To WFOE or not to WFOE, that’s the China Question:
Can one go it alone in China?

Wilfried Vanhonacker

Series No. MKTG 96.087
December, 1996
To WFOE or not to WFOE, that’s the China Question:
Can one go it alone in China?

by

Wilfried R. Vanhonacker *

Revised December, 1996

* Professor of Marketing, INSEAD (France) and HKUST (Hong Kong). Helpful comments on an earlier draft were provided by Jan Borgenjon (InterChina, Beijing) and Brian Porter (ABB, Zurich). An article based on this paper will appear in the Harvard Business Review in 1997.
To WFOE or not to WFOE, that's the China Question
Can one go it alone in China?

ABSTRACT

Equity joint ventures (EJVs) have been the dominant foreign direct investment mode to enter China. With the approval climate improving, the number of wholly foreign-owned enterprises (WFOEs) has been increasing in the last couple of years. This paper investigates in some depth the question of whether WFOEs are a realistic alternative to EJVs. The discussion focuses on strategic, legal, political, as well as operational issues and concerns.

Key Words: Equity Joint Ventures; Wholly Foreign-Owned Enterprises; Entry Mode; China.
Introduction

China's economic development since Deng Xiaoping put the country on the reform path in 1979 has received substantial attention in the popular press and academic literature. With one of the world's largest untapped markets opening up, the international corporate community has been contemplating, and in many cases actively pursuing, business investments and opportunities in the Middle Kingdom. Foreign direct investment, still predominantly coming from overseas Chinese, has been steadily increasing (over 300 billion US$ contracted by 1995) and has become an important financial pillar of China's industrial and economic transformation.

The predominant legal mode of entry for foreign direct investors has been joint ventures, primarily equity joint ventures (EJVs). In 1994, of a total of 47,549 foreign direct investment projects approved (with a contracted value of over 82 billion US$), about 59% were EJVs relative to 14% contractual joint ventures (CJVs) and 27% wholly foreign-owned enterprises (WFOEs). With the dominant joint venture mode, international companies continue to search all over China for partners. Some China watchers have argued that the JV paradigm is so strong that the search is often motivated by finding a partner instead of a good partner.

Within the JV paradigm, a lot has been written on happy and not so happy experiences; the "same bed, different dreams" problem has become a central focus of the China experience often ignoring the fact that JVs are short-term partnerships difficult to control and manage anywhere. Indeed, outside China, JV partnerships are typically short-lived and healthy partnerships surviving the "seven year itch" are the exception rather than the rule particularly in rapidly changing environments. The latter certainly describes China's environment where, after three decades of virtual isolation, the country has embarked on an aggressive drive to become an industrial and economic superpower early in the next century. In this context, it is no surprise that the dreams of JV partners have been diverging (and continue to do so).

With unhappy experiences accumulating and with the increasing realization that partnerships are difficult to dissolve in a social and political context where personal relationships are paramount, more and more companies are wondering whether or not the JV mode is the best and only way to enter China. Even within the JV mode, changing partnering strategies and
increased equity participating signal an attempt to get more management control over the partnerships. To some extent, such control can be achieved within an EJV structure. However, recent attempts to do so through increased equity stakes in a number of highly visible EJVs (e.g., China Schindler Elevator, where Schindler's equity share was raised from 15% to 60.33%; Shougang NEC Electronics, NEC's flagship investment in China and one of Deng Xiaoping's pet projects, where NEC raised its equity share from 40% to 51%) has raised concerns about "economic sovereignty" and has put the issue (and foreign direct investment in general) on the political agenda in Beijing.

With the current political attention on the Chinese side and the desire to increase management control (on the foreign side), the question arises whether a wholly foreign-owned enterprise (WFOE) is a realistic and practical alternative to invest in China and under what conditions. Although some literature exists on the legal and regulatory aspects of this question, there is no comprehensive overview of all the relevant dimensions (strategic, legal, political, and operational) which need to be considered in deciding between the JV mode and the WFOE mode for a foreign direct investment project in China today. The objective of this paper is to provide such an overview.

