Equipment Leasing & Finance Foundation

Your Eye On The Future

Knocking Down (Great) Walls:

Identifying Factors for Success in the Chinese Equipment Leasing Market

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Chinese Equipment Leasing Market

About The Equipment Leasing and Finance Foundation

The Equipment Leasing and Finance Foundation is a 501c3 non-profit organization that provides vision for the equipment leasing and finance industry through future-focused information and research. Primarily funded through donations, the Foundation is the only organization dedicated to future-oriented, in-depth, independent research for the leasing industry. Foundation products include the Industry Future Council Report, the State of the Industry Report, and the *Journal of Equipment Lease Financing* and numerous research reports. Established in 1989, Founders include leasing industry member Paul S. Gass, the Equipment Leasing Association of America, and others. Visit the Foundation online at http://www.LeaseFoundation.org.

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Preface

Members of the Equipment Leasing Association (ELA) business development mission to China in 1987 were very enthusiastic about the opportunities they saw in the Chinese equipment leasing market, as were those in the latest ELA mission to China. These latter mission members, however, saw something perhaps even more important than the size and significant growth of China's economy – i.e., the transition China has undertaken from a centrally planned to an increasingly market-based economy.

The delegates also learned that much of the necessary infrastructure to support a vibrant equipment leasing industry in China remains incomplete. Factors such as inadequate credit information and lack of judicial system support may continue to discourage many foreign lessors from establishing operations in China. Even so, lessors seeking expansion opportunities must consider the Chinese market, given its scope.

The Equipment Leasing and Finance Foundation, recognizing the need for significantly better information about equipment leasing in China, commissioned a White Paper on the Chinese equipment leasing market. Armed with data regarding the environment, unique risks, how others have entered the market, and how to enter the market, lessors can make informed decisions as to how, or if, they should pursue this opportunity.

Principals of The Alta Group, from our offices throughout the world, participated in the research and analysis for this White Paper. Lessors with experience in China also provided valuable assistance. It is hoped that this information will assist lessors in gaining an important "first-mover" advantage into this rapidly developing market. As Michael Fleming, President of the ELA, noted in a recent issue of Equipment Leasing Today, "Those companies in [China] now will be so far ahead of everybody else in 5 or 10 years that the costs of catching up will be dramatic multiples of going in now."

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Executive Summary

Lessors seeking expansion opportunities must consider the Chinese market, given its scope and transition to a market-based economy. This is particularly true for larger lessors with ambitious growth goals. Even so, much of the infrastructure needed for a viable equipment leasing industry in China is not yet in place. As a result, it is critical that lessors be armed with adequate and accurate information regarding the opportunities and pitfalls in this market.

Many of the risks lessors face in China are the same as those in the US, except they are compounded by time and distance. There also are uniquely Chinese challenges that go beyond differing tax and accounting rules. For example, the legal rules have basic similarities, but the lack of adequate leasing law makes collecting past-due rents and repossessing equipment in China very difficult. Other major differences between the US and China include language, culture, and the number and nature of business regulations.

Most international lessors with operations in China today have Chinese partners, due, in part, to the fact that a local partner was required to obtain a leasing license. With the recent availability of the Wholly Foreign-owned Enterprise (WFOE) option and the new leasing law being considered, however, many large lessors are seeking to establish operations on their own. Smaller lessors, on the other hand, may continue to seek out partners, primarily due to the regulatory capital requirements.

Investing in the Chinese leasing market can be a sound decision for lessors whose customers are asking for leases there and who can effectively manage the risks. This investment, however, will require a significant and ongoing commitment. A sound exit strategy also should be a part of the investment plan, keeping in mind that China is just as aggressive about keeping foreign equity investment from leaving the country as it is about bringing it in.

The key to success is to carefully consider the unique risks inherent in China. Although the analysis may not be much different than one performs in entering any new foreign market, it is important to remember that the differences in culture, economy, time, and distance magnify the risks, concerns, and operating issues.

Introduction

There are several traditional reasons why United States' lessors seek to establish an international presence. Some follow their vendors or customers overseas, while others do so to support their parent's products. There also have been lessors, though few, which have done so as part of a market expansion strategy. This latter motivation is becoming more prevalent because of today's highly competitive US leasing market.

While it is true the US leads the world in the volume of equipment leasing[1], it also is a very mature industry. This maturity includes product commoditization, slowing growth, and static market share. Given this maturity, many US lessors are seeking opportunities in new markets and channels to sustain asset growth and maintain profitability. The Chinese leasing market is being viewed as one of these opportunities.

Establishing leasing operations outside the US

Being a successful lessor is a challenge even in one's own country – the task becomes even greater in another jurisdiction, especially when it is compounded by time and distance, such as in China. There are many structural, legal, accounting, tax, and cultural differences that must be addressed.

According to *The Economist*,

> "At an operational level, doing business in China remains very challenging. Infrastructure has improved during the last few years, but remains deficient relative to demand. Restrictions on foreign firms in the manufacturing sector have been eased, but in the services sector they remain oppressive. Across the economic spectrum, skills shortages are severe and violation of intellectual property rights is rife"[2].

Beyond these factors, a US lessor seeking to establish an international presence also must consider the developmental stage of the leasing industry it is entering. Many emerging leasing industries, for instance, follow similar developmental patterns. They start out small and then grow very rapidly, as multiple lessors enter the market. After a relatively short period of growth and prosperity, however, there is an economic adjustment, usually in the form of a major contraction or, in some cases, a collapse.

A combination of government regulation and more rational business practices generally result in a subsequent period of slow growth, followed by a stabilization of the industry. It is at this point that the emerging leasing industry, strengthened

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[1] The US originates 40.65% of the global leasing volume worldwide, according to the World Leasing Yearbook 2005

[2] "Coming of Age: Multinational Companies in China," The Economist Intelligence Unit

by its trials, is poised to continue its development. The Indian, Korean, and Indonesian leasing industries, for example, followed similar patterns. By understanding this pattern, a US investor can avoid losing hard-earned traction in that industry.

Key differences

On a more granular level, US lessors must make decisions such as whether to act on a cross-border basis, or establish a permanent presence in the target market. Although a permanent presence generally proves to be the best formula for a sustainable strategy, due to its operational flexibility, there are many issues that need to be assessed in order to define the right structure.

It goes without saying that a lessor operating internationally will face differing tax, accounting, and legal rules and regulations. These differences can be reduced to a set of common differences. As an example, although legal systems differ between countries, they generally may be classified as either common law or civil law systems. Common law systems are present in all former British colonies and protectorates such as Canada, India, and Australia. Civil law systems, on the other hand, are present in countries colonized or influenced by Continental European cultures, e.g., Spain, Portugal, France, and Germany.

Accounting regulations are always an issue in any international expansion, but there is not much divergence in the accounting for leases between countries. Many countries now follow International Accounting Standard No. 17 (IAS 17) or a local lease accounting standard based on IAS 17 or FASB 13. And, although accounting systems still may be different, in line with the local legal systems and business cultures, there is a continuing trend towards unification.

The tax systems amongst the various countries of the world also share common threads. The particulars will differ, but each country has a tax on income, some form of cost recovery, and a tax on consumption. US lessors must still be cognizant of the differences in application of the tax laws, nonetheless. Top managers of enterprises in China, for example, may be held criminally liable if the company's tax returns are deemed as concealing or evasive[3].

Cultural differences also must be assessed and then addressed if the enterprise is to be successful. Special attention needs to be paid to languages, technological and physical environment, social organization, labor issues, country history, the concept of authority and political organization, religion, and even the prevailing business and social approach towards time. The many things that are taken for granted in the US business environment now become critical factors for success in an international environment.

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[3] Article 201 of the Peoples' Republic of China (PRC) Criminal Law, as amended in March 1997.

Regulatory guidance

The numbers and nature of the regulations and rules represent a major difference between the US and other leasing industries. Most countries outside of the US consider equipment leasing and financing as financial activities, so they regulate such activities with the aim of ensuring transparency, professional reliability, and minimum damage to the public interest. Consequently, regulatory agencies, generally those that supervise banks and insurance companies, also have oversight of leasing companies.

In many countries, finance leasing is reserved for certain financial institutions that must meet licensing requirements set forth by law, usually by the Central Bank. Asian countries, in particular, also may consider leasing to be a commercial activity subject to regulation by other government bodies, such as those in charge of internal trade, or commerce. In general, licenses are granted to those companies that can prove experience, skills, reliability, and capital enough to operate the leasing business.

Special attention needs to be paid to language, social organization, labor issues, and even prevailing business and social approaches towards time.

Risk management

As previously mentioned, being a successful lessor is a challenge even in one's own country and even more so internationally. An international expansion strategy, therefore, also must be supported by a very solid risk management culture and organization. The strategy also must assess unique market risks, including country, operating, currency, and funding risks. Lastly, a prudent lessor will analyze and define a sound exit strategy. Managing the risks of doing business in China is discussed in more detail later in the study.

Core Market Research

A full understanding of the competitive landscape and unique challenges of a new market is the key to any successful expansion strategy. The balance of this paper addresses the factors to be considered and analyses to be performed by US lessors contemplating conducting leasing business in China.

Equipment leasing in China

Before the legal and economic reforms of 1979, the central government and provinces undertook all capital investment in China. The first equipment leasing company, China Eastern Leasing Company Ltd., therefore, was not established until 1981. This construction and technology equipment lessor, a joint venture between CITIC (China International Trust and Investment Corporation) and Japan's Orix Corporation, was formed to meet the equipment needs of the expanding Chinese economy.

During the early 1980s, China was in the initial stages of its migration from a centrally planned economy to a market-based one, which stimulated economic growth. To take advantage of these growth opportunities, Chinese manufacturers needed new, state-of-the-art production equipment, much of which had to be imported. Since most Chinese manufacturers lacked adequate capital, several new lessors were created to provide financing to these firms. Most of these leasing companies were joint ventures between Chinese and either Japanese or Korean lessors; Deutsche Leasing was also present. All of these lessors had their plans reviewed and approved by the Peoples' Bank of China (PBOC).

By the late 1980s and early 1990s, the Chinese economy had expanded significantly. This expansion also made new sources of funds available to Chinese manufacturers. This combination of equipment demand and the availability of financing, while creating opportunities, also created problems. For instance many of the Sino-foreign lessors experienced severe liquidity problems, as lessees acquired new equipment and simply stopped making lease payments on their old equipment.

The lack of adequate leasing law and regulations made both collection of these past-due rents, and repossession of the equipment, very difficult for lessors. Many of the joint venture lessors, in particular, encountered difficulties because they had interpreted the Bank of China's joint venture approvals as a tacit guarantee of enforcement of asset ownership and collection rights. This proved not to be the case, and, as a result, many lessors went out of business. According to Qiu Qiyang, senior advisor of the Financial Leasing Professional Committee, China Society of Finance, the Chinese government did eventually pay off a significant amount of debt owed to lessors in the early 1990s.[4]

[4] *Cityweekend.com*, *"Leasing Sector: Financial Leasing on the Rise,"* Wang Pei, June, 2005

Most European and North American multinationals began leasing operations in China during the mid-1990s. Hewlett-Packard, IBM, Siemens, and AT&T Capital were among the companies that established small leasing operations in Beijing and Shanghai. Due to the limited credit information available, and questionable legal recourse in the event of default, these lessors tended to lease primarily to other creditworthy multinationals, as well as to a small number of the larger, and better-known, Chinese companies.

While the exact number of leasing companies is not known, it is estimated that China has over 10,000 small lessors, many or most of which are car rental companies. These lessors are in addition to the relatively small group of larger, well-capitalized lessors.

Market size

Data gathered by the Financial Leasing Committee of the China Society of Finance indicates that the total leased assets by leasing companies in China as of December, 2003, was 21.36 billion renminbi[5] (Rmb), which is approximately US$2.6 billion. This figure indicates a leasing penetration rate[6] of 0.44% of capital formation, which contrasts with the prevailing level of 30% in the US. This indicates the tremendous growth potential of the Chinese leasing industry.

Lease taxation

Chinese companies, like many of their European counterparts, do not maintain separate books for tax and accounting. Taxes are paid based on revenues and income as declared in their statutory accounting books. There are four principal taxes that impact lessors and leasing transactions. These include:

- Income tax
- Business tax
- Stamp duty
- Value added tax (VAT)

Income Tax

Following the economic reform initiatives of 1979, Chinese legislators promulgated the first piece of legislation taxing foreign-invested enterprises on their income[7]. Others followed this law[8] until the current tax law was enacted in 1991[9].

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[5] The renminbi is the Chinese currency

[6] This number does not include hire-purchase agreements. Including hire-purchase transactions would push the rate closer to 40%.

[7] The Income Tax Law of the PRC Concerning Sino-Foreign Joint Ventures adopted by the National Peoples Congress (NPC) in September 10, 1980 and revised on September 2, 1983.

According to this economic reform legislation, foreign-invested enterprises are subject to income tax applicable on their worldwide income, while foreign enterprises with permanent establishment in China are subject only to their territorial income in China. In 1993, the income tax also was extended to domestic Chinese enterprises at a rate of 33%[10]. Table One summarizes the applicable rates for foreign-invested enterprises and foreign enterprises with permanent establishment in China[11]:

In addition to the general rates and incentives, there are special tax rates for foreign-invested enterprises (FIEs), foreign enterprises with permanent establishment, and financial institutions. These tax rates are available in specifically identified economic zones and currently range from 15% to 24%. Examples of economic zones with reduced tax rates include national tourism and holiday resort areas, high and new technology investment zones, coastal open cities and economic zones, old urban districts, and certain cities along the Yangtze and Yellow Rivers.

