Cooperative Joint Ventures

Savvy foreign investors may wish to consider the benefits of this flexible investment structure

Paul H. Folta

Despite the attractiveness of China's business and foreign investment environment, the country is not an easy place to do business. Foreign businesses that seek to enter the China market must consider a wide range of strategies and business structures—each with its own advantages and disadvantages.

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Since China's World Trade Organization (WTO) entry and the PRC government's relaxation of investment regulations, foreign investors have been choosing to establish more wholly foreign-owned enterprises (WFOEs), which in the first three quarters of 2004 made up nearly 67 percent of the value of new foreign direct investment projects in China (see Table). WFOEs cannot be used in every sector, however, because the PRC government requires Chinese company participation or control in some sectors. In such cases, foreign companies must consider a joint venture structure. Even when they are not required, joint ventures can benefit foreign investors when a Chinese partner has certain strengths—such as central or local government support, brand reputation, land, licenses, distribution, and access to suppliers—that reduce start up costs and improve the foreign investor's chances of success (see p.20).

In China, most joint ventures are equity joint ventures (EJVs), though some investors establish cooperative (or contractual) joint ventures (CJVs). CJVs and EJVs are similar in many respects. The PRC government approval process, approval authorities, format of agreements, tax breaks, legal standing, and the means, laws, and authorities for dispute resolution are identical. The general management structure and governance procedures are also virtually the same.

But CJVs and EJVs differ in two important ways. First, unlike an EJV, a CJV does not need to be a separate legal person under PRC law. (A CJV that is not a separate legal person may benefit from lower costs, but also may expose the parties to greater liability than if they were legal

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China's Foreign Direct Investment (Utilized FDI)

	2000	2001	2002	2003	Jan.–Sept. 2004
Total FDI ($ billion)	40.7	46.9	52.7	53.5	48.7
Wholly foreign-owned enterprises (%)	46.9	50.3	60.2	62.4	66.8
Equity joint ventures (%)	35.8	34.7	28.4	28.6	26.9
Cooperative joint ventures (CJV, %)	15.9	12.9	9.6	7.2	5.2
Other (%)	1.4	2.1	1.8	1.8	1.1
Approved CJV Projects (No.)	1,755	1,589	1,595	1,547	996

Note: Other=Share-based enterprises with foreign investment; and cooperative development vehicles
Sources: PRC Ministry of Commerce, the US-China Business Council

persons, because CJVs with legal person status confer limited liability on parties to the joint venture.) Second, the CJV parties' profit, control, and risks are divided according to negotiated contract terms. In contrast, an EJV's profit, control, and risk are divided in proportion to the equity shares invested by the parties.

CJV disadvantages

As is true for any investment structure, CJVs have their drawbacks. First, since all CJV contract details need to be negotiated, establishing a CJV can be time consuming and expensive. Indeed, CJV negotiations can derail potential ventures as parties discover that they cannot reach agreement on every detail. Second, CJVs are sometimes not the most appropriate business structure for the project. For example, a Western automotive technology company recently signed a memorandum of understanding for a CJV with a Chinese state-owned enterprise (SOE) for the manufacture and sale of its patented system in China. The venture did not proceed, however, because the SOE ultimately determined that it preferred an EJV so that profit sharing ratios would match shareholdings and future changes in registered capital. In the end, the foreign company decided to form a WFOE, but planned to maintain and develop options to work with its Chinese partners in the future.

Why choose a CJV?

CJVs nevertheless can offer investors several advantages. Compared to EJVs, cooperative joint ventures

- **Allow access to restricted sectors**

In a CJV, Chinese partners can hold and "lend" assets and licenses that are forbidden to foreign investors under PRC law, or that are undesired by the foreign partner, until the venture terminates or foreign ownership rules are relaxed. Undesirable assets may include those with a high transfer tax, or those that are too complicated or costly for the foreign investor to obtain, such as land. For example, a Chinese company can "lend" its license to a CJV in a value-added telecom network (see p.22). A Chinese company would not be permitted to transfer such a license to an EJV because the license, if forbidden to foreign owners, would be considered part of the whole company's assets.