Foreign Direct Investment

Table 1 gives a quick overview of foreign direct investment in China over the last sixteen years. By 1995, a total of 304 billion US$ had been contracted for between Chinese and foreign parties, while an actual 94 billion US$ had been utilized. About 83% of the total had been contracted for during the last three years (92 - '94), with 75% of the utilized total invested during that period. The average contracted value has been edging up since 1990 reaching 1.774 million US$ in 1994. As has been documented extensively elsewhere, a large proportion of the investment comes from overseas Chinese (more than 75% in '92 - '93 from Hong Kong and Taiwan alone) and ends up in the coastal provinces (about 80% in 1993 going into coastal provinces with 30% going into Guangdong alone); there is however a slight trend towards increased investment in inland provinces (20% in 1993 relative to 7.5% in 1992).

Table 1 also indicates the breakdown over the three common investment modes: equity joint ventures (EJVs), contractual joint ventures (CJVs), and wholly foreign-owned enterprises
(WFOEs). Equity JVs are joint ventures where both foreign and Chinese partner(s) take an equity stake; they are separate entities with Chinese legal person status and the equity interests determine the risk, profit, and liability share of each partner. Contractual JVs (sometimes called Co-operative JVs) are strictly partnerships with each party jointly and severally liable for its operations; CJVs do not have a separate legal identity although hybrid CJVs exist which, like EJVs, have legal person status. In contrast to EJVs, the capital contribution ratio of the parties does not necessarily determine risk, tax, and profit sharing; the latter are determined as specified in the JV contract. Few pure CJVs are now approved as they are basically limited to hotel projects and resource development projects. Hybrid CJVs are more prevalent; until the CJV implementing regulations were promulgated in September 1995 (Halasz and Lan 1996), Chinese officials commonly applied EJV laws to CJVs. However, as the implementing regulations are likely to streamline the CJV approval process, because of sketchy documented precedents and limited legislative history, interpretation is likely to still be influenced by the EJV regime.

The WFOE has the distinctive characteristic that no Chinese partner is involved; 100% of the equity is owned by one or more foreign partners. In contrast to CJVs, but similar to EJVs, they have legal person status in China. In some industries such as services (retail, wholesale, financial, etc.), WFOEs are currently prohibited. Apart from the service sectors, they are generally allowed and approved in the manufacturing and industrial sectors where EJVs are allowed to operate. These sectors are broadly: manufacturing of machinery, instruments and equipment; electronics and computer industries; communications equipment; light industries; textiles; foodstuffs; and packing industries. With the ongoing liberalization of China's foreign direct investment climate, more sectors are likely to open up. In recent years, quite a few foreign companies have set up holding companies under China's WFOE law (technically, holding companies can be set up under either EJV or WFOE laws).
<table>
<thead>
<tr>
<th>Year</th>
<th>Number of FIE Contracts Approved</th>
<th>Contracted Value of Foreign Investment in FIEs ($ million)</th>
<th>Value of Utilized Foreign Investment In FIEs ($ million)</th>
<th>Average Contracted Value of Foreign Investment per Project ($ million)</th>
<th>Share of Equity Joint Ventures of Total Number of FIE Contracts Approved (Share of Total Contracted Value of Foreign Investment In %)</th>
<th>Share of Contractual Joint Ventures of Total Number of FIE Contracts Approved (Share of Total Contracted Value of Foreign Investment In %)</th>
<th>Share of Wholly Foreign-Owned Enterprises of Total Number of FIE Contracts Approved (Share of Total Contracted Value of Foreign Investment In %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>47,549</td>
<td>82,680</td>
<td>33,767</td>
<td>1.74</td>
<td>58.7 (49.2)</td>
<td>14.0 (24.9)</td>
<td>27.4 (26.9)</td>
</tr>
<tr>
<td>1993</td>
<td>83,265</td>
<td>110,852</td>
<td>25,759</td>
<td>1.33</td>
<td>64.7 (50.3)</td>
<td>12.5 (22.9)</td>
<td>22.7 (27.9)</td>
</tr>
<tr>
<td>1992</td>
<td>48,764</td>
<td>58,124</td>
<td>11,008</td>
<td>1.19</td>
<td>70.4 (50.1)</td>
<td>11.7 (22.9)</td>
<td>17.8 (27.0)</td>
</tr>
<tr>
<td>1991</td>
<td>12,978</td>
<td>11,977</td>
<td>4,200</td>
<td>0.92</td>
<td>64.7 (50.8)</td>
<td>13.8 (18.6)</td>
<td>21.5 (30.6)</td>
</tr>
<tr>
<td>1990</td>
<td>7,273</td>
<td>6,596</td>
<td>3,487</td>
<td>0.91</td>
<td>56.2 (41.0)</td>
<td>18.2 (22.0)</td>
<td>25.6 (37.1)</td>
</tr>
<tr>
<td>1989</td>
<td>5,779</td>
<td>5,600</td>
<td>3,393</td>
<td>0.97</td>
<td>63.3 (47.5)</td>
<td>20.6 (23.0)</td>
<td>16.1 (29.5)</td>
</tr>
<tr>
<td>1988</td>
<td>5,945</td>
<td>5,297</td>
<td>3,194</td>
<td>0.89</td>
<td>65.7 (59.0)</td>
<td>27.4 (31.9)</td>
<td>6.9 (9.1)</td>
</tr>
<tr>
<td>1987</td>
<td>2,233</td>
<td>3,708</td>
<td>2,314</td>
<td>1.66</td>
<td>62.5 (52.6)</td>
<td>35.5 (34.7)</td>
<td>2.1 (12.7)</td>
</tr>
<tr>
<td>1986</td>
<td>1,498</td>
<td>2,834</td>
<td>1,874</td>
<td>1.89</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1985</td>
<td>3,073</td>
<td>5,932</td>
<td>1,661</td>
<td>1.93</td>
<td>45.9 (34.2)</td>
<td>-</td>
<td>1.5 (0.8)</td>
</tr>
<tr>
<td>1984</td>
<td>1,856</td>
<td>2,651</td>
<td>1,258</td>
<td>1.43</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1983</td>
<td>470</td>
<td>1,732</td>
<td>636</td>
<td>3.69</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>79 - 82</td>
<td>922</td>
<td>6,010</td>
<td>1,166</td>
<td>6.52</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>221,605</td>
<td>303,993</td>
<td>93,717</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