Table One

Income Tax Rates in China

	Income taxes		
	National	Local	Total
General rate	30%	3%	33%
	Tax holidays and incentives		
Production-oriented enterprises (must operate a minimum of 10 years)	100% tax exemption for the first two years and 50% exemption for the next three years (2 plus 3 rule).		
Reinvestment of foreign investor profits	Refund of 40% of the income tax paid on such reinvested profits		

[8] The Foreign Enterprises Tax Law adopted by the NPC in December 13, 1981, and effective since January 1, 1982.
[9] PRC Foreign-Invested Enterprises and Foreign Enterprises Income Tax Law (FEIT Law), adopted by the NPC on April 9, 1991 and effective as of July 1, 1991.
[10] Provisional Rules of the PRC on Enterprise Income Tax, promulgated by the State Council on December 13, 1993, Arts. 2 and 3.
[11] Sources: FEIT Law, *"Taxation of Foreign Companies in China"* by Sabine-Stricker-Kellerer, Freshfields, Munich, Germany, and the WTO Working Party Report on China's accession to the WTO.

It is important to bear in mind that most of the differential tax rates are construed as subsidies of China's exports, and, under the World Trade Organization (WTO), will be phased out in the medium term. In addition, China has entered into tax treaties with 72 countries and has a tax beneficial arrangement with Hong Kong[12].

The party deemed to be the owner of the leased equipment is entitled to depreciate that equipment. Depreciation is straight line only, and equipment lives range from five years (for IT and office equipment) to 20 years (for buildings). There are no tax-based investment incentives such as the US Section 179 deduction or investment tax credits under current Chinese tax law.

Business Tax

The business tax is a tax on revenues and was introduced on January 1, 1994[13]. This tax is assessed on the revenues arising out of the provision of services or the transfer of intangible and real properties. It applies to revenues generated by any enterprise with permanent establishment in China. The rate applicable to financial services is 5% and it must be paid to the local tax authority.

The business tax is considered by the Chinese leasing industry as a major obstacle for the development of the industry. Although finance leases are not exempt from the business tax, it is only applied on the interest income, not on the entire payment, as in the operating lease. As a result, this tax unduly burdens the operating lease product and is, along with an undeveloped used equipment market, one of the main reasons operating leases have such a low acceptance in China. Unless the level playing field espoused by the ELA in the US also can be achieved in China, it will be difficult to obtain significant growth in the operating lease segment.

Stamp Duty

Another aspect of taxation that does not exist in most of the US leasing market is a stamp duty. Regarding stamp duty in China:

> "…documents issued for purchase and sale transactions, process contracting, property leasing, commodity transportation, storage and custody of goods, loans, property insurance, technology contracts and other documents of a contractual nature[14],"

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[12] Arrangement Between Mainland China and the Hong Kong Special Administration Region for the Avoidance of Double Taxation on Income, passed in February, 1998.

[13] Provisional Regulations of the PRC on Business Tax, adopted by the State Council on November 26, 1993, promulgated by the State Council on December 13, 1993, and effective since January 1, 1994.

[14] Provisional Rules of the PRC on Stamp Duty promulgated 6 August 1988 by the State Council and effective since October 1st, 1988.

are subject to the payment of a stamp tax or duty. The stamp duty is payable according to the following rates:

- 0.1% of asset value for all property leasing contracts, and
- 0.05% of asset value for all loans perfected between banks and other financial institutions and borrowers.

Although there are some interpretations that hold that financial leasing contracts could be assimilated and treated as loans, thereby subject to the lesser rate[15], there is a risk associated with following such an interpretation.

Value Added Tax

A VAT, or value-added tax, was introduced to China in 1994[16]. The VAT is imposed on the sales value of the goods and operates as follows:

> "It is generally assumed that the burden of the value-added tax, like that of other sales taxes, falls upon the final consumer. Although the tax is collected at each stage of the production-distribution chain, the fact that sellers receive a credit for their tax payments causes the tax, in effect, to be passed on to the final consumer, who receives no credit. The tax can be regressive (i.e., the percentage of income paid in tax rises as income falls), but most countries have at least partly avoided this effect by applying a lower rate to necessities than to luxury items"[17].

The applicable general rate of VAT in China is 17%[18], which also is the rate that applies to equipment leasing. There are some reduced rates for certain items (especially staples and other necessary commodities, which rate is 13%),[19] and for so-called "small scale taxpayers" who are subject only to a 6% rate.[20]

Several aspects of Chinese tax law, such as stamp duty and the VAT, do not exist in the US.

VAT makes lease financing very expensive for micro, small, and medium-sized enterprises, since it represents a surcharge of 17% that rarely is recouped by such companies. The application of the "small scale taxpayer" exemption to reduce the rate

[15] KPMG, "Taxation of Equipment Leasing in China", presentation made by Fuli Cao, Tax Partner, to the ELA Mission to China, Beijing, November 2, 2004

[16] Adopted by the PRC's State Council by means of the Provisional Regulations on Value Added Tax, December 13, 1993, and effective since January 1st, 1994, and Implementing Rules for such Provisional Regulations issued by the Ministry of Finance on January 1st, 1994.

[17] value-added tax." Encyclopædia Britannica. 2005. Encyclopædia Britannica Premium Service 7 Feb. 2005 http://www.britannica.com/eb/article?tocId=9074747 .

[18] Provisional Regulations on Value Added Tax ("VAT Regulations"), Article 2.

[19] Ibidem, Article 2.

[20] Ibidem, Article 12.

from 17% to 6% is not easy to implement. Since most such companies are informal entities, it does not seem rational for lessees to assume such additional cost if they cannot deduct the VAT.

An argument can be made that whenever the customer exercises its purchase option at the end of the lease, in principle, no VAT should be assessed.[21] There is a risk, however, of a different interpretation, since the language of the VAT regulations is not clear in respect to this.

Consumption Tax

A consumption tax was introduced in China on January 1, 1994[22] and is a revenue tax levied on the sale of consumer goods considered luxury or non-essential by the central government. The rates range from 3 to 45%, in addition to the 17% VAT, on 11 categories of goods. This tax is relevant for the equipment leasing and financing business on items such as motorcycles (10%), and small cars (ranging between 3% and 8%, depending on their cylinder capacity)[23].

Lease accounting

In terms of accounting rules and standards, China has evolved from a centrally planned accounting system, put in place after 1949, to a comprehensive set of standards that tend to harmonize the Chinese standards with those of the International Accounting Standards Board.

In 1993, with a view of aligning China's accounting and reporting practices with global standards, and supported by funding from the World Bank, China's Ministry of Finance (MOF) developed around 30 accounting standards that were to be applied in China's socialist market economy.

In addition to the significant progress achieved in the formulation of these standards, at the end of 2000, MOF released a new accounting system for business enterprises. This system is an integrated framework for accounting preparation and reporting, and its standards are more far-reaching, comprehensive, and more in line with international standards. In addition, the new system covers nearly all items for which detailed standards have been released.

[21] Although article 16(8) of the VAT Regulations reads: "The following items shall be relieved from value-added tax: …(8) sale of articles already used by the seller," the language does not refer explicitly to the sale of fixed assets as an exempt concept. It could be questionable, therefore, whether the lessor "used" the equipment for tax purposes.

[22] Provisional Regulations of the PRC on Consumption Tax, adopted by the State Council on November 26, 1993, promulgated by the State Council on December 13, 1993 and effective as of January 1st, 1994.

[23] Implementation Rules for the Provisional Rules of the PRC on Consumption Tax promulgated by the Ministry of Finance on December 25, 1993 and effective as of January 1, 1994.

When it comes to accounting for leases, Chinese accounting standards, like the rest of the world, recognize two types of leases. The classification of these lease types, referred to as financial and operating leases, is based on the economic substance of the transaction, rather than its form.

A financial lease is a full-payout lease, with the ownership of the leased asset transferred to the lessee at the conclusion of the lease term. In an operating lease, just as in the US, the lessor assumes the risk of residual value of the asset, and there is no automatic transfer of the asset at lease-end.

The Chinese accounting tests for operating leases are very similar to the FAS 13 and IAS 17 tests, although there are five tests rather than four. A lease is classified as a financial lease if any of the following criteria are met:

- There is an automatic transfer of title at the end of the lease;
- There is a bargain purchase option;
- The lease term exceeds 75% of the useful life of the asset class;
- The present value of the lease payments equals or exceeds 90% of the asset purchase price; or
- The asset is considered a special asset unique to the lessee, and of limited value to another entity.

Table Two shows the parallel between the Chinese Accounting Standards and IAS 17, *Accounting for Leases*.

Leasing associations

There currently are three types of professional leasing associations in China:

- The Leasing Business Committee (LBC) of the China Association of Enterprises with Foreign Investments. LBC is the largest leasing association in China and its approximately 45 members primarily include lessors licensed and regulated by the Ministry of Commerce (MOFCOM)**.**
- The Financial Leasing Professional Committee is based in Shanghai, and its 13 members are licensed by the People's Bank of China (PBOC) and regulated by the China Bank Regulatory Commission (CBRC). There are no foreign-owned lessors in this association.
- Various local leasing associations, such as the Beijing Leasing Association. China has over 10,000 small lessors, many or most of whom are car rental companies, and many of these firms belong to the local leasing associations.

A listing of the top Chinese leasing companies can be found in Appendix One.

Table Two

Comparison Between Peoples' Republic of China Lease Accounting and IAS 17

Topic	PRC Accounting	IAS 17
Finance leases - classification	If the present value of the minimum lease payments amounts to substantially all the carrying amount of the leased asset originally recorded in the books of the lessor, the lease should be classified as a finance lease.	A lease is classified as a finance lease if the present value of the minimum lease payments amounts to substantially all of the fair value of the asset.
Finance leases – recognition by lessees	Lessees should recognize finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the carrying amount of the leased property or, if lower, at the present value of the minimum lease payments.	Lessees should recognize finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments.
Sale-leasebacks	Finance leases – Any difference between the sales proceeds and carrying amount of the asset is deferred and amortized as an adjustment to depreciation expense according to the depreciation pattern of the leased asset.	Finance leases – Any excess of the sales proceeds over the carrying amount of the asset is deferred and amortized over the lease term.
	Operating leases – Any difference between the sales proceeds and carrying amount of the asset is deferred and amortized in proportion to the lease payments during the lease term.	Operating leases – If the sales price is established at fair value, the profit is recognized immediately. If the sales price is below fair value, the loss is recognized immediately. If the loss is compensated through future lease payments at below market price, the loss is deferred and amortized. If the sales price is above fair value, the excess amount is deferred and amortized.

Current Developments

After gaining membership to the WTO, the Chinese government undertook various commitments, including opening the financial services industry to direct foreign investment. In 2004, the National People's Congress started drafting a new leasing law that will eliminate the duplication of effort between CBRC and MOFCOM. The new leasing law will authorize, regulate, and govern financial leasing operations.

An official draft of the law has been issued and currently is moving through a process of comments and proposed changes. The draft of the law, revised to take into account comments gathered nationwide, will be submitted to the Finance and Economic Commission for review and discussion around the third quarter of 2006, with the plenary session of the National People's Congress expected to adopt the law at the beginning of 2007.

The proposed new law contains the conditions for establishing a financial leasing company, along with the ongoing regulatory requirements for a financial leasing operation. The conditions for establishing a financial leasing company include:

a. Minimum registered capital of Rmb80,000,000 (equivalent to slightly less than US$10,000,000)
b. A management team with professional knowledge of financial leasing and the law
c. Adequate organization, management, internal management systems, and systems for risk control and handling
d. The business premise, safety measures, and other required facilities corresponding to the business operation

The ongoing regulatory requirements for a financial leasing operation under the proposed law include the following:

a. Assets/debt ratio.
    - Risk assets, including contingent liabilities, shall not exceed ten times the total assets
    - Investment in industries other than the financial lease industry cannot exceed 30% of the total assets
    - The leased assets under the financial leases cannot be less than 60% of the total assets
b. Management of leased property. The leasing company shall set up separate accounts for leased property under sublease and entrusted lease business.
c. Cost control for leased-back property. In a sale and leaseback transaction, the acquisition cost for the leased property shall not exceed 20% of the actual value or the book value of the leased property.

Table Three lists factors addressed in the proposed law that should be considered when establishing leasing operations in China.

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Table Three

Considerations of the Proposed Law

Factor	Description
Tax incentives and accelerated depreciation	1. Any tax incentives and holidays applicable to manufacturers apply to the lessor or lessee that is eligible to record the leased property on its books as fixed assets for depreciation
	2. Accelerated depreciation is permitted, provided that the depreciation period is not shorter than three years.
Special reserve	A reserve for uncollectible accounts is permitted for leasing companies.
Source of funding	A leasing company, after its establishment has been approved, may finance its operation through public equity offerings or issuance of corporate bonds
Special treatment for purchase and leasebacks	The sale/purchase in a purchase and leaseback transaction is not considered as a true purchase, therefore, relevant taxes and fees imposed on sales/purchases will not be imposed

Although it is anticipated that the new law will be enacted by 2007, there are two principal sets of regulations currently in effect for foreign leasing companies: (1) the financial leasing company measures promulgated by the PBOC on June 30, 2000 and (2) the foreign invested leasing company measures promulgated by MOFCOM last January. These two sets of regulations, which are summarized in Appendix Two, set forth the procedural and documentation requirements for PBOC and MOFCOM to work together in approving the establishment of a foreign leasing company.