A CJV could also allow negotiated levels of management and financial control, as well as methods of recourse associated with equipment leases and service contracts; in an EJV, foreign investors cannot always obtain such control since EJVs typically rely on equity levels to assign board seats and key staff and to determine other rights.

- **Alleviate capital contribution difficulties**

The CJV's foreign partner can contribute or lease to the joint venture expensive Western technology and equipment, such as medical diagnos-

Cooperative Joint Venture Case Studies

The following cooperative joint venture (CJV) cases illustrate potentially useful strategies that may apply to companies in other industries.

Case 1: A Chinese Toll Road CJV

Typically, toll road projects in China involve construction and operation of roads that have been classified and approved for toll collection. The PRC government sees toll roads as a way to encourage foreign investment in the development of China's transportation infrastructure.

CJVs are almost always used for such investments because other investment structures cannot effectively address the financial risk to investors that contribute a large amount of cash. A CJV enables such investors to recoup their investment more quickly than other structures, since the parties can negotiate how and when profits are ultimately divided. Because toll roads are "build-operate-transfer" projects (the assets—the roads—will return to the government at the end of a project's life), foreign investors are concerned about how much time it will take to recoup the investment and focus on more than just the total investment return by the end of the project. Since the value of cash flows declines over time, most foreign investors measure investment returns by internal rate of return. Foreign investors typically negotiate to get more than a proportionate share of the cash relative to share capital in the early years. For example, a foreign investor could negotiate to receive up to 100 percent of the available cash for an initial period (perhaps the first 5 to 15 years). In the next 5 to 10 years, available cash could be split to match the parties' shareholding. In a final period, perhaps the last 5 to 10 years, the foreign party could receive a share in the available cash less than proportionate to its shareholding. All agreements and definition of rights should be carefully spelled out in the detailed CJV contract.

In many toll road CJVs, the foreign party owns the majority of share capital. Most toll road CJVs have two categories of investors: financial and local government affiliate. Financial investors may be foreign or local; for the sake of simplicity they are called "foreign investors" here. This side contributes most of the needed cash. The second category of partners, which usually includes a subsidiary of the local traffic bureau, contributes licenses, construction, and the workforce. This side, for simplicity's sake called "local investors" here, puts in assets but may also contribute cash.

In one example of a toll road CJV, a project included an expressway and a Class 2 road (a parallel or connecting road giving access to the expressway). Most of the cash was used to build the expressway, and a lesser portion was used to repair and upgrade the Class 2 road. The foreign party maintained management control by assigning 60 percent of board seats—matching its share capital. The foreign party appointed the general manager and the financial controller so that it would be on top of daily operations and in charge of the material fund flows. The CJV set up checks and balances to communicate among foreign parties, local parties, and authorities. The CJV, a legal person with limited liability, had a four-year construction period and has a 30-year life. The parties divide profits based on the schedule described above. All of this was written into the CJV contract.

In toll road projects, the CJV structure should not inhibit exit strategies. Some investors view toll road projects as being similar to a utility with a limited life. Others have a strategy to expand their projects by adding more roads and by focusing on projects within a region or on key city-to-city projects. Thus, a successful exit strategy in this sector has been to pool toll roads and package them into a holding company for listing on a public stock exchange.

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Case 2: A Chinese Gold Mining CJV

Today China is the world's fourth-largest gold producer. Growth in China's gold industry was driven by domestic demand and heavy government investment in the sector from the 1980s to the mid-1990s. With the deregulation of China's mining laws, the nation's World Trade Organization (WTO) entry in December 2001, and the official opening of the Shanghai Gold Exchange in October 2002, many observers believe the risk for foreign investment in this sector has fallen. Although a foreign investor registered in China as a representative office, equity joint venture (EJV), CJV (including a nonlegal person CJV), or a wholly foreign-owned enterprise (WFOE) may apply for an exploration license, the vast majority of foreign investments in this sector have been through CJVs.

Foreign companies set up CJVs in mining for many reasons. CJVs help counter government restrictions and can allow foreign investors to seek attractive financial returns and management control in exchange for taking risk and contributing capital. A CJV's flexibility can also help investors survive the high risk of failure in an individual mine because the partners can sign new contracts for new mines.

