SOURCES OF CAPITAL FOR A SINO-FOREIGN EQUITY JOINT VENTURE: A CASE STUDY OF SHANGHAI GENERAL MOTORS CORPORATION

by

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Abstract

Sino-foreign equity joint ventures are firms created by contractual agreements between Chinese and non-Chinese companies. Structured like western-style corporations, these joint venture firms represent an important way for non-Chinese companies to make inroads into the emerging Chinese market. This study of the capital formation of the large joint venture Shanghai General Motors Corporation provides insight into current opportunities and risks facing new joint venture firms in China today. This paper highlights the role that the Chinese government plays in the capitalization of Sino-foreign joint venture firms.

I. Introduction

A joint venture is an agreement between separate firms to form an independent company through the contribution of resources from each participating firm. Joint venture firms are jointly owned and in many cases jointly operated by participating firms. Generally, joint venture firms have two dominant "parent" firms with ownership rights based on the initial proportion of investment made to the joint venture company by each parent firm. Sino-foreign joint ventures are joint venture firms located and registered in China that are jointly owned by at least one Chinese firm and one non-Chinese firm.
Joint venture firms are important because they are a primary vehicle for entry into some international markets. In certain countries like China and Russia, the economic and political climates are evolving so rapidly that local "know how" is a prerequisite to conducting successful business in these markets. The time and risk of making direct investments by setting up wholly-owned subsidiaries in these countries is much greater than those required to establish a joint venture company with an indigenous firm. Since these developing markets are potentially lucrative to successful new business ventures with "western" products and production techniques, the urgency to enter these markets in a timely fashion is great (Dutton 1998).

This paper articulates the sources of capital and the underlying relationship to new business prospects for a joint venture firm in China. This knowledge is useful in understanding both the opportunities and obstacles facing future joint venture efforts by foreign firms in China. Sources consulted include periodical publications, text books, U.S. government documents, and Internet resources. Substantial insights were gained from direct assistance from key leaders in the Shanghai General Motors Corporation (SGMC) joint venture firm, including the SGMC treasurer, Mr. Caijian Wu. All money values expressed in this paper are in U.S. dollars unless otherwise indicated.

II. Joint Venture Firms and the Chinese Automobile Market

<u>Sino-Foreign Equity Joint Ventures</u>

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The Fifth National People's Congress in July 1979 passed "The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures", commonly known as the Joint Venture Law. The promulgation of new regulations and updates to this law in 1983 and 1990 have addressed many concerns of foreign investors. The basic law defines the legal entity of an equity joint venture in China and spells out several conditions and features of this form of business:

- Joint ventures must be approved and registered by the Chinese government.
- Joint venture entities are subject to the jurisdiction and protection of Chinese law.
- Equity joint ventures take the form of a limited liability company.
- Parties to the joint venture are jointly responsible for investment, management, and share risks, gains, and losses.

Sino-foreign joint ventures are therefore bona fide Chinese companies with structures modeled after Western corporations (Ran, Brahn 1996).

The rapid and prolonged growth of the Chinese national economy has attracted the attention of thousands of non-Chinese firms world-wide anxious to sell their wares to the largest potential market on Earth. Over the past 19 years, the government of the Peoples Republic of China has allowed a gradual relaxation of strict rules governing business ownership, international trade, and capitalization. The congruence of growth and reform has led to careful scrutiny of the Chinese business environment by firms hoping to be on the front line of development of what could grow to be the world's largest economy (Leonard 1997). Many firms have determined that the establishment of an equity joint venture in China is the best balance of opportunity and risk compared to the limited opportunities associated with exporting goods to China, or the extensive commitment of developing wholly-owned subsidiaries. Equity joint ventures provide an ideal middle road solution to the market entry question (Tomlinson 1998).

The Chinese Joint Venture Law establishes guidelines for both cooperative and equity joint ventures. Cooperative joint ventures are the first tier of business organization for parties cooperating in a for-profit enterprise, while equity joint ventures reflect a higher degree of organizational formalization. Equity joint ventures are differentiated from cooperative joint ventures based on the contribution of capital by a foreign party to the equity joint venture firm. Additionally, many other features in a cooperative joint venture that are contractually determined (structure, liability, management, longevity of agreement) are codified in law for an equity joint venture (Ran, Brahn 1997).