In addition, the financial leasing company measures set forth the framework for the PBOC to supervise and regulate the operation of financial leasing companies, foreign or domestic, as a special business. Further guidance is contained in numerous and scattered rules covering commercial, tax, accounting, and customs aspects.

Establishing a Leasing Company in China

There is a clear distinction between the domestic and the foreign-owned leasing companies in China from a rules and regulations perspective. There are two types of domestic leasing companies in China - financial leasing companies approved by the PBOC and other leasing companies - those that do not need the approval of the PBOC.

Currently, there are twelve financial leasing companies approved by the PBOC. These lessors, which include the New Century Financial Leasing Company, Shen Zhen Leasing Company, and Zhe Jiang Leasing Company, enjoy more rights and flexibility than the nonregulated companies.

> "Unlike other domestic leasing companies not approved by the PBOC, these companies can issue bonds and engage in inter-bank lending. Although they were able to take advantage of this privilege in the 1980s, it is difficult for them to exercise these rights now due to the current strict regulations on bond issuance."[24]

Other leasing companies, i.e., those that do not need the approval of the PBOC, can engage in financial or operating leasing, and are subject to few restrictions. While most of these domestic leasing companies have historically concentrated on finance leases, there is some movement toward offering operating leases.

All foreign leasing companies in China are regulated by the government and, as such, must receive authorization to conduct business. Authorization to establish a foreign leasing company is obtained through MOFCOM. There are several structural alternatives available to foreign leasing companies, including representative offices, branches, joint ventures, and WFOEs.

The easiest way for a vendor to increase sales in China is by referring leasing opportunities to existing lessors, although this approach should not be considered as entering the market. Establishing a representative office can facilitate these referral activities. This structure allows the office to be a liaison between the foreign company and its Chinese clients. The representative office cannot perform profit-making activities such as executing sales contracts or directly billing customers. This business form does, however, allow the foreign leasing company to perform cross-border leasing, mainly for large ticket items like, aircraft, rail, power plants, etc.

China's Company Law[25], which has been in effect since July 1, 1994, permits the opening of branches by foreign companies but, as a policy matter, China still restricts this entry approach to selected banks, insurance companies, and

[24] International Business Strategies, www.internationalbusinessstrategies.com, February 2005

[25] The first PRC Company Law was adopted by the Standing Committee of the NPC on December 29, 1993. It is effective since July 1, 1994 and was amended in December 25, 1999.

accounting and law firms. While representative offices are given a registration certificate, branch offices obtain an actual operating or business license and can engage in profit-making activities. It should be noted that there are significant restrictions as to the activities representative and branch offices can conduct.

Joint ventures, another organizational option, can be formed as equity joint ventures, cooperative joint ventures, or foreign invested joint stock companies. The different joint venture forms are based on the amount and type of equity investment provided by the local and foreign partner. A joint venture can be difficult to implement when the leasing company is part of either a manufacturer or a bank holding company. There are approximately 33 joint ventures in China, with the foreign investors mainly from the US, Japan, and European countries.
Historically, foreign companies were not allowed to own 100% of leasing companies in China, so joint ventures were very popular. Effective March 5, 2005, MOFCOM amended its existing rules by promulgating new measures regarding the administration of foreign investment in the leasing industry. These new rules effectively open up the leasing market to foreign investment by allowing WFOEs to operate as leasing companies. There currently are five leasing WFOEs in China – Caterpillar Financial, GE Capital, Hitachi Capital Leasing, Siemens Finance and Leasing, and Xerox Leasing.

Even though a WFOE gives ownership control of the company to the foreign investor, the need for local alliances and know-how is critical for the success in this market. The newly created WFOEs are captive companies whose parents have years of experience in the market. Their extensive networks of local dealers and distributors let them know their end-users' behavior better than a bank-owned or independent leasing company.

…the need for local alliances and know-how is critical for the success in this market.

Approvals and time required

As part of the regulatory process, an application must be filed with MOFCOM, accompanied by several documents, which are outlined in Table Four. MOFCOM at the central level shall, within 45 working days upon receipt of the relevant application materials, make a decision as to whether to grant approval. If approval is granted, it will issue a "Certificate of Approval of Foreign Investment Enterprise". The investors whose applications have been rejected will be notified in writing with the reasons for the rejection stated therein. The exact application process and timeframe under the new proposed law is not known at this time.

Partnership considerations

There are many reasons why the majority of international lessors operating in China have entered the China leasing market with a local partner, rather than as a WFOE.

Aside from a much lower paid-in capital requirement, local partners offer the following advantages that are particularly important in China:

- **Local market knowledge –** Experienced Chinese lessors will be familiar with local businesses, credit histories, and the reputability of many local business leaders and their companies. For example, virtually all assets imported into China are imported by Import/Export Companies (IECs); IECs take legal ownership of the asset during the import process. There are thousands of IECs in China, and lessors must be sure they are dealing with a reputable IEC or they could discover the IEC does not own the asset that it claims.

  An experienced Chinese partner should know which IECs are reputable, and with whom dealings are safe. Given the lack of generally available credit information in China, this sort of knowledge is vital to preventing fraud, and building a leasing business with a creditworthy portfolio.

- **Existing business relationships –** Chinese lessor partners may bring an existing portfolio, business relationships, or both, to a partnership. Depending on the desire of the international lessor, this may allow the partnership to begin operations with a critical mass and with a core set of clients.

- **Staffing –** Beginning leasing operations with an experienced staff can be an important difference-maker in China, given the severe shortage of experienced leasing personnel.

- **Familiarity with the Chinese legal system –** China is gradually moving, from a “rule by man” to a “rule by law” legal system, but the transition will take many years. Non-Chinese lessors that lack local experience with the Chinese legal system will benefit from a partner that knows the local judiciary and legal practices.

- **Speed to market –** An experienced Chinese partner can save time through its knowledge of what leasing products are most popular, what marketing and advertising media are effective, which companies may be the best potential customers, and how to get approvals and credit information faster and more effectively.

- **Language –** This is a particularly important issue in China. The Chinese language is word-based, rather than letter-based, and new concepts are expressed as a compilation of existing Chinese words. Written phrases and sentences are subject to a much wider range of interpretation than most Westerners expect. While an experienced Chinese partner may not eliminate misunderstandings due to language, it can reduce the chances of a misunderstanding being an expensive one.

- **Guanxi –** Personal relationships are critical to getting business done in China – even more so than in most western countries. An experienced Chinese partner with solid relationships in the government and business community can help western lessors get quick regulatory approvals, and avoid expensive investment mistakes.

Table Four

Ministry of Commerce Application Documents

► A feasibility study signed by all the investors
► The joint venture contract and/or the articles of association (a WFOE only needs its articles of association)
► A letter of creditworthiness issued by a bank
► Photocopies of the certificate of incorporation or commercial registry and/or identification of individuals acting as investors and/or legal representatives
► Audited reports of each investor, stamped by a certified public accountant
► List of names of the Directors, and letters of appointment for each Director, signed by all investors
► Qualification certificates of the senior management staff
► The Enterprise name pre-verification certificate
► All other documents required by the applicable law to the type of company selected.

Though Chinese law permits wholly owned foreign leasing companies, in furtherance of China's commitments with the WTO, business experience demonstrates that having a Chinese business partner can be, in many cases, critical to the lessor's success.

Capital requirements

As mentioned, leasing WFOEs must have a minimum paid-in capital of US$10 million. In addition, the value of the portfolio exposure of a foreign-invested finance leasing company should not generally exceed ten times its total amount of net asset value.

Before 31 March of each year, the lessors must submit to MOFCOM a report setting out the business operations of the previous year and the audited financial statements for the preceding year. There also are filing requirements and regulations applicable to leased assets subject to government quota systems, or that are commodities controlled by permits.

Funding and currency considerations

Funding options available to lessors in China are tied both to the lessor's type of leasing license, and to the terms of the license itself. Lessors with licenses to lease only in foreign currency, for example, generally fund offshore. For those lessors leasing in local currency, this cross-border funding creates regulatory barriers (generally exchange barriers) along with an exchange risk factor.

> "…foreign-invested firms, like domestic firms, must register all foreign loans with the State Administration for Foreign Exchange (SAFE). Along with the People's Bank of China, SAFE regulates the flow of foreign exchange into and out of China"[26].

Because of these factors, and other regulatory barriers, most multinationals tend to self-fund their operations.

Onshore funding options are limited, and most renminbi funding is done via bank loans. MOFCOM leasing licenses prohibit lessors from issuing commercial paper, and there is no securitization market in China, so lessors requiring renminbi funding generally have little option but to fund through banks.

PBOC licensees are allowed to issue commercial paper, but the commercial paper market is very underdeveloped as there is little available credit information on most companies. According to the PBOC and the National Statistics Bureau, corporate bond issues in 2004 totaled approximately US$9 billion – "close to non-

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[26] "China Country Commercial Guide FY 2004. A Guide to Doing Business in China & Information on Current Economic Conditions," prepared by the U.S. Embassy, Beijing

existent", according to the American Chamber of Commerce. Hence, bank loans represent the only real funding opportunity for most lessors.

Staffing

China has a hard-working population and its culture reflects the general understanding that continuous education and hard work represent keys to success. This fact is reflected in a 90.9% adult literacy rate in China relative to 79.1% for the world as a whole. In spite of this work and education ethic, salaries generally are lower among Chinese professionals than they are among expatriate employees, even when performing the same work.

For example, an expatriate may by paid $100,000 while the Chinese worker, doing the same work, may only be paid $20,000. Chinese joint venture partners generally object to this practice, as might be expected. The Chinese joint venture partners often propose that the joint venture pay all employees the same if the work is the same. The rub is that, oftentimes, the Chinese partner will pay the Chinese worker the $20,000 and pocket the rest, a practice of which foreign partners should be aware.

Despite a literate and generally well-educated work force, staffing represents one of the biggest challenges for lessors in China. There is a dearth of experienced leasing personnel at all levels, from executive management to administrative staff. Most foreign lessors bring in expatriate management at the commencement of operations, and hire and train local management during the first two to three years of operations.

Lessors also must be cognizant of the domestic picture, including statutes, case law, and prevailing practices. The employment system in China is in a transitional phase. It was not until January 1, 1995, for instance, that a law was enacted that materially broke the former cradle to grave "iron rice-bowl" employment system in existence since 1949.

In addition, recruiting employees is regulated to the extent that it is mandatory to register the employees and report their recruitment in special files. Such personnel files keep track of almost every Chinese individual from a certain age. The personnel files system, although not as rigid as during the Cultural Revolution era, is still important in many areas of Chinese life.

Systems and service providers

The lease service provider market in China does not exist in a way comparable to that in western countries. Most IT leasing systems are either self-developed or are supported offshore. Currently, there are two IT systems providers with support offices in China. There are no lease servicing/collections firms, however, nor any onshore asset management specialists (other than several small, niche players in the IT and construction equipment sectors).

Tax, accounting, and consulting services are available from the larger worldwide consultants, but there are few partners that specialize in leasing. Many international lessors with China operations utilize firms in Hong Kong that have niche expertise in the Chinese leasing market. Legal services are available but, again, there are few attorneys that specialize in leasing. Currently, there is only one lease consulting firm, located in Beijing, with an onshore presence.

Geographical considerations

China is the largest of all Asian countries, has the largest population of any country in the world, and covers approximately one-fourteenth of the Earth's land area. China's land frontier is about 12,400 miles in length, and its coastline extends for some 8,700 miles. Based on size alone, it is easy to visualize the economic opportunity and potential operational challenges of the country, as illustrated in Figure One.

Figure One: Map of China and Provinces

China has 33 administrative units directly under the central government, consisting of 22 provinces, five autonomous regions, four municipalities (Chungking, Beijing, Shanghai, and Tientsin), and two special administrative regions (Hong Kong and Macao). Beijing, the capital of the PRC, is also the cultural, economic, and communications center of the nation. Shanghai is the main industrial city while Hong Kong serves as the leading commercial center and port.

Within China's boundaries exists a highly diverse and complex country. Its topography encompasses the highest and one of the lowest places on Earth, and its relief varies from nearly impenetrable mountainous terrain to vast coastal lowlands. China's climate ranges from extremely dry, desert like conditions in the northwest to tropical monsoon in the southeast, and the country has the greatest contrast in temperature between its northern and southern borders of any nation in the world.

Probably the single most identifiable characteristic of China is the size of its population. The great majority of the population is Chinese (Han), so China is often characterized as an ethnically homogeneous country. Even so, few countries have as wide a variety of indigenous peoples as does China. Because China's population is so enormous, the population density of the country also is often thought to be uniformly high, but vast areas of China either are uninhabited or are sparsely populated.

Although, over the centuries, the provinces have become centers of political and economic authority, a strong central leadership in Beijing has curtailed this power.

> "Nonetheless, while the Chinese state has remained unitary in form, the vast size and population of China's provinces—which are comparable to large and midsize nations—dictate their continuing importance as a level of subnational administration." [27].

