venture in China with Great Wall in 1999, has expanded “at a measured pace,” as a result, says Boland. “We spend significantly more time on due diligence before extending credit than we do in more ‘credit developed’ countries.”

4. Undeveloped used equipment market. Demand for used equipment has not been strong in China, according to numerous experienced Chinese lessors. Delegates in the ELA business development mission were told by several local leasing companies that while small, niche markets exist for certain used equipment, most demand is for new equipment. “Our research did not indicate much demand for used medical equipment,” confirms GEHFS’s Raven. “We’ll find out more as we gain experience in China, but at this point, we are not planning on writing much

in the way of operating leases. Residual recovery would appear to be difficult at best.”

This results in a chicken-and-thousand-year-egg problem: no used equipment market means limited operating leases, but few operating leases mean little used equipment returning to lessors to create such a market in the first place. Without operating leases to serve as a meaningful product differentiator from bank financing, vendor lessors face using rate subsidies – or taking more credit risk – as ways to build leasing volumes.

5. Tax and accounting issues. Although less important to most lessors than the issues above, Chinese tax and accounting regulations can be a further irritant to lessors considering the use of operating leases. China imposes a 5 percent business tax on gross rental payments, which includes payments on operating leases (but not finance leases). This negates a significant part of the lower-payment benefit a residual value-based operating lease offers to lessees. Further, Chinese tax regulations prohibit the use of MACRS depreciation on operating lease assets. The default depreciation methodology is straight line, and lessors desiring to use other methodologies, such as double-declining balance, must make a special application to the tax authorities for approval.
6. Foreign exchange restrictions. Don Chan, the Beijing-based general manager of the Leasing Division of Canada International Investments, Ltd., notes that “Foreign exchange restrictions in China are much less cumbersome than just a few years ago, though there are still some meaningful restrictions on capital movement that lessors must consider.” This includes restrictions on the removal of any funds in an onshore entity’s capital account without MOFCOM approval, unless the entity is dissolved or is acquired by another company. For foreign lessors investing in a financial leasing company (FLC) in China, the minimum registered capital is \$20 million, so the amount of “frozen capital” is not insignificant.

On the brighter side, current account restrictions have largely been removed since China’s accession to the World Trade Association in 2001. “Formerly there were many restrictions and a lot of paperwork associated with moving current account funds offshore,” says Chan, “but today there are essentially no restrictions on remitting dividends offshore, and the paperwork required has been dramatically reduced.”

7. Cultural predisposition to ownership. Chinese businesspeople historically have viewed asset ownership as desirable, and debts or financial obligations as weaknesses. This is now changing, as many new, young Chinese executives and managers have obtained a Western education and job experience, but the change in attitude is occurring gradually. “There still appears to be a strong ownership culture,” says Key Equipment Finance’s Larkins, “and that seems likely to have an impact on leasing volumes, at least in the near future.”

Vendor Leasing Activity in China

Despite all of these obstacles, there is active vendor leasing activity in China. IBM and Hewlett-Packard have well-established joint venture leasing companies, and Caterpillar Finance and GEHFS both have formed Wholly Foreign Owned Enterprise (WFOE, pronounced “woofie”) leasing companies in 2004. Siemens should follow soon with its own WFOE in 2005. Sun Microsystems has been writing leases in China for several years through the use of local Chinese funding partners.

Why are they there, and how have they circumvented the problems above? The first question is easier to answer than the second. “We follow the needs of our parent,” says James Beard, president of Caterpillar Financial Services Corporation. “Our dealers in China tell us that financing is a critical requirement for many of their customers, and we believe our leasing expertise, coupled with their customer knowledge, can help drive Caterpillar business volumes in this very important market.” Caterpillar Finance was the first WFOE leasing company approved in China and formally commenced operations in mid-December 2004.

Adrian Pang, managing director of Asia Pacific for Sun Microsystems Finance, agrees. “We are after the same things in China that vendor lessors in any country want – higher parent product sales and revenue, control of the customer footprint and manageable payment terms for credit-qualified customers.”