Shanghai General Motors Corporation

Shanghai General Motors Corporation is one of the largest joint venture projects yet undertaken in China. This link between the Shanghai Automotive Industrial Corporation and the world's largest company, General Motors, is designed to advance the long-term missions of both firms. The Shanghai Automobile Industrial Corporation (SAIC) is in need of design and manufacturing expertise to adequately serve new customers in the Chinese and Asian marketplace. General Motors Corporation needs a presence in China to accomplish its long-term goal of being a dominant automobile manufacturer around the globe. Together, these companies have formed Shanghai General Motors Corporation (SGMC) to make engines, transmissions, and cars patterned after Buick sedans currently designed and built in North America. SGMC was founded on the belief that the market for relatively large and upscale sedans will steadily increase as the Chinese economy continues its pattern of growth.

It should be noted that SGMC is not a typical Sino-foreign joint venture. It's immense size (approximately $1.5 billion total capital) and the clout of the General Motors name have provided opportunities and benefits to SGMC that would not normally be available to smaller organizations. The amount of capital that has been committed to SGMC by all financiers in light of the financial turmoil in Asia would not have been possible without high-level prodding by GM officials. The high visibility of SGMC has also been a factor atypical of most Sino-foreign firms.

The Automobile Market in China

China has indicated that automotive manufacturing is one of six key "strategic industries" that will be the engines for technology growth in the manufacturing sector (Clark 1997). Expansion of this industry in China through strong domestic and export growth is attractive for several reasons, but SGMC is now focused on the domestic market as production readiness nears early in 1999. Because of a weak Asian market, strong export demand for SGMC's relatively large sedan products is not anticipated in the short run. The congruence of the Chinese government's current interest in stimulating domestic consumption and the very poor economic condition of China's major Asian trading partners drives current attention to the domestic market.

The domestic market, however, has several deficiencies according to recent analysis. Domestic automobile manufacturing capacity has been estimated to be more than double current demand (Hanes 1998). Volkswagon and its joint venture partners, which currently control more than 50 percent of the sedan market, have cut their sales growth targets for 1998. VW's Martin Posth, who pioneered joint venture automobile manufacturing in China 15 years ago, asserts that the total cost of automobile ownership in China is so high that auto sales will stay below projections for years to come. Posth says that in ordinary income terms, a Chinese citizen must work 230 years to afford a car. Combining retail price, license, and more than 20 individual taxes, Posth estimates putting a car on the road in China costs around US$200,000 (Clark 1997). Restrictions on the issuance of license plates reflect the central government's concerns that increased auto traffic could overload existing infrastructure. New government rules bar lower-level Chinese government officials from buying "large displacement" sedans like the SGMC models. This myriad of obstacles in the automobile market in China has caused a drop in auto prices of more than 20 percent in the last two years (Hanes 1998).

This is not to say that the Chinese automobile market is moribund. Long-range projections continue to show growth in automobile ownership and use in China, and recent major infrastructure projects should help ease concerns about inadequate roads and bridges (Smith 1998). The growing middle class in China should continue to see gains in income and standard of living, especially if the regional export market rebounds. Furthermore, General Motors corporation in September 1998 reaffirmed its commitment to compete in the global auto business by reorganizing world-wide operations under a single leadership structure. "Waiting out" the financial malaise and preparing for eventual growth in the Chinese auto market is GM's strategy to maximize the opportunity of being the largest automotive joint venture project in Chinese history.

Current Joint Venture Environment

The current market environment for joint venture firms in China is less positive than in previous years. According to the Chinese Ministry of Finance, 61% of nearly 56,000 foreign invested companies lost money in 1997. The dollar value of accumulated losses by joint venture firms increased 50 percent from 1996 to 1997. During this same time period, foreign investment commitments decreased 35 percent, and government approvals for joint venture initiations decreased 56 percent. Actual paid investment still increased 8.3 percent in 1997, but this increase is a marked reduction from government expectations. Auto firms are experiencing both growth and divestment; in recent years France-based Peugeot Citroen and U.S.-based Chrysler have left the market, while global veterans Ford and Honda have entered. Overall, joint venture firms in China face a uncertain futures as the Chinese economy moves ahead in uncharted waters (Hanes 1998).