China, as many other countries, has stark contrasts between the richest regions of the East and the backwards regions of the West, as well as between wealthy urban centers and the poor rural areas. But within the urban centers, the concern of unemployment is a trait shared in common with the rural areas. The distribution of the different ethnic groups also determines many of the economic and cultural influences. These aspects are very relevant for risk assessment and business strategies.

The eastern region is the most developed part of China. The main business centers are Beijing, China's political capital, Shanghai, its largest commercial city, and Shenzhen, a large manufacturing city located in southern China. These

[27] China." Encyclopædia Britannica. 2005. Encyclopædia Britannica Premium Service 5 June 2005 <http://www.britannica.com/eb/article?tocId=9117321>.

three areas contain most of the equipment investment in China. The current leasing law does not allow a foreign owned company to finance in local currency in all three areas at the same time. The law requires a phased growth into the market when financing in local currency.

From a lessor's standpoint, most leasing activity today is confined to the major eastern cities – Beijing and Shanghai – and to Guangdong. This is driven by several factors:

a. Leasing licenses from MOFCOM restrict geographic activity, and most licenses are granted for these areas initially;
b. Most business activity, and, hence, leasing opportunity, is in these areas;
c. The enforceability of contracts is easier in the larger cities, as the courts tend to be more familiar with the concept of leasing and leasing law.

Risk Considerations

Any lessor seeking to establish a presence outside the US must carefully consider the unique risks inherent in that jurisdiction. Although the analysis may not be much different than one performs in entering a new market in the US, it is important to remember that the differences in culture, economy, time, and distance magnify the risks, concerns, and operating issues.

Market entry risk

Sovereign risk is a prime example of the type of unique risks that US lessors may face internationally but do not have to contend with at home. This risk can be considered from two different perspectives. One is political risk, which is the likelihood that a given country would subject foreign and/or domestic investors to measures that would impair the security of enjoyment of life, freedom, and property. In concrete terms, such political events are political violence and revolution, expropriation, and other factors such as government breach of contracts.

In terms of protection of property, Chinese law forbids nationalization of joint ventures, WFOEs, and investments from Taiwan, except under "special" circumstances. The Chinese government has not defined "special" circumstances, although officials claim that such circumstances include national security considerations and obstacles to large civil engineering projects. Chinese law calls for compensation of expropriated foreign investments but does not define the terms of compensation.

Sovereign risk is a prime example of the type of unique risks that US lessors may face internationally but do not have to contend with at home.

Although there have been no cases of outright expropriation of foreign investment since China opened to the outside world in 1979, the US State Department believes that there are several cases that may qualify as expropriations under the Foreign Relations Authorization Act, most notably in the telecommunications sector.[28] However, US lessors may obtain protection against political risks through the Overseas Private Investment Corporation or the Multilateral Investment Guaranty Agency, a World Bank Agency that provides political risk insurance to international investors.

According to the CIA report on China, however, “no substantial political opposition groups exist, although the government has identified the Falungong

[28] http://www.usembassy-china.org.cn/econ/ics2002.html. Last visited November 21, 2004

spiritual movement[29] and the China Democracy Party[30] as subversive groups"[31]. Furthermore, data compiled by the United Nations Interregional Crime and Research Institute indicate that China has crime rates that are comparable to the safest developed countries.

Although sometimes mentioned in discussions of cultural issues faced in China, there is no serious evidence of xenophobia. It must be noted, however, that Chinese culture bundles many centuries of ethnocentrism, namely, considering itself as the center of the world. This very strong cultural trait that China has dominance over the rest of the world must, therefore, be considered in all aspects of business.

Regulatory

Lessors in China are regulated by either MOFCOM, or CBRC, depending on their license. These regulatory agencies may intervene, regulate, or otherwise restrict leasing companies activities on different grounds at any time. A good example of this concept is the upcoming new legislation on leasing referred to on page 22. Because there is little or no education about leasing in certain areas, confusion or misunderstanding as to basic concepts may trigger unfair government actions or negative regulations.

CBRC, for example, is much more restrictive than MOFCOM as to reporting requirements and requires more paid-in capital. It is advised that lessors sit down with the various regulators to go through and understand the licensing process. Once the process is understood, the lessor can complete the application, making certain to include all its potential future activities, so as not to limit its scope of operations.

Structure

As previously discussed, there are several structural alternatives available to foreign leasing companies, including representative offices, branches, joint ventures and WFOEs. The most common structures are joint ventures and WFOEs.

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[29] The Falungong spiritual movement is a political movement that challenges the Chinese policy of only recognizing five faiths as legitimate. Falungong is a form of an ancient Chinese deep-breathing exercise system sometimes combined with meditation that enthusiasts claim promotes physical, mental, and spiritual well-being by enhancing the flow of vital energy through a person's body. It also includes elements of popular Buddhism and Daoism and offers followers a road to salvation. Further information can be found in Human Rights Watch website www.hrw.org.

[30] The China Democracy Party is a political movement originated in 1997 under the inspiration of Wang Youcai, a former student activist who had been jailed for two years for involvement in the 1989 pro-democracy movement. The China Democracy Party has failed to obtain official recognition as a political party. Further information can be found in the Human Rights Watch website www.hrw.org.

[31] CIA World Factbook; China report, http://www.odci.gov/cia/publications/factbook/geos/ch.html

When considering structural alternatives, most lessors that have been through the process have considered paid-up capital requirements, reporting and regulatory requirements, the time to negotiate a joint venture agreement, and the advantages and disadvantages of having an equity partner when evaluating which structure is most appropriate.

Exit risks also should be an important element of the analysis. Joint ventures, while allowing foreign lessors to shorten the learning curve, also are more difficult to terminate, as they require the parties to work out satisfactory terms if the structure is unwound. Paid-in capital cannot be repatriated from a discontinued joint venture until the Chinese partner consents, and there have been several instances of negotiations dragging on for two or three years while negotiating satisfactory exit terms. If a lessor chooses a joint venture structure, a winding-up process should be documented in the partnership agreement to the extent that it is possible to do so.

Operational risk

Operational risks also must be considered when entering the Chinese market as they have a direct impact on the day-to-day business of the lessor and, hence, its profitability.

Market Risk

Market risks are a fact of life for any business whether it is in the US or China. Interestingly enough, one of the market challenges lessors are facing in the US also is present in China – the Chinese market is flush with cash. This challenge is even more problematic in China, however. For example, operating leasing is not generally known, making the financing decision one between finance leases and loans.

The US experience tells us how difficult this bank loan competition hurdle becomes. This challenge is made even more difficult by the nature of the lessees. Large companies generally have ample access to inexpensive bank loans, so it is difficult to compete with more expensive finance leases. The market for small and medium companies is wide open but, unfortunately, there is almost no credit information available to assess the risk, making this segment of the market very risky. In this regard, the captives will be better positioned to compete due to their local experience, but independents will have a difficult time creating volume.

Funding

The funding risks to be faced in China are the same as those in the US, with the addition of currency risk, depending on how the lessor's transactions are denominated. Mitigating the currency risk is the belief that the renminbi will

become more valuable over time, as current financial thought sees it as being undervalued.

The effect of inflation on interest rates also must be considered. Although to date the PBOC has played a strong and active role in controlling inflation, China is consuming a tremendous amount of the world's resources (for example, according to the American Chamber of Commerce, in 2003 China consumed 21% of the world's steel, 25% of the aluminum, 31% of the coal, 35% of the iron ore, and 40% of the cement). This creates a potentially overheated economy and inflationary pressures on interest rates. Although recent reports indicate that inflation is under control and, perhaps, may be slowing, lessors must carefully monitor its impact on interest rates.

Credit

Credit risk is always of primary concern whenever a lessor enters a new market. When doing business with listed companies (which, generally, are only the larger companies in China) the best source of information can be found in a firm's filings with the stock exchange. Credit reporting agencies are still in their infancy in China, and the information they provide usually is not comparable with what is available in western countries. Since these reports are particularly expensive in China, lessors should assess whether the value of credit agency services are worth the cost.

Unfortunately, there is not a similar source of data for the smaller companies; in fact, there is hardly any publicly available data at all. Credit performance also, in many cases, is specific to each industry segment. The captives will have an advantage in this regard because they know their customers very well due to their dealer networks and time in the market. Independent lessors wishing to lease to the small/medium business segment will need to invest a significant amount of time studying the local market, and, more importantly, developing personal customer relationships.

Compounding these issues is the fact that the habit to pay on time is the result of an educational process in which, for generations, individuals trade goods and services in free interchange markets. China started this economic environment in 1979, only one generation ago. Prior to that time, the Cultural Revolution adamantly ignored the value of binding obligations, so a transition to a payment culture should be expected.

Residuals

While residuals represent a primary risk for many lessors in the US, the operating lease market in China has not developed to the level at which lessors are concerned with residuals, other than from a collateral perspective. Given that there is no tax efficiency, used equipment data, or even a secondary equipment

market, Chinese lessors have not developed operating lease products to the levels found in the US and Europe. Those lessors who are able to overcome the Chinese lessees' ownership mentality will have to develop a secondary market for their equipment.

Structuring

Just as the Chinese leasing market has not reached the operating lease phase of the leasing cycle, neither has it reached the point where structuring is necessary to differentiate the financial leasing product. This represents an opportunity for those lessors who have structuring capabilities and can get comfortable with the lessees' credit positions.

From a more fundamental perspective, there is more risk in the Chinese market, therefore, leverage in the portfolio will be less. Lease terms also will be shorter than those in western markets due to the credit issues and lack of data. Lessors also must make certain the transaction structure is properly reflected in the documentation, which is discussed next.

Legal/documentation

Any time a new language is introduced into the business process there is an opportunity for a broader range of interpretation. Furthermore, since leasing is a relatively new concept, it is important to use local counsel. Other risk factors include:

- The recent adoption of contract law
- The language – in particular, the difficulty of interpretation of written characters
- The culture, especially concerning negotiation tactics

Although documentation can be used to differentiate a lessor from its competition, the market first needs to achieve a certain level of maturity before introducing innovative structures. For example, courts, other authorities and businesses must be able to understand and navigate on a solid legal basis prior to combining elements of creativity in the transactions.

Collections

The concept of paying over time, with repeated payments, is relatively new in China. Not only does this increase the risk of nonpayment by lessees, it also creates problems in the collection process. Since paying over time is a new concept, the collectors themselves may not understand the need and necessity to enforce the lease payment provisions.

There is a shortage of collectors with experience in China, making the staffing and training of this critical function a high priority. Furthermore, the rigor as to performance and metrics is not at the same level in China as it is in the US and Europe, thereby compounding the staffing problem. Lessors will have to work very closely with local resources to understand the payment mindset and find adequate collection staff.

Repossession and recourse

The enforceability of the lease agreement is a primary concern in China. The components necessary to enforce leasing transactions include (i) the rule of law, (ii) the efficiency of the legal system, and (iii) a corruption-free environment. The first component, the rule of law, refers to the overall likelihood of prompt payments and voluntary repossessions, and is based on past practices and recognition of the legal obligation to make payments.

The second factor to be considered is the efficiency of the court systems in China, particularly in connection with collection and repossession risks. If negotiations do not succeed, for whatever reason, going to court must be an effective alternative. Unfortunately, in China, the police and judiciary do not always understand leasing and its legal processes. The reality is that going to court is not necessarily an efficient alternative for enforcing the lessor's rights, particularly in smaller cities and locales.

Table Five contains a corruption ranking (the CPI score) for the US's major trading partners. Since the higher the ranking, the less corrupt the country, it can be seen there is a high risk of corruption emasculating the enforceability of leasing and asset based financing contracts in China.

When it comes to bankruptcy, the law does not contemplate any restructuring processes such as in the US Bankruptcy Code. Furthermore, there is not yet an effective test as to whether Chinese bankruptcy courts and liquidators will accept the preferential range of lessor's rights in bankruptcy proceedings. This fact creates additional legal risk for lessors.

On the positive side, China currently is committed to the International Monetary Fund and WTO to reform its insolvency law. For the time being, however, lessors are best served by avoiding involvement in bankruptcy proceedings.

The bottom line, based on the experience of lessors in this market, is to do everything possible to avoid having to repossess the equipment because it is such a painful and time-consuming process. The solution is to know your customer and perform adequate due diligence.

Competition

In China, the competitive environment is wide-ranging and diverse. Cash currently is the primary competition, particularly since operating leasing is not generally known. Banks also represent formidable competition, especially for large companies that have access to inexpensive bank loans.

Table Five

Corruption Perceived Index 2004[1]

Country	CPI SCORE
Finland	9,7
New Zealand	9,6
Denmark	9,5
Singapore	9,3
Sweden	9,2
Switzerland	9,1
Norway	8,9
Australia	8,8
Netherlands	8,7
United Kingdom	8,6
Canada	8,5
Austria	8,4
Germany	8,2
Hong Kong	8,0
United States	7,5
Belgium	7,5
Ireland	7,5
Chile	7,4
Spain	7,1
France	7,1
Japan	6,9
Israel	6,4
United Arab Emirates	6,1
Taiwan	5,6
Malaysia	5,0
Costa Rica	4,9
Italy	4,8
South Africa	4,6
Kuwait	4,6
Korea, South	4,5
El Salvador	4,2
Brazil	3,9
Colombia	3,8
Panama	3,7
Mexico	3,6
Thailand	3,6
Peru	3,5
China	3,4
Saudi Arabia	3,4

In this respect, although the market for small and medium companies is wide open, this segment of the market is very risky, as there is almost no credit information available. Captives will have an advantage in this regard, while independent lessors wishing to lease to this business segment will need to invest a significant amount of time learning about the local market.