Obviously, navigating the tricky waters of the China leasing market is challenging. “We’re going to rely on the relationships our Chinese dealers have built with their customers over the years,” says Beard. “Credit quality and recourse are two important issues for us in China, but we think the customer knowledge our dealers have will help us make good credit decisions.”

Vendor lessors with experience in China point to well-trained, experienced staff as vital to a successful operation. “We have a dedicated team responsible for deal structuring, funder management, program creation and marketing integration activities,” says Sun’s Pang. “The team is comprised of local hires, each with experience at working with banks, the government and other local authorities. Their ability to manage customer relationships is an important part of our success in China thus far.”

IBM’s Boland has had similar experiences. “Our IBM Global Financing team in China has a strong background in credit and banking. We took the time, when we first established operations there, to define and document our processes clearly. And we actively manage both our credit delegation levels and our accounts receivable process. So far, we’ve had good results.”

Vendor and Lessor Options

Should you consider establishing leasing capabilities in China?

If you are an equipment vendor with Chinese customers, it may be worth further thought. Although the problems delineated above are real enough, China is changing, and the day will come when many of these issues – the transparency of financial statements, the availability of credit information, and recourse in the courts among them – are resolved.

“You must understand that we are moving from a command economy to a market-based economy, and this transition takes time,” MOFCOM’s Hu told ELA mission delegates last November. “The government previously could – and did – mandate almost everything. We can’t just snap our fingers and say, ‘OK, now we’re a market-based economy.’ Things are changing, but it will take awhile.”

As that time comes – gradually, but inexorably – first movers will have a distinct advantage. Customer relationships will continue to be a linchpin to successful business relationships in China, and vendors like Caterpillar, GEHFS, IBM, HP and Sun are developing those relationships today in equipment leasing. Vendors that wait to begin leasing programs in China will face a steep learning curve if and when they decide to jump in.

Much the same argument can be made for lessors that provide vendor financing programs and services, but with an important, if obvious, caveat: the “build it and they will come” approach is not likely to work in China. Leasing is a not yet a fully accepted or understood acquisition alternative for most Chinese companies. ELA mission delegates were warned repeatedly about the importance of local knowledge in China generally, but especially in a new market like equipment leasing. Vendors with established China operations, distributors and resellers may make good initial partners for lessors in China. Certain Chinese lessors may as well, although many of them have encountered financial problems in recent years and have been dissolved or recapitalized. It is extremely important to find an experienced guide familiar with the leasing market in China before pursuing a local lessor as a partner.

There are a variety of legal entities that can be used to promote vendor leasing or house a leasing business in China. They range from a Foreign Enterprise Representative Office in China (which has no capital requirements, but is quite limited in permitted business activities) to equity and cooperative joint ventures, to a WFOE or even a Joint Stock Company with minimum initial capital requirements of \$20 million or more. The appropriate structure to use will depend on the vendor or lessor’s strategy and growth requirements in China.

One popular method for providing customer financing in China is offshore leasing, particularly from Hong Kong. In the case of Hong Kong, the leasing documentation is signed there and is subject to Hong Kong law; the lessee is usually a registered company in Hong Kong. Even if the asset is physically in China (and unlikely to be recovered in the event of a default), the lessor can use the much more predictable Hong Kong court system to pursue recourse from the lessee. Offshore leasing is widely used for leasing

assets into Guangdong province in the south of China, where many of the manufacturing firms are part-owned by Hong Kong businesses.

The ELA's Fleming observed in the November/December issue of ELT that "One thing is clear to everybody – get in now, even a little toe-hold. Those companies in now will be so far ahead of everybody else in 5 to 10 years that the costs of catching up will be dramatic multiples of going in now." For vendors and lessors that see China as an important opportunity, getting started and dealing with the obstacles now may well pay big dividends in the future.