III. Capital

Role of the Chinese Government in Capital Projects

Economic activity in the last half of 1998 illustrates the behavior of the government relating to efforts to accomplish long-term economic goals. According to the Wall Street Journal, in 1998 the central government instituted a huge public fixed-asset investment plan designed to stimulate local economic growth and arrest the conspicuous decrease in GDP growth rate. Influencing the economy through active government intervention is the current policy of the governing communist party (Smith 1998).

Generally, policy makers in Beijing have worked for years to control GDP growth while simultaneously moving toward limited "deregulation" of key components of the People's Bank of China and related state-run financial institutions (Ran, Brauhn 1996). The GDP growth rate has been steadily falling since 1992 (from 14 percent in 1992 to nine percent in 1997). Retail prices are showing deflationary trends, and the export trade balance has decreased from the 1997 level. Current manufacturer's inventories are high; production capacity is idle, and debt problems are rampant in Chinese state-owned factories. Some blame for these conditions can be placed on the financial crisis of major regional trading partners, resulting in severe price competition for manufactured goods in the international market. Faltering and uncompetetive state-owned enterprises also contribute to the problem (Tomlinson 1998).

China's economic "liberalization" plans retain large roles for the central government in the establishment of macro-economic policy. The key goal of the ruling Communist Party is to keep growth strong and sustained for an indefinite period. Large scale unemployment and falling incomes could trigger political unrest and social instability. China's chief economic engineer, Premier Zhu Rongji, has indicated his commitment to execute a national "soft landing" from the overheating economy of previous years, and from the turmoil of the Asian financial crisis.

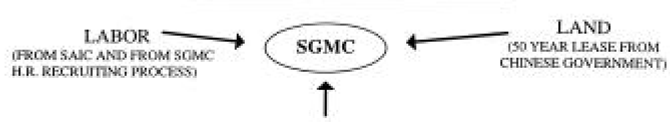
One key tool used by government economic planners is a capital budget schedule for industrial and infrastructure development. Firms planning capital projects in China must apply for approval before commencing capital projects. Domestic and foreign-invested firms have limited flexibility in determining their own capital projects and their sources for capital via domestic and international banks. Foreign invested firms are generally encouraged to seek expansion capital in the international market. Control of capital spending and the effective rationing of domestic capital allow for significant government influence over regional and national economic growth patterns.

Capital Sources for Shanghai General Motors

Capital requirements for starting up an automobile manufacturing system are high. The SGMC project involved new facilities for manufacturing engines, transmissions, and vehicles, and each of these facilities is complex and expensive. Capital expenditures for fixed equipment, automation, and local infrastructure for this project exceeded $1 billion. Since land cannot be purchased by firms in China, land requirements for SGMC were satisfied via a land use grant from the Chinese government for a period of 50 years. Labor acquisition was originally through the SAIC organization, but is now managed by a SGMC human resource hiring team that emphasizes personal behavior characteristics over specific job skills. Figure 1 illustrates the basic resource flow diagram for the startup of SGMC.

Inflows for the capital portion of the resource flow are illustrated in Figure 2.Total capital inflows come from two primary sources: joint venture partners and banks. Capital initially put forward by the key stakeholders in Sino-foreign joint ventures is referred to as registered capital, and this capital both validates the application and approval process for joint venture operations, as well as defines initial ownership rights between the partners.