There also is significant competition from other lessors, with over 10,000 domestic leasing companies in this market. Most of these companies have low market entry barriers, offer relatively unsophisticated leasing services, and concentrate on financing simple, commodity-type equipment such as automobiles. Such companies lack any funding strength and are, in general, relatively unstable.

Other, stronger lessors include the leasing companies subject to the control of the PBRC and MOFCOM, with many foreign lessors, such as the WFOEs, either implementing new business models and structures in China or redefining them. In addition to these lessors, leasing companies that operate from Hong Kong, using

government benefits, and those lessors operating cross border, are part of the competitive landscape.

Financial risk

The leasing and financing business, by definition, has a high degree of risk associated with it. Understanding those risks, in the context of the Chinese market, is essential element of expanding into the Chinese market.

Interest rates

Forward contracts are readily available in China to hedge against interest rate movements for lessors borrowing in renminbi. The two major issues of current concern related to interest rate risk, therefore, are (1) the rate of inflation in China, and (2) the relative strength of the banking system.

China's economy has grown at a breathtaking pace over the last 25 years. According to the China National Statistics Bureau, China has averaged annual GDP growth of 9.7% since 1979. This growth, coupled with rising commodity prices and a large increase in urban middle class disposable income, caused the economy to overheat in 2003 and 2004 (the consumer price index exceeded 3% in 2004)[32]. Although the PBOC raised deposit and lending rates by 27 basis points in October 2004 in an effort to reduce inflationary pressures, further increases may be necessary as China's economy continues to grow.

The health of the Chinese banking system is another important factor that impacts interest rates. China's banks are slowly adopting western banking and credit practices, but there is a huge "overhang" of nonperforming loans in the system. Estimates of these nonperforming loans, as a percent of total assets, range from 15% to over 40% (potentially as much as US$600 billion, according to Goldman Sachs estimates). China's banks have already tightened credit policies, especially for small and medium businesses, and, as lending policies continue to tighten, there is likely to be upward pressure on interest rates.

Currency

Lessors and equipment financiers face currency risk not only in their ongoing operations if the rentals are denominated in local currency, but also at end of lease. At the time of liquidation, for example, they will need to convert the proceeds in local currency into a hard currency such as US dollars or Euros.

On a transactional level, renminbi hedges are available. On a more global basis, China has been pressured to float its currency. Most analysts assert that if the renminbi floats, the currency would be revaluated, as opposed to devalued. The

[32] American Chamber of Commerce: China Business Environment Briefing, November 2004, as presented to ELA China Trade Mission delegation on November 1, 2004

Chinese government has made clear, however, that no floating will be allowed until the financial system is cleared and in order.

The Economist magazine has created a purchasing power index called the Big Mac index, which measures the equivalent purchasing power of a currency. This index indicates that the Chinese currency is undervalued by 52%, which means that, if the renminbi currency was free to float today, the new exchange rate (Rmb/US$) would strengthen from approximately 8 to 1 down to 3.5 to 1.

Profit repatriation

The remittance of profits is fairly straightforward and is regulated by SAFE[33]. China does not impose any withholding tax on dividends paid by a foreign-invested company to its foreign stockholders and Chinese banks are authorized to transfer the money. Since foreign exchange reforms in 1996 made the renminbi partially convertible, current account transactions in Chinese banks can include import/export payments and fees for services, although much paperwork has to be completed before a transaction can take place. As a general rule, a leasing company's method of getting profits out of China should usually be included in the business articles of association and approved by the local government at the time the business is established.

China allows foreign lessors issuing shares offshore to remit their profits, dividends, and bonuses out of the country. Such remittances do not require the prior approval of SAFE. The enterprises, by presenting the necessary documents, can make the remittance direct through the bank, which will report details of the remittance to the local foreign exchange administration.

Appendix Two summarizes the steps that need to be undertaken in order to legalize profit repatriations, pursuant to SAFE Regulations[34]. In accordance with the “Notice on Issues Concerning the Remittance of Profits, Dividends and Bonuses by Designated Banks,” SAFE is authorized to carry out random checks of remittances amounting to an equivalent value of US$100,000 or more, or remittances deemed suspicious, to determine their authenticity.

Profit figures are determined by reference to the government accounting statements. Before getting profits out of China, companies have to make up any losses from previous years. Furthermore, a slice of profits also has to go to two funds, a reserve and expansion fund (10% of after-tax profits)[35] and a separate

[33] Notice on Issues Related to Designated Foreign Exchange Banks’ Handling of Remittance of Profits, Dividends and Bonuses Abroad (Hui Fa [1998] No.29) (the “Remittance of Profits Notice”), issued by SAFE on September 22, 1998.
[34] Remittance of Profits Notice.
[35] Article 179 of PRC Company Law.

fund for employee bonuses and welfare (5%-10%)[36]. For joint ventures, profits are split according to the equity share of each partner.

Tax

As mentioned, China does not impose taxes on dividends to foreign investors of FIEs,[37] therefore, provided that the determination of profits is proper, no tax cost associated with the repatriation should be involved.

Capital investment

Repatriation of capital is not restricted at all, provided that all taxes have been paid. Repatriation of capital may come from either the proceeds of the liquidation of the company or the proceeds of the sale of the stock.

China is just as aggressive about keeping foreign equity investment from leaving the country as it is about bringing it into the country.

In the first case, the FEI company must pay any income tax due. The company computes this tax is by deducting the amount of paid up capital, reserves and expansion funds from its net assets or remaining property. Any liquidation expenses also may be deducted. The net proceeds after taxes may then be repatriated.

In the second case, the seller shareholder must assess its capital gains between the price of transfer and the shares acquisition costs and pay an enterprise income tax at a rate of 10%.

Exit strategy risk[38]

The process of ceasing operations in China is similar to that in most other countries. This process involves filing documents with the appropriate government authorities, submitting audited financial statements and bank records, settling with partners, and paying any debts and taxes due. The process, however, moves much more slowly in China than it does in the west.

China aggressively pursues foreign equity investment in the country, and it is equally aggressive about keeping as much of this equity in the country as possible. Lessors considering establishing an onshore entity should be aware

[36] Article 180 of PRC Company Law.
[37] Guo Shui Fa [2003] No.28, issued by the State Administration of Taxation dated March 12, 2003 and effective since July 1, 2003.
[38] The story of the Five Stars Brewery recounted in "Mister China" a book by Tim Clissold, ISBN-0-06-076139-3, provides a real life illustration of how an exit strategy, motivated by the decision to leave the country, was handled.

that, if operations are not successful, repatriating its investment is likely to take longer than it will in western countries.

Under the old joint venture structure, it is difficult to take equity out of China in the event circumstances or strategies change. The only option for the foreign lessor to recoup its equity is to sell its shares to a new buyer. The selling process, however, takes months to complete as the Chinese partner has a "right of first refusal" to buy the foreign shares, and, in most cases, finds ways to block the sale. It took GE three years, for example, to get agreement from its Chinese shareholder to sell Daye Leasing. CIT also encountered delays when it sought to make changes to its Chinese leasing operations.

The new regulations issued in March of 2005 this year, allowing 100% foreign-owned lessors, will reduce the exit risk for lessors. Under the new law, a foreign lessor can spell out in its application the conditions under which it can terminate its leasing operation. It is also easier for the foreign lessor to find a buyer to take over the 100% owned entity.

If the leasing entity is dissolved, the foreign lessor must apply for capital repatriation from SAFE, although, since China has over US$600 billion in foreign reserves, it is unlikely SAFE will block the application. If the leasing entity is sold, the purchase price can be settled outside China without SAFE approval. This combination of the new regulations and the huge China foreign reserves help mitigate the lessor's exit risk.

Case Studies

Interviews were conducted with five separate lessors in an effort to learn more about the realities of equipment leasing in China. These lessors are either active in, or seriously considering entering, the Chinese equipment leasing market. Diverse lessors were incorporated as part of the case studies in order to glean a variety of experiences, and included:

- A WFOE captive lessor whose parent is a large, US-based manufacturer of industrial equipment
- An international technology company whose China leasing activities are conducted by a joint venture leasing company with a Chinese lessor partner
- A Hong Kong-based bank that writes offshore leases into China
- A local Chinese-owned lessor
- An international bank-owned equipment lessor that has studied the Chinese equipment leasing market carefully, but as of the time of this writing, has chosen not to enter the market.

As part of the interviews, each lessor was asked details about its background (including parent, if appropriate), its leasing operations in China, the decision process used to enter the market, any experience gained, and lessons learned. The various case studies can be found on the following pages:

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US Manufacturer-owned WFOE Captive Lessor

Company Background

The parent company is a large, worldwide manufacturer of industrial equipment with operations in approximately 40 countries. The parent established onshore operations in China in the early 1970s and, today, has numerous wholly owned subsidiaries and joint ventures in China. It currently has over 4,000 employees in China.

The parent's wholly owned captive financing company is US-based, with operations in many of the same countries as its parent. It was established in the early 1980s, and today has assets and annual lease originations in the multiple billions of dollars, over 1,000 employees worldwide, and operations in approximately 30 countries.

The captive's WFOE obtained its leasing license in early 2004, and opened for business in December 2004. Prior to this time, the parent's China-based distributors handled the customer financing on an ad hoc basis (when it was provided at all).

Description of Financing Operations in China

- **Organization** – The WFOE is headed by an expatriate managing director. This director reports to the Singapore-based general manager for the captive's Asia Pacific financing operations. His staff includes an operations manager (who manages both a credit manager and a customer service manager), a sales manager and a finance manager.

  Unlike some other multinational companies, the WFOE does not have a matrix reporting structure with "dotted lines" into the parent company. It is part of the worldwide captive financing organization, and ultimately reports to the president of the captive in the United States. In practice, the WFOE works closely with both the parent and its dealers to drive its business volumes and support the parent.

- **Employees** – The WFOE had approximately 25 employees at the time of the interview. All the management team has prior employment experience with the parent. There also is an individual with six sigma black belt qualifications on the team. The rest of the employees are local hires and were sourced through the use of recruiters.

- **Business Model** – As with most captives, the WFOE exists to help drive sales of its parent's equipment, as well as to generate an acceptable return to the financing business. The WFOE is licensed to provide finance leases to its parent's customers, and intends to drive business volumes through WFOE sales reps that work closely with parent and dealer sales teams throughout China. Promotional offerings are likely to be tailored to specific dealer needs – perhaps including skip payments up front – but at the time of the interview there were no plans to offer low-rate or similar financing programs. In its first year of operations, the WFOE will focus on developing awareness of its financing capabilities, and developing working relationships with the dealer network.

- **Credit** – Operations are similar to those in most other countries in which the captive operates. Credit limits are delegated (in increasing amounts, respectively) to the WFOE credit manager, the operations manager, and the managing director; approval for transactions above the delegated limits go to captive Asia Pacific vice president, and, above that, to the captive's worldwide credit committee.

  The managing director noted during the interview that the availability of reliable credit information in China is extremely limited…banks won't provide information, there are no personal credit bureaus yet, credit rating agencies have limited capabilities and are expensive, and the reliability of credit information from most other sources is of questionable value.

  However, the WFOE has an advantage in that the captive's dealer network has accumulated useful knowledge about many of their customers over the years. Many dealers have provided financing to their customers, and are able to give information such as payment history, strength of the customer's business, and personal knowledge of the customer executives to the WFOE. This allows the WFOE to make more informed credit decisions than many other foreign-owned lessors in China.

- **Funding** – All funding is provided by the parent.

Decision Process to Enter the Chinese Leasing Market

- **Drivers** – The major driver for the establishment of the WFOE was to help support the parent's growth efforts in China. The parent faces significant competition from other major international manufacturers in China, and believes that customer financing can be a meaningful differentiator in the marketplace. Also, some of the parent's competitors already have financing operations elsewhere in the world, and it is likely they will try to establish financing entities or programs at some point in the future. By

getting a head start on the competition, the parent believes it may gain first-mover's advantage in the market.

- **Decision Process** – The captive and the parent formed a six sigma study team in 2002 to study the Chinese market, determine whether customer financing capabilities were desirable, and, if so, what form and structure they should take. Due in large part to the parent's growth objectives in China, as well as the captive's history of successful international operations, the team concluded that a wholly owned captive financing company should be established. Ultimate approval of the decision came from the parent's headquarters organization, with the support of the captive executive team.

Experiences

- **Volumes** – At the time of the interview, the WFOE was newly established and had not been in operation for a full year, so no volume information was available.

- **Bad debt and delinquencies** – None had been incurred at the time of the interview, but because of the brief time in business this was not considered meaningful.

- **Personnel** – Finding Chinese/English speakers with leasing experience was extremely difficult. The WFOE conducted "mass interviews", according to the managing director, and used recruiters to identify prospective candidates. They targeted university graduates with working experience, but the pool of qualified candidates turned out to be smaller than anticipated. As a result, the process took longer than the WFOE thought it would.

  The WFOE was able to use much of its training material that it had developed in the US to educate its new hires. The new hires generally spoke good English, so no translation of the training materials was required. The availability of training materials and classes in China, in either Chinese or English language, was minimal.