With respect to the breakdown of the foreign direct investment in Table 1, the majority of projects remain EJVs: 59% of the number of contracts in 1994 with 49% of the contracted value. WFOEs account for over 27% of the number of contracts with 27% of the contracted value; hence, the average contracted value of WFOEs is larger than EJVs. This pattern is somewhat consistent with Pan and Vanhonacker (1994) who found that the foreign equity shares in EJVs are typically larger when the registered capital (and, hence, the size of the investment) is larger. Hence, there seems to be an indication that foreign partners are looking for larger equity when larger capital investments are involved. One can obviously not extrapolate this trend directly to WFOEs and argue that large projects (large in terms of equity investment) are likely to be WFOEs; at this point in time, most WFOEs are trial projects although some sizable WFOEs have been approved recently (in Tianjin’s Economic Development Area, there are two: Motorola - Telecom equipment - with an investment of over 200 million US$, and Novo Nordisk - biotechnology - with an investment of over 100 million US$).

As the average contracted value goes up (as we see in the last couple of years in Table 1), the number of WFOEs does increase (from 18% of the contracts in 1992 to 27% of the contracts in 1994), a trend which is likely to continue. Furthermore, and although not evident from Table 1, as the % of EJV contracts declines (over 70% of the contracts in 1992 to 59% of the contracts in 1994), the number of EJVs with foreign majority equity stakes has been increasing (Pan and Vanhonacker 1994). As equity stake (and, hence, representation on the board) is one way to exercise control over a JV partnership (Geringer and Hebert 1989), one could interpret the increase in number of WFOEs and in foreign equity stakes in EJVs as exemplifying a desire by foreign partners to gain increased control over their China operations.