FIGURE 1 - RESOURCES OF THE FIRM



Registered capital for SGMC totaled $700 million from the primary stakeholders General Motors and Shanghai Automotive Industrial Corporation. A description of each source of funds in summarized below:

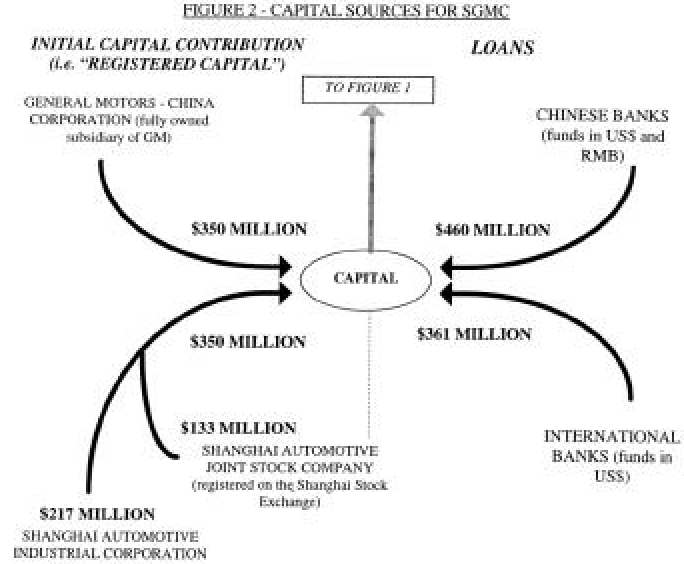
General Motors:

$350 million dollars was contributed to SGMC by the General Motors-China, Inc. corporation. GM-China is a wholly-owned subsidiary of General Motors Corporation, and is a registered U.S. corporation in Delaware. GM-China functions as a link between SGMC and the parent corporation General Motors, Inc.

Shanghai Automotive Industrial Corporation:

The equivalent of $350 million was contributed to SGMC through SAIC. These funds came from two sources: SAIC and the Shanghai Automotive Joint Stock Company (SAJSC). SAIC directly contributed the equivalent of $217 million (62 percent of the SAIC total) , while Shanghai Automotive Joint Stock Company contributed the equivalent of $133 million (38 percent of the SAIC total). The SAJSC is listed on the Shanghai Stock Exchange, and SAJSC shares are traded in the Chinese stock market. The Shanghai Automotive Joint Stock Company is a subsidiary of the SAIC, but is partially "publicly owned" via stock sales. Since stock market listing of Chinese firms with partial foreign ownership is very difficult, this source of capital funds is not currently available for SGMC.

FIGURE 2 - CAPITAL SOURCES FOR SGMC



Joint venture firms require the approval of the central government via an application process called "registration". Registration of the joint venture firm and the initial capital provided by key stakeholders is the first step in the establishment of a functional operation. In the case of SGMC, considerably more capital would be required beyond the initial $700 million contribution to buy machinery and equipment. For additional needs, SGMC in conjunction with GM headquarters in the U.S., Chinese banking officials in Shanghai, and key GM financial partners around the globe assembled a $821 million bank loan package to help launch the SGMC product. Key information regarding this loan package is summarized below:

- 39 Chinese and foreign banks are involved in the loan package for SGMC.
- The equivalent of $460 million (56% of bank loan total) was contributed by Chinese banks in denominations of US$ and renimbi (RMB).
- $361 million (44% of bank loan total) was contributed by international banks operating in Shanghai, Hong Kong, and abroad.

It should be noted here that the scale, scope, and visibility of this major joint venture project make the capital procurement for SGMC somewhat anomalous. Several factors contributed to the success of the capital arrangements with the 39 bank consortium, and these include the size of General Motors Corporation and the leverage applied by GM's Treasury offices to major banking partners like Citicorp, Chase, BankAmerica, Deutsche Bank and others. The severe economic turmoil in the Asian region worked against the culmination of the bank loan package, but the combination of size, leverage, and political visibility ultimately prevailed.

Currently, opportunities to raise non-bank capital are limited for foreign-funded firms in China. The use of bonds to raise additional debt capital is restricted by complex government approval requirements, and is essentially limited to state-owned enterprises. The use of equity capital instruments like stock is similarly limited to companies that are licensed to trade on the Shanghai Stock Exchange, and approval for this type of license is effectively limited to Chinese-owned firms.
Generally, long-term loans for Sino-foreign joint venture firms come from the international banks conducting business in Shanghai or Hong Kong. Working capital loans are typically managed through a combination of domestic and international banks. The emphasis of having foreign companies seek foreign capital sources serves two purposes: 1) preserving limited local capital resources for indigenous firms, and 2) increasing the inflow of foreign capital into the Chinese economy. The web of central and local government approvals and licenses effectively supercede the market allocation of capital resources regarding local versus international sources. The size and clout of SGMC overcame some of these bureaucratic obstacles, which explains the unique mix of domestic and international capital sources for the initial long term capital loan.