- **Other Considerations**

  - The used equipment market in China for industrial equipment "is fragmented and not well coordinated", according to the managing director. Part of the reason for this may be that, in the past, similar equipment made by Chinese manufacturers was not durable and often failed to last much beyond two years. Users became accustomed to using the equipment until "the wheels fell off", and the concept of leasing equipment for three to four years made no

sense. Nonetheless, there will be a future requirement to develop a used equipment market in China, particularly when operating leases become more popular. The managing director believes this may need to be done through a "push" strategy by manufacturers, rather than relying on demand to develop naturally.

- One surprise was the lack of understanding by prospective customers about the concept of leasing. Many of the state-owned enterprises (SOEs) were heavy borrowers from banks in the past, but do not yet understand the concept of making monthly payments and then not necessarily having ownership of the asset at the end of the financing term. The managing director believes a large-scale series of training seminars, promotional literature and marketing campaigns will need to be developed and marketed to increase the concept and advantages of equipment leasing to prospective lessees.

- Another surprise was that many things that appeared simple (or were taken for granted) in the early stages of the WFOE have proven to be more complex and time-consuming than anticipated. "There are a huge number of tax, accounting and legal issues that remain unclear," the managing director said. "We generally go to the government for clarification, but in some cases they don't know the answer and, many times, it's impossible to get an opinion in writing. It can be frustratingly difficult to get a concrete yes-or-no answer to a very basic question.

  "There's a saying in China: 'Anything is possible, but nothing is easy.' That has been our experience."

Hong Kong Bank Writing Offshore Leases Into China

Company Background

The bank, headquartered in Hong Kong, was incorporated in the mid-1950s, although one of its predecessor parents began operations in Hong Kong in the 1920s. The bank had slightly less than US$10 billion in assets as of the end of 2004. In addition to operating over 30 branch offices in Hong Kong, it has branches in both the United States and China, and has a wholly owned finance company subsidiary based in Shenzhen.

The bank's cross-border equipment leasing operations began in 2000. The leases are offered to bank customers that require equipment financing/leasing in China.

Description of Financing Operations in China

- **Organization** – The leasing operations group is a department within the bank in Hong Kong. The group includes a department manager, credit analysts and customer support reps that run the business. The group was organized to support bank customers (most of whom are Hong Kong based) with operations in China.

- **Employees** – There are approximately 10 employees in the group, all of whom are employees of the bank.

- **Business Model** – The group exists solely to support the bank's customers with equipment leasing requirements in China. Most of these companies are manufacturers with plants in the Guangdong province in China, so the majority of the cross-border leases are written for equipment located in the province. Most lessees are Hong Kong-registered businesses.

  Lease contracts are written under Hong Kong law, and are adjudicated in Hong Kong, not in China. In the event of lessee non-performance, the leasing group works within the bank infrastructure – including its credit, collections and legal groups – to make repayment arrangements with the lessee. All leases are finance leases.

  The bank recognizes that leased assets are unlikely to be repossessed or resold in the event of default, so the underlying assets are not considered as collateral for the lease. Court judgments are relatively easy to obtain in Hong Kong, but enforcement and collection of a repossessed asset in

China is difficult and can take a very long time. Most leases are underwritten based on the banking relationship of the lessee.

- **Credit** – Because all lessees are existing bank customers, the leasing group has full access to the bank's credit files on all lessees. Credit decisions are made based on bank statements and the lessee's financial statements; other external credit information is rarely used in making credit decisions.

  The leasing department has a delegated credit limit, and transactions exceeding that amount are routed to the group credit organization for approval.

- **Funding** – All funding is provided by the bank.

Decision Process to Enter the Chinese Leasing Market

- **Drivers** – The bank's desire to enter the Chinese leasing market was driven both by the need to service its customers, and by the huge market size. The Guangdong province is home to an enormous number of manufacturers, almost all of which have sizable requirements for capital equipment. The bank competes against many Hong Kong- and China-registered banks for business in China, and believed it needed to offer offshore equipment leasing to remain competitive.

- **Decision Process** – The interviewee was not certain of the bank's decision process to establish a leasing department, but believes that the bank's investment board made the decision to create the department as part of its ongoing investment activity in China.

Experiences

- **Volumes** – Annual lease origination volumes are in the range of US$35 million. Leased assets include manufacturing and CNC equipment, IT and telecom equipment, and other manufacturing-related assets.

- **Bad debt and delinquencies** – The interviewee described bad debt levels as "perhaps somewhat high, but acceptable. We compensate to a degree with higher yields than we can get in Hong Kong." He also pointed out that, with access to the bank's credit information for each lessee, the leasing department has a good idea of the credit quality of its lessees, and can risk-price the leases effectively.

- **Personnel** – The bank shares the view of other bank lessors in Hong Kong that it is difficult to find and retain trained, experienced equipment leasing personnel in Hong Kong – and exceptionally difficult in China.

"Anyone planning leasing operations in China will find there are not too many experienced people there. Hong Kong lessors should plan on recruiting people from Hong Kong, as hard as that may be, to run and manage their China leasing operations."

- **Other Considerations**

  - "All of our business is originated from equipment dealers [with a bank relationship] and the bank account managers' own direct contacts. We do not have to carry any sales or marketing overhead; the bank provides all these services for us."

  - The bank considers pricing as its key differentiator from its competitors. The bank knows its customers, knows their credit history, has access to a low cost of funds, and is comfortable doing business in China. Only competitors from significantly larger banks, or from banks that also have relationships with the same customers, can compete effectively from a pricing standpoint.

  - "I am still optimistic about the financing business in China generally," our interviewee said. He cited the rapidly growing Chinese economy, and the bank's increasing experience with the leasing business, as the causes for his optimism.

International Technology Company JV with Chinese Partner

Company Background

The parent company is an international provider of technological products and services, with operations in more than 50 countries worldwide. Its annual sales are in the tens of billions of dollars, and it employs in excess of 100,000 people. The parent established operations in China in the early 1980s, and its annual sales there are estimated to be over $250 million annually.

The parent has a strong, well-established captive leasing company with a long track record of successful worldwide operations. It was an early entrant to the Chinese equipment leasing market, and established a joint venture leasing company (JV) with a Chinese partner in the late 1990s.

Description of Financing Operations in China

- **Organization** – The JV is headed by a China-based Region Sales Leader, who manages a team of in-country leasing professionals. The managing director is also responsible for the captive's leasing operations in Hong Kong and Taiwan. From a career perspective, all of the JV employees are considered as affiliated with the parent, rather than with the parent's Chinese partner.

  The JV reports into the captive's Asia Pacific headquarters office, which, in turn, reports to the captive's worldwide headquarters location. The Chinese partner has representation on the JV board of directors, but is not involved in day-to-day operations.

- **Employees** – Although the number of China-based JV employees is confidential, it is estimated to be fewer than 25. The JV includes several sales reps with a responsibility to work with the parent and parent-affiliated reseller sales reps in an effort to drive business volumes.

- **Business Model** – The JV exists to drive its parent's business volumes, to support the parent's growth initiatives in China, and to achieve a suitable financial return to the business. Although it will finance third party products and services to support the sale of parent products, it does not pursue financing opportunities in China for standalone transactions with no parent product content. The JV considers these transactions on an exception basis only, in support of important clients of the parent.

In the early days of the JV, success was measured by new business volumes and return on invested capital; as the JV has matured, it is now measured by lease penetration rates, new business volumes and net income, similar to most of the captive's other country operations.

The JV markets primarily to its parent's enterprise customers, and does not target the Chinese small and medium business (SMB) segment. Most leases tend to be custom-structured to meet the needs of these larger customers, and, as a result, the JV rarely offers promotional programs such as low-rate financing in China (although the captive does offer these programs in several other Asian countries).

- **Credit** – The JV has a credit analyst, with a modest delegated approval level, located in China. Since most JV leasing transactions tend to be large in size, the majority of credit decisions are reviewed and approved by the captive's credit operations group in its Asia Pacific headquarters.

  During the interview, the executive noted that the availability of credit information in China is marginally better than it was at the inception of the JV, but it is still nowhere near as plentiful or reliable as it is in the captive's more mature Asian country operations. The JV has experienced a high level of repeat business among its Chinese customers, so the availability of information via personal experience is good. Some information generally can be gathered on new, larger customers, but for its few, new SMB customers it remains very difficult to get useful credit data.

- **Funding** – The parent, through the captive, provides all operating capital for the JV.

Decision Process to Enter the Chinese Leasing Market

- **Drivers** – Aside from supporting its parent's growth plans in China, an important driver was the need for the parent to demonstrate its ability to support its customers in China. China was, and remains, a critical long-term growth market for many of the parent's largest clients, and the parent believed that the ability to provide on-shore customer financing there demonstrated tangible market leadership to its customers.

- **Decision Process** – The business case for the establishment of the JV was developed by the captive and the parent's business development organizations and, following approval by the captive's executive management, was presented to a corporate global investment group for analysis, modifications and approval. At the time, no WFOE licenses were available to lessors in China, so a significant amount of time was spent identifying the appropriate Chinese partner, and negotiating the terms and conditions of the partnership agreement.

Experiences

- **Volumes** – Annual lease origination volumes, and assets under management, are confidential. However, during the interview the executive shared that the JV business volumes for the first full year of operations were quite modest. Second year volumes picked up significantly, due in large part to a series of sizeable transactions with a large customer of the parent. This relationship continued to drive new business volumes in subsequent years, while business from other new clients evolved more slowly but at a steady pace.

  Approximately 90% of all JV lease transactions are finance leases, according to the executive, "because the effect of the business tax on operating leases is so onerous. There are occasions where an operating lease still can make sense for a large transaction, but we do not write a large quantity of them."

- **Bad debt and delinquencies** – These numbers are confidential as well, although the JV's bad debt levels are "not terribly high" due to the preponderance of large, enterprise customers as their lessees. Many of these companies are also repeat clients of the parent, so there is an incentive for both the client and the parent to ensure that lease payments are made on a timely basis.

  The executive shared that the JV has had the opportunity to use the Chinese court system to attempt to collect outstanding receivables. Although their effort proved successful in the end, "it is not something we would enjoy repeating unless absolutely necessary." He encouraged lessors to get to know their customers, and work diligently through the parent, the reseller and directly with the customer before resorting to legal action.

- **Personnel** – The executive noted that it is difficult to find and hire qualified personnel in China for their leasing business. "The equipment leasing community in most places in the world is a pretty small group, but it is very small in Asia and exceptionally small in China. Everyone knows everyone else, and it is hard to look to this community to find prospective employees."

  The executive said the JV often recruits from the Chinese banks, although there are challenges there as well. "Most banking employees know little or nothing about leasing, so we have to teach them that," he said. "They do come with a background in finance, which is helpful, but it does not obviate the need for training.

"Also, there is a significant cultural transition for an employee coming from a large Chinese bank – particularly if it is state-owned – to a smaller, foreign-controlled leasing company. The concept of selling generally, and of selling a value-add proposition to a customer in particular, is something most of these people have never done and do not understand at all. We need to manage that transition very closely, or risk poor performance or a disgruntled employee. Effective training is very important."

- **Other Considerations**

  - A surprise for the JV was the lack of understanding about the concept of leasing among customers. Many of the JV sales reps assumed that, since most of their clients were enterprise customers, they had the financial sophistication and exposure to leasing, but they were mistaken. "Most of these people and their companies – the Chinese companies, anyway – have come from a cash economy; the concept of credit and leasing is brand new to far more people than we had anticipated."

  - The used equipment market is still largely undeveloped in China. However, there is likely to be a growing demand among the parent's customers for large-scale takeouts of equipment as new technology becomes available. The executive pointed out that the lack of a used equipment market is a chicken-and-egg problem – no market can develop without used equipment, but few takeouts and lease returns are encouraged because there is no market for the used equipment. "I think we'll see the supply side of that problem getting addressed in the foreseeable future," he said.

  - The executive lamented that the JV sales force is not yet fully-integrated into the parent and reseller sales force, despite several years of trying. This appears to be related to the lack of knowledge about the leasing product among both customers and the parent/reseller sales reps.

  - The initial license the JV obtained significantly limited the scope of their leasing activities, to certain cities in China. This meant that the JV could not provide leases for some of the parent's largest customers unless they happened to install the equipment in cities where the JV was licensed to do business. "In retrospect, I wish we had been able to remove this restriction to our license, but at the time we weren't sure what the demand would be and it did not seem worth ruffling the feathers of the Chinese authorities over." Although licensing restrictions have eased in the ensuing years, prospective market entrants should consider whether other types of

restrictions, such as currency or funding limitations, might cause similar operational restrictions.

- Scope of operations also may have been an issue for the JV managing director. Like many other multinationals, the parent company groups China, Hong Kong and Taiwan into a "Greater China Group" within its Asia Pacific operations, and, in an effort to mirror this organization, the JV gave operational responsibility of these three countries to its initial managing director.

  "In retrospect, we probably shouldn't have done that," the executive said. "As expats, we tend to lump these three countries together but they pose different challenges for a lessor. The business and leasing volumes in Hong Kong are relatively small, and Taiwan has some challenges that are unique to that country," he said. "A start-up operation in China requires someone focused on it full-time, and I think we probably should have let our MD do that…and let someone else worry about the other two markets."

Local Chinese-owned Lessor

Company Background

The company was established in 1995 as a state-owned leasing company. In subsequent years it was sold, via a cross-shareholding arrangement, to a foreign-owned, independent leasing company and private individuals. Today the company operates as a stand-alone, independent entity with no government ownership.