With a more positive climate for WFOEs, the increase in their number is relatively recent and their average equity investments are limited (as exemplified by the fact that their value share has not changed - remained around 27% - despite a significant increase in number); although some are holding companies (over 40 had been established by the end of 1993), the numbers suggest a careful “testing of the waters” for a relatively new investment mode. Table 2 indicates that in Shanghai in 1995 almost one third of all approved FIE contracts
Table 2

Trends in Foreign Direct Investment in Shanghai

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of FIE Contracts Approved</th>
<th>JVs</th>
<th>Number</th>
<th>% of Total</th>
<th>% Increase Over Previous Year</th>
<th>Number</th>
<th>% of Total</th>
<th>% Increase Over Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>365</td>
<td>300</td>
<td>82</td>
<td>-</td>
<td></td>
<td>65</td>
<td>18</td>
<td>-</td>
</tr>
<tr>
<td>1992</td>
<td>2012</td>
<td>1540</td>
<td>77</td>
<td>413</td>
<td></td>
<td>472</td>
<td>23</td>
<td>626</td>
</tr>
<tr>
<td>1993</td>
<td>3550</td>
<td>2958</td>
<td>83</td>
<td>92</td>
<td></td>
<td>592</td>
<td>17</td>
<td>25</td>
</tr>
<tr>
<td>1994</td>
<td>3502</td>
<td>2882</td>
<td>82</td>
<td>-3</td>
<td></td>
<td>620</td>
<td>18</td>
<td>5</td>
</tr>
<tr>
<td>1995</td>
<td>2522</td>
<td>1728</td>
<td>69</td>
<td>-40</td>
<td></td>
<td>794</td>
<td>31</td>
<td>28</td>
</tr>
</tbody>
</table>

1 By 1991, the cumulative number of JVs and WFOEs approved was 569 and 130, respectively.
were WFOEs, a 28% increase over 1994. More indicative of the trend in WFOEs is that by April 1996, the Suzhou Singapore Investment Park had 120 projects approved, 94% of them WFOEs with an average investment of 30 million US$.

What is also interesting to note is that, where EJV contract termination clauses traditionally specified that the Chinese partner(s) would purchase the foreign party's share of assets at the end of the contract, some recent EJV contracts have provided that the foreign partner will acquire the Chinese party's share of assets and continue to operate the venture as a WFOE.

What is a WFOE?

In terms of current regulations and laws, Table 3 provides a profile of the main characteristics of a WFOE. Overall, a WFOE is substantially the same as an EJV in terms of taxation, corporate liability, import/export issues, foreign exchange, and approval process. The differences arise in scope, management, and approval time. As discussed above already, WFOEs are restricted and prohibited in certain sectors. However, two issues are important here. First, there is a gradual process of liberalization going on with more and more sectors opening up for foreign direct investment. Although some sectors are likely to remain closed, a practically relevant observation is that laws and regulations follow practice in China. Particularly local governments are often more liberal in their interpretation and implementation of laws and regulations, and "experimentation" outside the prevailing legal paradigm is not unheard of (often with the objective of forcing Beijing's hand in relaxing or changing regulations). Hu Xingxing (1996), for example, reports that some WFOE retailers exist despite being prohibited by law. Such retailers operate on a given site but have no import/export rights (for which State Council approval is needed) and might not even have a retail license from the Ministry of Internal Trade (perhaps operating under a real estate management license provided by the local government). In other words, what might not be legally possible (in a strict interpretation of the letter of the law) is often practically possible in China.
### Table 3