Companies also form CJVs in mining because no one can predict what will be extracted and because it is difficult to determine the value of an exploration and mining permit or mineral right—intangible assets that are usually owned by the state. Furthermore, intangible assets generally may not represent more than 35 percent of a project's registered capital. For potentially ore-rich areas, this might not grant enough shares for Chinese parties that do not wish to put up capital. Even though valuation methodologies for prospective mines exist, valuation could make the investment cost too high for foreigners who contribute most of the capital, want a significant return for their risk, and seek majority control of the project. The joint venture's Chinese partner is responsible for preventing the loss of state assets. If the exploration venture fails, rendering the exploration permit worthless, the foreign investor likely will return the exploration permit to the original Chinese owner so that there is no "loss of state assets" on paper. This is another reason why Chinese partners prefer the CJV structure.

In one example of a gold mining CJV, Victor Mining Ltd., a wholly owned subsidiary of SKN Resources Ltd. (SKN) of Canada, formed a CJV with a subsidiary company of the Henan Provincial Governmental Geological Bureau (HPGGB) in April 2004, to acquire a 70 percent effective equity interest in a high-grade silver and gold project in Henan. After initial exploration and contract revision, the contract was modified in summer 2004 to give SKN the right to acquire 77.5 percent of the silver and gold project. SKN will earn its stake by funding exploration and development and making cash payments over four years, with a first year minimum contribution of $750,000. HPGGB has a 22.5 percent

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Case 3: A "Smart Card" Wireless Security Technology CJV

E-Smart Technologies, Inc., a US company with wireless security technology for smart cards, signed a CJV agreement with two Chinese companies in early 2004. Under the agreement, the CJV would operate nationwide value-added networks made up of e-Smart's operating platform and its multi-application, secure ID and payment smart cards; market the system and technologies to the government and financial sectors; and maximize the technology's use in as many fields as possible.

One of the Chinese CJV partners is majority owned and controlled by an entity of the Ministry of Information Industry (MII); the other is made up of Chinese media and public relations personnel. E-Smart owns half of this joint venture (the maximum allowed by law for a value-added service venture), and the two PRC companies will own 30 percent and 20 percent, respectively. E-Smart will contribute roughly $3 million in capital to the CJV over time, after all required permits and licenses are issued. This $3 million will represent 100 percent of the CJV's registered capital, though the venture may be expanded. E-Smart will own the exclusive licenses to provide and operate the system and technologies in China, and it will receive 20 percent of the CJV's gross operating income. The Chinese parties will use their relationships with the authorities to obtain the needed licenses and approvals, participate in market promotion and negotiations with customers, address network infrastructure issues, and help obtain financing. The board and operating management team will be determined by the parties in consultation with each other.

According to e-Smart executives, specific telecom sector restrictions had nothing to do with using the CJV structure (see p.22). "The CJV gave us the flexibility required to deal with the constantly changing circumstances, regulations, and laws one must contend with when doing business in China," they said. The CJV contract's flexibility allowed the company to negotiate with its prospective partners without having to argue about valuation methods. The CJV form also allowed e-Smart to obtain the management rights it desired, and the company's tax advisors felt more comfortable with the CJV for overall international tax planning.

The CJV required a detailed agreement (as, generally, would an EJV) and, coupled with all of the ancillary agreements and a clear licensing agreement, e-Smart believed that this detail helped protect its technology. According to a company spokesperson,

"All of the agreements mentioned made it very clear that the technology was not being transferred and that the ownership remained in our hands alone....While the CJV is often more time-consuming and complex to negotiate in the beginning, it is this complexity that is its main benefit. You are forced to think through all of the possible problems that may occur in the future and deal with them up front. The result is a smoother relationship with your partner(s) and a good blueprint for the operation of the CJV."

—Paul H. Folta

interest based on its contribution of the mineral rights (exploration permits) covering the project. After SKN has earned its 77.5 percent interest, contributions to fund the exploration and development of the project will be made pro rata. The share capital of HPGGB, the Chinese property owner, may be diluted to no less than 10 percent if it elects not to make cash contributions.