Description of Financing Operations in China

- **Organization** – The Company is headed by a managing director, who reports to a board of directors. Reporting to the managing director are teams that are responsible for sales and lease structuring.

- **Employees** – The Company has approximately 30 employees.

- **Business Model** – The Company is focused on two markets in China: large-ticket structured transactions (over US$1 million), and smaller, flow-like transactions for high-technology products from well-known multi-national manufacturers. Its lessees are generally larger companies with good credit histories.

  The Company's sales force is the lifeblood of the business, as, unlike bank lessors and vendor captives, it had no existing customer base when it began operations. Its sales reps have developed relationships with larger, reputable Chinese firms, and identify larger transactions through their contacts. The sales force also cultivates relationships with technology-related vendors and resellers; these firms have become the source of a flow of smaller-sized transactions.

  Most of the Company's employees are focused on generating new business, and on structuring transactions. The Company keeps few assets on its balance sheet; it was one of the first lessors in China to fund its operations through the sale of its receivables to banks.

  All of the Company's business volumes are domestic today, although it is possible they may expand into cross-border leasing for particular assets in the future. The interviewee noted that the Chinese government has considered implementing tax incentives to promote the export of certain assets, most notably telecommunications equipment and vessels used for

transportation and shipping. Such a move may make it lucrative for Chinese-based lessors to finance these assets.

- **Credit** – The Company has few employees focused on credit analysis. For larger transactions, the Company works directly with the credit departments of the banks providing funding for each transaction. The Company's focus on these deals is to create a lease structure that is agreeable both to the lessee, and to the funder. On flow transactions, the Company is given credit parameters to use by its funding sources, typically including maximum transaction size, assets to be financed, and acceptable lessee industry groups. The Company's small credit team ensures that prospective lessees meet these credit guidelines. Exceptions are referred directly to the funding source for approval.

- **Funding** – The Company was one of the pioneers of lease funding through the sale of receivable streams in China. In the early days of its operations, most funding was provided by foreign banks, but as domestic interest rates declined the Company increasingly used Chinese banks for funding. Today the Company has several funding partners, both foreign and domestic, that it uses regularly.

  Large transactions are analyzed and structured on a case-by-case basis with the prospective funding bank. Smaller transactions are funded through a warehouse line of credit; the Company has developed a steady stream of lease transactions from the resellers of several internationally well-known manufacturers of information technology, printer, and telecommunications equipment.

Decision Process to Enter the Chinese Leasing Market

- **Drivers** – The Chinese government created the company in 1995 to provide lease financing for large-ticket assets. Today, the Company is privately owned and profit-driven; return on invested capital is in the range of 20%, according to the interviewee.

- **Decision Process** – The Ministry of Trade and Economic Cooperation (MOFTEC) created the Company because of the perceived need of lease financing in China; it was formed as a result of the Chinese government central planning process in effect at the time.

Experiences

- **Volumes** – The Company has provided lease financing of over US$1.5 billion since its inception. It expects to generate approximately US$300 million in lease originations in 2005. The vast majority of its leases are finance leases, since, according to the interviewee, "the business tax

makes it very difficult to make operating leases economically viable for lessees. Still, we do write a small number of operating leases each year on some of our large-ticket transactions."

- **Bad debt and delinquencies** – Bad debt has been "an acceptable level", according to the interviewee – in the range of 1.5% of assets. "We have been able to keep this level low because of the high degree of cooperation we have with our vendors and funding sources," he said. "We are viewed by our vendors and resellers as an important facilitator of sales, and by our banks as a generator of significant new business volumes each year, so they do not want to see us fail. When we encounter delinquency problems with lessees, both the bank and the vendor will intervene and work with the customer to resolve the situation."

  Bad debt levels are also kept low because most lessees are larger companies that are creditworthy. Many of the lessees are Chinese subsidiaries of large multinational corporations. An interesting note is that, while corporate guarantees are required on some transactions, most Chinese banks strongly prefer guarantees from the local subsidiary than from the (presumably) more creditworthy parent. "The banks know they can 'touch' the local company if there are problems," the interviewee pointed out. "Having to go to the headquarters of an American or European-owned firm, in a different country with different laws, to collect money is not something most Chinese banks want to do."

- **Personnel** – The Company recognizes that skilled leasing people are scarce in China, so they work hard to retain their staff, and have had good success. "First, we pay our people on a scale comparable to Chinese investment bankers, so financially-speaking they are not motivated to look elsewhere for work. Second, we train our people extensively, so their job satisfaction is strong. And third, there simply aren't a lot of other places for these people to take their skills. The leasing industry is not that big in China yet, so there is not as much poaching of skilled people as there is in other industries."

- **Other Considerations**

  - On raising funds: "Even though we were among the first to fund leases through receivable sales in China, we have never had problems raising funds. The banks were willing to lend to us from day one, because we were careful to generate business from well-established, creditworthy companies, and to finance only brand-name assets with strong international reputations. This was different from many other Chinese lessors, some of whom focused on the SMB space where creditworthiness is spotty at best."

- On flexibility: "Our average transaction size is approximately US$5 million, but we are proud of the fact that we can also accommodate small-ticket transactions easily…we will do deals as small as $5,000. We have to do this to stay competitive in the market."

- "We believe we have a significant advantage over most foreign lessors because of our knowledge of the local market. We understand how to collect money without resorting to the court system; we know our customers, and we have very strong relationships with our banks. We believe we can put a good deal together when many foreign lessors might walk away, simply because we know the customer better than they do."

- "We believe there is a huge opportunity for used equipment in China that is untapped. Recently, a major IT vendor posted a large quantity of used PCs on the Internet for sale, and they were completely sold out in just one day. The government recognizes that China will need to begin to make better use of used assets in the future as a means of slowing the high rate of new capital acquisition spending by manufacturers in the country. We think it is possible we may see some incentives for firms to deploy used equipment sometime soon, which would be good news for leasing companies."

International Bank-owned Lessor with No China Leasing Operations

Company Background

The Company is a wholly owned subsidiary of one of the world's largest banks. It has equipment leasing operations in Asia (including Australia), Europe, North America and South America, with managed assets in the multiple billions of dollars.

The Company provides a wide range of financial services, including equipment leases and loans, vendor programs, inventory financing, lines of credit and several other services.

Decision Process to Enter the Chinese Leasing Market

- **Drivers** – The major driver for establishing leasing operations in China is the need to support the Company's vendor partners. "Our focus is on the vendor," said the Company executive that was interviewed. "We have received many requests from both our European and our American vendors to offer equipment lease financing in China for their customers. We will do so, but we need to ensure that we will be able to offer the same high level of service that we offer in our other country vendor program operations."

- **Decision Process** – Before it establishes operations in any country, the Company performs extensive research on the market to determine the nature of the equipment leasing environment, the demand for leasing from its clients and from the market generally, all relevant tax/accounting/legal/licensing regulations and requirements, and then develops a business case. Approval ultimately must be obtained from the subsidiary's executive board before proceeding.

Experiences and Expectations

- **Efforts to date** – The Company has investigated the China leasing market for several years, but for a variety of reasons has not entered it – yet. "Up to this point there have been a number of issues that concern us," said the executive. "Like most western lessors, at the top of our list are the lack of available credit information, and the lack of a well-defined legal process to support lease enforcement and recovery of assets." The executive added that the Company recognized that these conditions "would never be perfect in China – or anywhere, for that matter – but they

have been significant-enough obstacles that we have chosen the 'go-slow' approach until now."

Another issue the Company has faced is operating structure. Three to four years ago, no WFOE licenses were available for foreign lessors in China, so on-the-ground operations required a relationship with a Chinese partner. "Frankly, we were surprised at the difficulty we encountered in finding a suitable partner," the executive said. "We have fairly stringent partner selection criteria, but the process took much longer than we thought it would. In the end, we did not find a partner that had the industry experience, contacts, financial strength and creditworthiness that we sought." The Company is now considering the establishment of a WFOE in China, and is not actively looking for a local partner.

The Company also was surprised at the length of time it takes to navigate the Chinese regulatory infrastructure. "We have established operations in many countries, and are familiar with government bureaucracy…but it still surprised us that even the simplest requests took an inordinate amount of time to get answered…and sometimes the answers weren't terribly clear, either."

- **Volume expectations** – As part of the decision process, the Company has modeled anticipated business volumes in China, and has assumed modest lease originations in the initial years. "We think it will take several years for lease penetration rates in our China vendor programs to approach what we have today in other countries," noted the executive, "but we plan to get them up to our current worldwide levels eventually. That is not dissimilar from start-up programs in other emerging-market countries."

- **Bad debt and delinquency expectations** – The Company, conservatively, plans on higher bad debt levels in China than in other countries – and probably higher than in other emerging markets in which the Company operates, at least initially. "We really won't know until we get there," said the executive. "We do have a track record for comparison purposes from some of our other emerging markets operations – and our experiences have been pretty good overall – but, in the end, each country is unique. For planning purposes we have chosen a conservative approach and assumed slightly higher levels of bad debt than in our other emerging markets."

- **Personnel** – When the Company establishes operations in a new country, normally it places an experienced expatriate Company veteran in charge of operations for the initial years. The executive commented, "We're aware the market for experienced local leasing personnel in China is quite tight. We need to get into the market first, though, before we begin the process

of hiring the local staff. We've done this before in other countries, and it's never easy. But it's a critical step that must be done right to ensure a successful operation."

- **Other Considerations**

    - On establishing operations in China: "For us, it's not a question of whether we enter China, but when and how. China is a market that has substantial potential for our vendors, and for us as well. Many of our vendors need to demonstrate to their clients that they are 'global', and for most of them that includes having a customer financing capability on-shore in China. It's a competitive advantage for many of them today; it will be a market requirement to be there in the not-too-distant future for global lessors."

    - On customer acceptance of leasing in China: "We have not been able to determine how well customers will accept a leasing product in China. Our vendors tell us that they are getting requests for leasing from their clients, and there are many Chinese and a limited number of foreign-controlled leasing companies already operating in the country, so we know there's demand there. I think it's the size of the demand that's the issue, rather than whether there is demand. The size of the demand will certainly play a factor in how rapidly we grow."

    - On his outlook for equipment leasing in China: "We think the potential is large. It is clear why there aren't more foreign lessors there today – for all the reasons I've stated previously – but things are changing. We're very encouraged by some of the regulatory changes in the last few years, particularly the emergence of a WFOE as an option for foreign lessors.

      "Some people think there is a tipping point for the leasing industry in China, a point after which the leasing volumes increase quickly and substantially…I've heard the 2008 Olympics mentioned as being that tipping point, and others have cited different events. I'm not sure it's going to play out that way. I think we'll continue to see the gradual evolution of the industry, more and more lease-friendly legislation being passed, and an increased acceptance of leasing by the country as a whole. But I'm convinced that this will become a very significant market for lessors, and we will be there in a big way."

Conclusion

Equipment leasing in China is alive, growing, and poised to become a major business opportunity for international lessors in the coming years. To be sure, China poses a number of significant risks that must be managed to be successful in the market. There also is much market development activity to be done before leasing is accepted as a mainstream financial product by Chinese businesses.

Significant factors that should be useful to lessors considering entering the Chinese market include:

> **The key driver for market entry, for most non-Chinese lessors studied, has been the need to support their existing customers.** China's rapid economic expansion has drawn many firms across a variety of industries to establish on-shore operations in China. These firms increasingly need financing solutions for their customers and themselves. It should not be assumed that a "build-it-and-they-will-come" approach will work in the Chinese leasing market, though. Foreign lessors without a customer-driven need for equipment leasing in China probably should not consider entering the market at this time.
>
> **There is no single, successful business model**. Leasing companies analyzed in this study include WFOEs, joint ventures, offshore and Chinese-owned onshore lessors, each of which is successful in its own way (although the subject of the WFOE case study in this paper is still in the early days of its existence). Partnerships with Chinese lessors can shorten the time to market and help lessors get assimilated into China more quickly, but it can be difficult to find a suitable partner – financial strength, control issues, cultural differences and a lengthy approval process often are obstacles. Based on past and current lessors' experiences, it appears that most western mid- and large-size lessors will view a WFOE license as their favored vehicle to enter the market.
>
> **Identifying and managing the risks of doing business in China is the critical factor to success, but the task should not be overwhelming.** Many prospective market entrants that were interviewed for this paper simply rolled their eyes when asked about the risks of doing business in China. "The risks are way too big for us to even consider going there," was a typical response.
>
> There is no question that the credit and legal environment in China is extremely challenging, the regulatory process is burdensome, and the tax system discourages operating leases. There also is no question that the environment is gradually improving, and that there are dozens of lessors already on the ground and doing business successfully.

Problems such as these are common in many countries, however, and are being successfully managed. They just need to be identified, quantified, and addressed through well-designed, closely monitored business processes. For example, many lessors view the lack of sufficient credit information as ample reason to avoid China, yet all the lessors interviewed indicated their loss experience in the country was about what they had expected and built into their pricing.

Other interviewees view the unclear recourse process as a showstopper, but the experience of in-country lessors is that they avoid going to court by conservative transaction structuring, carefully screening their lessees, and knowing their customers. Yes, these processes will result in lower leasing volumes initially, but as conditions in China change and lessors gain more experience, it is likely that volumes will gradually increase without an accompanying increase in bad debt. The key is for lessors to manage their risk-related processes effectively.