A Wholly Foreign-Owned Enterprise (WFOE) in a Nutshell

| **Definition:** | 100% of equity is owned by one or more foreign parties (i.e., no Chinese partner or shareholder); |
| **Scope of Operation:** | more restricted but generally in same industrial/manufacturing sectors where EJV's are allowed; prohibited in service industries; |
| **Legal Status:** | Chinese legal person with limited liability; with multiple foreign partners, their liability is limited to their individual capital contributions; |
| **Length:** | typically between 10 - 30 years; no maximum term imposed; |
| **Management:** | must be conducted in accordance with the enterprise's approved articles of association (no board of directors is required); production and operating plans must be filed with the Chinese authorities; |
| **Tax:** | effectively same rate as EJVs; |
| **Profits:** | required to maintain a statutory reserve fund and pay into it a minimum 10% of after-tax net profit until fund exceeds 50% of registered capital; required to maintain employee bonus and welfare fund (no minimum contribution requirements); right to repatriate profits tax-free after making up losses from previous years; required to maintain accounting books in China and submit them for independent auditing; |
| **Operational Issues:** | required to transact imports and exports at international market prices and are subject to scrutiny by tax authorities for transfer pricing; |
| **Legislation:** | Law of the PRC on WFOEs (National People's Congress; April 12, 1986); Detailed Implementing Regulations for the Law of the PRC on WFOEs (Ministry of Foreign Economic Relations and Trade (MOFERT) - renamed to MOFTEC in 1993 - December 12, 1990); Interpretation of Several Provisions of the Detailed Implementing Regulations for the Law of the PRC on WFOEs (MOFERT), December 6, 1991). |
| **Approval Authorities:** | Primarily: depending on total investment size: up to 5 million US$: municipal trade bureau, under dual authority of MOFTEC and municipal government; 5 - 10 million US$ (depending on the province): COPERT (provincial or equivalent level - Beijing, Tianjin, Shanghai - Commissioning for Foreign Economic Relations and Trade), under dual authority of MOFTEC and provincial government; over 30 million US$ MOFTEC; for projects over 100 million US$, China's State Council. Other authorities: SAEC (State Administration of Exchange Control) and State Council (when land use exceeds 67 hectares of arable land or 133 hectares of non-arable land); |
| **Registration:** | for business license with local SAIC (State Administration for Industry and Commerce); taxation bureau; public security bureau (for expatriate staff); |

---

Second, and related to what is practically achievable, if a project involves high technology, new and high quality products, increased production efficiency, or substantial export potential, the probability of approval is enhanced. Hence, in assessing feasible modes of entry it makes more sense to think of direct spillover (in terms of forex and technology) of the project than of what is strictly legally permitted. Indicative of the nature and the potential flexibility on the regulatory side are the foreign investment policy guidelines contained in Articles 5, 6 and 7 of the Provisional Regulations on the Guidelines of Foreign Investment, promulgated on June 27, 1995 (see Table 4).

Although the regulations contain lists of specific projects and industries, the principles contained in those articles are more informative of what could potentially be negotiated and under what conditions. As Table 4 indicates, foreign investment is broken down in projects that are encouraged, restricted, and prohibited. Article 7 clearly spells out what is off limits under any form of foreign direct investment; it illustrates the government’s concern for national security, social welfare and stability, the environment, and use of arable land (which is less than 1/3 of China’s surface and finds itself primarily in the coastal areas where most of the industrial development has been taking place). The projects that are encouraged, and to the extent that they provide the necessary ingredients can be constructed under either an EJV or a WFOE, involve technologies for the priority sectors (agriculture, energy, transportation, and industrial raw materials), technologies which improve product quality and energy and raw material efficiency (including recycling), technologies which provide products and materials in short supply domestically, and projects which develop resources in the hinterland and/or improve export potential. Although these define in broad terms the main parameters of China’s current industrial policy, with some creativity many (if not all) projects could be “packaged” to fit within those parameters. Even the restricted investment projects are not that “restricted”; as article 11 stipulates in the same regulations “.....restricted foreign investments may be regarded as permitted projects .... if their export volume accounts for no less than 70% of the total sales volume”. In sum, there is some flexibility and the approval of a foreign direct investment project (either an EJV or a WFOE) is enhanced when Chinese authorities see the project to fit within their industrial policy with spillover in areas of interest.
Table 4

Foreign Investment Policy Guidelines

1. Foreign investment shall be **encouraged** when it:
   (1) Engages in new agricultural technologies, comprehensive agricultural development, as well as the construction of energy, transportation and important industrial raw material projects;
   (2) Brings in high, new and advanced technologies which are able to improve product quality, save energy and raw materials, promote corporate efficiency, or produce new equipment and materials whose domestic supply fall short of demand;
   (3) Helps explore new markets to boost exports of upmarket products;
   (4) Engages in new equipment and technologies for the comprehensive utilization of resources and recyclable resources, as well as environmental protection;
   (5) Brings into full play the advantages of the central and western parts of China in human and natural resources in line with the nation's industrial policies;