Capital Risk in China

Capital allocation in the U.S. is driven by the relationship between the demand for capital at certain risk levels and the related supply of capital for these projects. Capital allocation is different (and changing) in China because of controlled approval for capital spending initiatives, and because of imperfect information that exists in this developing market. The development and application of risk premiums to various categories of debt capital are difficult because of the lack of highly developed risk models and historical experience, and because of the large influence of government regulation on potential project cash flows (Chang 1998). The rapid evolution of financial rules and policies in China add new dimensions to risk analysis versus firms in Western countries (Lardy 1996).

Chinese banks obviously rely less on empirical risk knowledge than do large-scale international banks. Typically, domestic Chinese banks require collateral or some type of third party guarantee before providing capital loans, whereas international banks can assess risk based on business case analysis and other factors. However, the incomplete and imperfect information in the Chinese capital marketplace has had a damping influence on both domestic and international sources of capital, and this influence must be tempered by careful analysis of both the source and application of capital for projects by joint venture firms (Euromoney Magazine 1997).

Risks and Rewards

All indications are that the SGMC joint venture has major components of moderate to high risk coupled with the potential for high return. The sheer size of the operation and its related impact on the industrial environment make the stakes for success of SGMC unusually high for a Sino-foreign manufacturing joint venture. Weakness in the current Chinese domestic and local Asia auto market, as well as regional excess capacity lower the short-term prospects of product market success. Infrastructure shortcomings, tax consequences, and consumer credit availability add risk to this ambitious project to introduce a new vehicle to China (Hanes 1998).

However, the clout of the partners involved and visibility of the project support optimism regarding the progress of the SGMC through 1998. General Motors has used its size to negotiate an acceptable debt finance package that raises necessary capital without over-extending any one institution, thereby reducing the loan risk to all stakeholders. And when the inevitable rebound in regional economies increases the demand for luxury cars, SGMC may be well positioned to leverage location and experience in satisfying regional demand.

The capital procurement for SGMC reflects the state of the business today in China. As economic liberalization moves forward, new opportunities for foreign firms develop as the Chinese market becomes assessable to foreign manufacturers and service providers. The government's goal is to use this enthusiasm and know-how to elevate the state of Chinese industry to fuel GDP growth through domestic consumption and export growth.

A traditional economic model balancing supply and demand with perfect information available does not explain capital allocation in China. Rather, capital allocation is a powerful government tool to tailor industrial investment and overall economic performance of the country (Leonard 1997). Although banks and foreign firms are allowed, and in many cases encouraged, to put capital funds into productive enterprises, the final cash flow streams and profit-taking opportunities are highly influenced (if not controlled) by government finance and taxation authorities (Mufson 1997). As an example, removal of operating profits earned in domestic currency requires government approval for conversion to an international "hard" currency. It is clear that profitable business activity in China requires government support, because the central government. maintains final control of capital resources and conversion of Chinese funds.

IV. Conclusion

SGMC is a massive undertaking in a relatively uncertain market. The fact that the project has been fully funded is a testimony to the individuals who have persevered to make the project a reality, and to market reforms in China that allow a much more market-oriented business environment. Success of SGMC may have a large impact on new businesses and government rule-makers who must guide China's transition from a state-planned economy into a capitalistic/socialistic structure.

A major factor in the business risk of SGMC is the behavior the Chinese government. Since the government can either encourage or dissuade the consumption of the company's products, the success of the enterprise is dependent upon the support of the government. In the same way, the capital sources for SGMC must effectively satisfy government expectations, or the operation of the company will be impossible. The lesson here is that a focus on the market is only one aspect of doing business in China today. A keen awareness of the total business environment, which includes major roles of the central government, is required to generate real returns on capital investments in China.

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