An SKN representative explained that CJV structures are attractive for mining projects because the Chinese parties typically do not contribute working capital. To attract foreign investors, the Chinese side contributes the right to use, but not own, the property (all land in China is owned by the state). After 25 to 30 years the foreigners walk away.

An EJV structure is unsuitable in this sector because foreign investors usually require a share of the profit during that time period that is higher than their share of investment to compensate for their risk. Also, Chinese parties often seek a minimum carried interest. At the outset, it is unknown how much investment will be required to determine the prospects of a property. If the partners find nothing, then the joint venture must decide whether to invest in more exploration. Since further exploration could prove fruitless, the Chinese side typically would not want to invest cash to maintain its interest level. But if the mine is successful, then the Chinese side would want to be assured of a nondiluteable interest (such as the 10 percent carried interest in the silver and gold project). A CJV's flexibility can accommodate these divergent interests.

The CJV structure accommodates other contingencies as well. Often a mining project evolves in two stages. In the first stage the parties reach an agreement and form a CJV. The agreement usually contains a minimum expenditure requirement and an option to quit the project if the results are unsatisfactory and the expenditure requirement is met. But if the foreign investor quits, it will lose all rights (and liabilities).

China's foreign investment regulations require at least 15 percent of the project's registered capital to be contributed within three months after a business license is issued to the joint venture company governing the project. For example, if a project is given a $4 million total value, the Chinese side could contribute mineral rights negotiated at a value of $1 million for a 25 percent interest, and the foreign side could pledge to invest $3 million in cash for a 75 percent interest. The interest would be "earned-in" over an agreed period of time. In the second stage, the partners must decide—as exploration or mining proceeds—whether to make additional investments beyond the originally agreed amounts to achieve the project's goals. The Chinese and foreign parties may invest more at the same proportion, or one side can be diluted. Alternatively, the sides could agree to move the project to another property since many resources were invested to establish the company.

—Paul H. Folta

tic equipment. The CJV can then repay the foreign partner at an "advanced rate" from revenues before profit sharing. This strategy can be used in sectors in which the law caps foreign ownership and when the Chinese partner cannot afford to fund assets up front. Under an EJV ownership structure, such an arrangement is impractical or impossible unless the Chinese side can contribute the amount of cash or assets needed to fund its equity up to the minimum Chinese ownership level required.

- **Allow more foreign management control**

Foreign partners can often obtain the desired level of control by negotiating management, voting, and staffing rights into a CJV's articles of association. Because these rights do not have to be allocated according to equity stakes, the CJV again provides more flexibility than an EJV.

- **Reduce risk**

The CJV structure also tends to force partners to address rights and responsibilities in advance. The

The Ups and Downs of Telecom and Internet Joint Ventures

China's telecom and Internet sectors are slowly opening up to foreign direct investment, marking a shift from the uncertainty of and prohibitions against foreign investment in telecom projects in the 1990s.

In the early to mid-1990s, cooperative joint ventures (CJV) were the most common foreign investment structure in telecom. A format known as *Zhong-Zhong-Wai* (Chinese-Chinese-Foreign) was particularly popular. The Chinese partners in these projects were usually companies affiliated with China Unicom Ltd., a competitor to China Telecom, which was owned by the Ministry of Post and Telecommunications (MPT, now the Ministry of Information Industry [MII]). In these CJVs, the foreign parties often formed an offshore entity to lease equipment and provide consulting services through a CJV *(Zhong-Wai)* by using a revenue-sharing contract between the CJV's Chinese partner and the Chinese telecom operator, usually Unicom, *(Zhong-Zhong)*. The structure technically avoided equity "ownership" by the foreign party in a key asset—a license to access and operate services over the public switched network. The Chinese operator pledged use of the license to the CJV's Chinese partner. The CJV's Chinese partner thus acted in a role equivalent to a trustee. Throughout the 1990s, the legal status of such projects was at best uncertain. In the last half of the 1990s, China banned telecom joint ventures. Subsequently, a few Chinese telecom companies and their offshore investment vehicles successfully accessed capital through initial public offerings (IPOs). PRC rules that declared equity joint ventures (EJVs) the only form of foreign investment allowed in basic telecom and value-added services under China's WTO commitments took effect in January 2002.