The lack of trained local personnel should be factored into the business plans. All lessors interviewed, both foreign and domestic, are acutely aware of the dearth of Chinese/English speaking leasing talent in China. Lessors entering the market should have a carefully vetted hiring plan, and be prepared to provide in-depth training to their local hires.

Leasing is still a new concept for many businesspeople in China. All foreign lessors interviewed commented on the surprisingly low level of understanding that business people, including vendors and resellers, have about leasing. This issue can be overcome with sufficient marketing and training, but lessors should not underestimate the effort involved.

The used equipment market is largely undeveloped, but could be a huge opportunity for certain assets. Anecdotal evidence from interviewees indicates that there may be a very large, as-yet-untapped market for used IT assets. If the government enacts incentives to promote the use of used equipment, the demand could rise quickly and lessors could be among the key beneficiaries. Other assets may face asset-specific barriers, such as a reluctance to buy used industrial equipment when consumers are unfamiliar with high quality equipment that does not fall apart after two years. Without tax or other government incentives, the used equipment market in China for most assets will continue to evolve slowly.

As a final note, lessors should plan on everything taking longer than anticipated in China. Both Chinese and foreign lessors have found, through painful experience, that tasks requiring government approval simply take a long time. Interviewees recounted stories of waiting several months just to get a simple document signed and approved. Equally frustrating is the lack of willingness of

many government officials to commit their opinions or rulings to writing. There is an old adage regarding vacations that suggests to “always bring twice the money you think you need.” The same concept as it applies to lessors entering the China market is – “always plan for twice the time you think you need.”

Appendix One
Current Chinese Lessors
(as of September 2005)

China Orient Leasing Co., Ltd.
Hua-He International Leasing Co., Ltd.
China Universal Leasing Co., Ltd.
China International Packaging Leasing Co., Ltd.
China International Non-Ferrous Metals Leasing Co., Ltd.
International Leasing Co., Ltd.
Pacific Leasing Corporation
United Leasing Co., Ltd.
China United International Leasing Co., Ltd.
North China International Leasing Co., Ltd.
Central China International Leasing Co., Ltd.
Ever Bright International Leasing Co., Ltd.
Industrial & Commercial International Leasing Co., Ltd.
Southwest International Leasing Co., Ltd.
China Kanfu International Leasing Co., Ltd.
Yellow River International Leasing Co.,Ltd.
Fujian International Leasing Co., Ltd.
Hua Tong Int'l Leasing Co., Ltd.
International Union Leasing Co., Ltd.
Nanjing International Leasing Co., Ltd.
South China International Leasing Co., Ltd.
Pec International Leasing Co., Ltd.
International Far Eastern Leasing Co., Ltd.
Chongqing Changjiang River Int'l Leasing Co., Ltd.
Da Ye International Leasing Co., Ltd.
Zhuhai Union Leasing Co., Ltd.
New Century Int'l Leasing Co., Ltd.
Xinhuawen International Leasing Co., Ltd.
Shanghai Gezhouba-NI Equipment Leasing Co., Ltd.
Cosmos Posts & Telecommunications Int'l Leasing Co., Ltd.
Xin De Telecom International Ventures Co., Ltd.
Hewlett-Packard Leasing Ltd.
New Court Leasing Co., Ltd.
IBM Leasing Co., Ltd.
Shanghai Teng Fa Engineering Construction Co., Ltd
Shanghai Hyster Forklift Ltd.

Appendix Two
Leasing Company Regulations

Leasing Companies Organized as Non-bank Financial Institutions

Licenses must be granted by CRBC, and the following criteria shall apply:

- Criteria for authorization to deal in China's financial services sector are solely prudential (i.e., contain no economic needs test or quantitative limits on licenses). Within five years after accession, any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses, shall be eliminated.

- Foreign financial institutions that have total assets of more than US $10 billion at the end of the year prior to filing the application are permitted to establish a subsidiary of a foreign bank or a foreign finance company in China.

- Foreign financial institutions that have total assets of more than US $20 billion at the end of the year prior to filing the application are permitted to establish a branch of a foreign bank in China.

- Foreign financial institutions that have total assets of more than US $10 billion at the end of the year prior to filing the application are permitted to establish a Chinese-foreign joint bank or a Chinese-foreign joint finance company in China.

- Qualifications for foreign financial institutions to engage in local currency business are as follows:

    - Three years business operation in China and being profitable for two consecutive years prior to the application, otherwise, none.
    - No less than US$1 billion of total assets of the foreign investor if investing in a Chinese non-bank financial institution;
    - Its long-term credit rating for the last two consecutive years assigned by the international rating agencies recognized by the CBRC shall be favorable;
    - It shall remain profitable for the last two consecutive fiscal years;
    - The ratio of its total capital to its total risk-weighted assets shall always be no less than 10 percent
    - It shall have in place sound internal controls;
    - Its home country (or region) shall have in place sound framework and systems for financial regulation and supervision;

  - o Its home country (or region) shall have a favorable economic environment;
  - o It shall satisfy other prudential requirements set out by the CBRC[39].
  - o the foreign investor may not acquire more than 20% of the financial institution equity[40].

- The minimum paid-in capital of a non-bank financial institution shall be Rmb200 million (approximately US$24 million)[41]. Therefore, this applies to financial leasing companies organized as non-bank financial institutions.

Leasing Companies organized as Foreign Invested Enterprises (FIEs)

Such foreign invested leasing companies must comply with the following requirements:

- Mode of investment and organizational form of the company
  - o Foreign investors can conduct general leasing business and finance leasing business in China by setting up wholly foreign-owned enterprises, Chinese-foreign equity joint venture companies or Chinese-foreign cooperative joint venture companies, which can be in the form of limited liability companies or companies limited by shares.
  - o Foreign-invested enterprises engaging in operating leasing are called "Foreign-invested Leasing Companies", while foreign-invested enterprises engaging in finance leasing business are called "Foreign-invested Finance Leasing Companies".

- Minimum capital requirement and other conditions
  - o The total asset value of the foreign investor who wishes to set up a Foreign-invested Leasing Company or a Foreign-invested Finance Leasing Company in China cannot be less than US$5,000,000.
  - o The registered capital of a Foreign-invested Leasing Company should comply with the requirements of the PRC Company Law (i.e., it should not be less than Rmb100,000), while the registered capital of a Foreign-invested Finance Leasing Company should not be less than US$10,000,000.
  - o The term of operation of Foreign-invested Leasing Companies and Foreign-invested Finance Leasing Companies (which are

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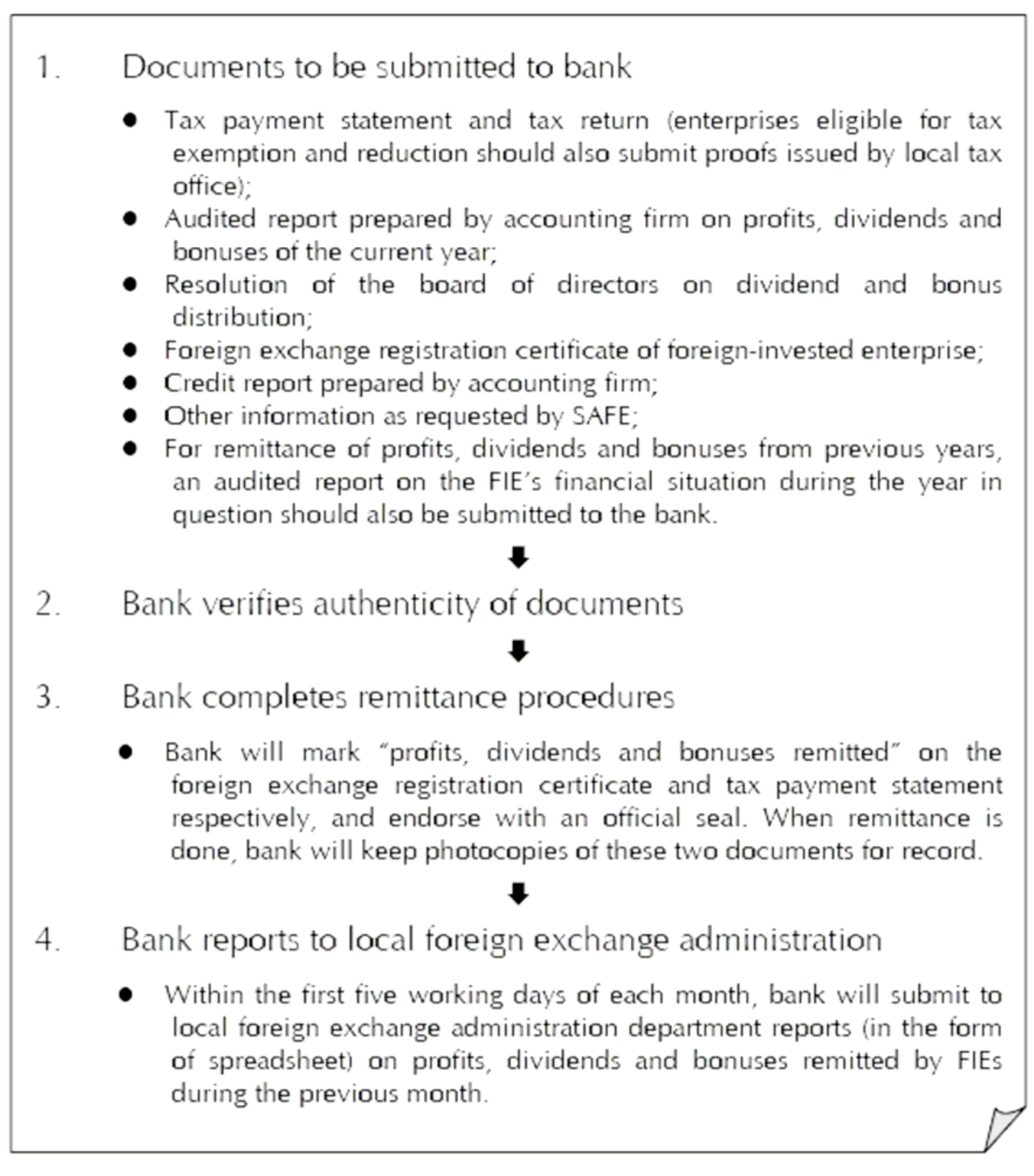
[39] Article 7, Order of China Banking Regulatory Commission (No. 6, 2003) promulgated on December 8, 2003.
[40] Article 8 ibidem.
[41] Decree 340 of December 20, 2001 promulgated by the State Council. Effective since February 1, 2002.

established in the form of a limited liability company) generally cannot exceed 30 years.

- Permitted scope of business
    - Foreign-invested Leasing Companies are allowed to engage in the following businesses:
        - Leasing business;
        - Purchase of leased assets inside and outside China;
        - Residual value disposal and maintenance of leased assets;
        - Other business as approved by the examination and approval authority.
    - Foreign-invested Finance Leasing Companies are allowed to engage in the following businesses:
        - Finance leasing business;
        - Leasing business;
        - Purchase of leased assets inside and outside China;
        - Residual value disposal and maintenance of leased assets;
        - Provision of advisory and guarantee services in respect of leasing transactions;
        - Other business as approved by the examination and approval authority.
        - The license is granted for 30 years.
    - Other leasing companies (those engaged in transactions regulated under Chapter 13 of the Unified Contract Law-UCL)[42], shall comply with the following minimum requirements:
        - Chinese partners must have assets of not less than Rmb$100 million at the closing of the preceding year;
        - Foreign partners must have total assets of not less than US$ 50 million at the closing of the preceding year[43];
        - The minimum paid in capital required is US$5 million (Chinese investors being minimum 20% stakeholders, until December 11, 2004);
        - The license shall be granted for 20 years;
        - Same requirements concerning the experience and skills of personnel and senior management of the company as set forth for financial leasing companies[44].

[42] In this aspect, Chinese Law follows the Civil Law principles, where form prevails over substance. Therefore, both companies can offer Finance Leases and Operating Leases under FASB 13 guidelines, but under the form of non-financial leases. This is similar to regulations in most of Latin America and Continental Europe.
[43] Article 8 of the MOFCOM Measures.
[44] Article 9 of the MOFCOM Measures.

Appendix Three
Paperwork Process for Repatriating Profits



1. Documents to be submitted to bank

- Tax payment statement and tax return (enterprises eligible for tax exemption and reduction should also submit proofs issued by local tax office);
- Audited report prepared by accounting firm on profits, dividends and bonuses of the current year;
- Resolution of the board of directors on dividend and bonus distribution;
- Foreign exchange registration certificate of foreign-invested enterprise;
- Credit report prepared by accounting firm;
- Other information as requested by SAFE;
- For remittance of profits, dividends and bonuses from previous years, an audited report on the FIE's financial situation during the year in question should also be submitted to the bank.

⬇

2. Bank verifies authenticity of documents

⬇

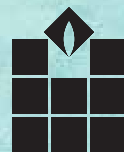
3. Bank completes remittance procedures

- Bank will mark "profits, dividends and bonuses remitted" on the foreign exchange registration certificate and tax payment statement respectively, and endorse with an official seal. When remittance is done, bank will keep photocopies of these two documents for record.

⬇

4. Bank reports to local foreign exchange administration

- Within the first five working days of each month, bank will submit to local foreign exchange administration department reports (in the form of spreadsheet) on profits, dividends and bonuses remitted by FIEs during the previous month.



Equipment Leasing & Finance Foundation

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