The PRC government likely banned CJVs because they allowed foreign investors to negotiate disproportionate returns, management control, and protection of their technology when structuring deals with the financially weak Unicom. But after Unicom was placed under the powerful influence of MII, this was no longer a strong argument since, with more clout, Unicom and other Chinese telecom companies became better able to negotiate favorable terms for themselves.

Interestingly, in China's 2002 Catalogue Guiding Foreign Investment in Industry, telecom services were moved from the prohibited to the restricted category, and the catalogue does not specify the type of joint venture permitted. (As the *CBR* went to press in early December, China released another revision of the catalogue.)

Between 2002 and 2004, EJVs using "cooperative agreements" and a few CJVs were established, all providing Internet-related services. For example, AT&T Corp.'s "Unisiti" Shanghai Symphony Telecommunications EJV announcement in 2002 referred to "cooperation contracts" that were needed to access China's telecom network. (Though AT&T faced serious restrictions in equity, business scope, and geographic scope in the venture, AT&T and its Chinese partners have been able to achieve broader objectives through approved cooperative agreements.) In August 2004, American IDC Corp. and China Unioncom Digital Technology Co. formed an EJV with "cooperative contracts" to provide broadband Internet television technology to TV stations and other content providers across China. According to private equity investment groups that invested in or knew of other Internet projects, foreign investments in such projects in the past few years have structures similar to the *Zhong-Zhong-Wai* format, including one or more service agreements and equipment leasing arrangements. Some have been CJVs (see p.20).

Given the flexibility offered by separate commercial agreements that may accompany an EJV or CJV, the actual form of such joint ventures might not be of critical importance. Compared with IPOs, joint ventures can deliver more reliable funding to Chinese parties facing unpredictable stock markets and are not constrained by securities regulations designed to protect public shareholders. Arguably, CJV structures could provide greater comfort than EJVs to PRC authorities who might still be concerned about foreign direct equity ownership in traditionally sensitive "state assets," such as licensed carriers or software systems that access financial and personal data. Rather than complicate an EJV with too many side agreements, CJVs can offer more flexibility in foreign party financing, make it easier for foreign parties to recoup their investments, and give the foreign side the confidence—through practical mechanisms specified in the detailed CJV contract such as management controls—to contribute sensitive technology.

—*Paul H. Folta*

PRC government must approve all CJV investments to determine that the venture may legally engage in the specified business scope. Government approval of detailed CJV contracts has the added benefit of sanctioning the detailed agreements and deterring local partner noncompliance. Thus, CJV contracts commonly provide better recourse than EJV contracts if one partner fails to comply with agreements.

- **Are easier to terminate or modify**

Ending a CJV may be easier than ending an EJV—particularly if the partners held assets separately and clarified contingency dissolution terms in advance. In some sectors, when risk of failure in the development phase of a project is high, CJV contracts can be modified without terminating a partnership and forgoing investments and goodwill.

- **Resolve expense controversies**

If the CJV's foreign party finds it necessary to incur expenses that the Chinese party disapproves of, the expenses may be structured under a contract with the foreign party. For example, parties may be able to more easily resolve debates over the high cost of expatriates, whom the Chinese partner could consider unnecessary, by negotiating an acceptable cost in a service contract with the CJV.

- **Offer tax advantages**

Though CJVs and EJVs have the same tax advantages, CJVs offer some extra tax benefits. For instance, CJVs can sometimes appropriately avoid the asset transfer tax.

A CJV parties' profit, control, and risks are divided according to negotiated contract terms.

The future of CJVs

In a market economy with better laws and enforcement, the number of CJVs in China—in proportion to other investment vehicles—will continue to decline. But as long as SOEs and government entities want to do business, they will find ways to make EJVs and CJVs attractive investment options. Private Chinese entrepreneurs will increasingly see these vehicles only as temporary means to a different end—expansion without reliance on foreign equity partners. But since they too can benefit from foreign finance, technology, market access, and business know-how, some Chinese entrepreneurs may be willing to cut interesting and creative JV deals with foreign companies. 完