2. Foreign investment shall be **restricted** when:
   (1) Domestically developed or imported technologies can ensure sufficient supply to domestic demand;
   (2) The targeted industries are attracting foreign investment on a trial basis or are simply monopolized by the State;
   (3) Investors mean to explore and develop rare and precious mineral resources;
   (4) The targeted industries come within unified State planning;

3. Foreign investment shall be **prohibited** when:
   (1) It threatens national security or social public benefit;
   (2) It pollutes the environment, natural resources or brings harm to people's health;
   (3) It occupies a large plot of arable land, producing negative effect on land resource development, or threatens the security and efficiency of military facilities;
   (4) It takes advantage of crafts and technologies unique to China for the purpose of production;

---

1 Adopted from Articles 5, 6 and 7 of the Provisional Regulations on the Guidelines of Foreign Investment, promulgated by the State Planning Commission (SPC), the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), and the State Economic and Trade Commission (SETC), June 27, 1995 (working translation, CBIN).
One important point to raise here are the regulations on export quotas. There is a common perception that the required export quotas for WFOEs are higher than for EJVs. On average, WFOEs probably do export more of their production; this is, however, not a result of the foreign investment regulations per se but an outcome of approval negotiations. Apart from the 70% or higher export quota in article 11 to secure approval of projects in restricted areas, the rules and regulations on EJVs and WFOEs do not contain specific percentages for how much the project needs to export or how much it is allowed to sell domestically. The EJV regulations stipulate only that “exports are encouraged” which is typically interpreted as more than 50%. However, the exact % is negotiated and specified in the contract. Lower percentages can be negotiated when the products are “urgently needed” in the domestic market or they substitute products currently imported (and, hence, save foreign exchange). Similar principles hold for WFOEs although Chinese approval authorities are more rigid and will typically stick to the minimum 50% export quota. Hence, there is no strict minimum requirement which leaves the door open to negotiate export quota percentages below 50% on the grounds of China’s industrial policy (priority) principles (i.e., high-technology, increased quality and efficiency, energy savings, etc.).

In recent years, there has been some loosening of the export requirement with Chinese authorities willing to accept a pledge to make an effort to export a specific percentage. Furthermore, Chinese authorities have not typically enforced the requirement and many foreign companies operating in China simply ignore the export requirement. Such an approach implies a risk particularly now that foreign direct investment is on the political agenda. As we will discuss below, the concern about “economic sovereignty” is likely to lead to a stricter enforcement of agreed to export quotas.

Understanding what China needs and wants and to what extend the proposed projects contribute to that is key. Operating in such a way involves risks corporate lawyers are not always willing to take but is often necessary (and strategically required) as reactive regulatory development in China resembles practice just short of what has been achieved by pioneering firms willing to push the limits; hence, the reactive regulatory development entails a first-mover advantage for those foreign firms willing to operate and push in “the grey area” of the law. In sum, scope and mode of entry should not be necessarily determined exclusively by the letter of the law in China.
The difference in management between an EJV and a WFOE lies in the necessity to have a board of directors: EJVs are legally required to have a board of directors, where WFOEs don't. Hence, in setting up a WFOE one can implement a more flexible management structure as long as it has been approved and is part of the articles of association of the WFOE. Practically speaking, however, as Chinese authorities use the EJV law often as reference (and indeed rely on it where the WFOE law is either silent or ambiguous), many WFOEs structure their management in line with EJV requirements (and construct a board of directors) as not to confuse or create suspicion among Chinese authorities.

With respect to time of approval, the approval authorities have less time to act on a WFOE proposal than an EJV proposal (local authorities are required to respond to initial project proposals within 30 days of submission). This, in combination with lack of partner negotiations, results in typically very short time periods to establish a WFOE (anywhere from one to five months). As timing can be of strategic importance, one has much more control over the clock in establishing a WFOE than an EJV. For example, because of delayed progress in their existing two JVs in China, Asia Pacific Resources International Holdings (the Indonesian paper group) decided to invest 430 million US$ in two WFOE paper mills.

Although a number of differences emerge that can be of strategic importance, one should not forget the frame of mind of Chinese authorities. Particularly in periods of political uncertainty, for fear of being held responsible Chinese officials will stick to the rule of law and regulations. In case of a WFOE, those are in first instance the directly relevant laws and regulations (see Table 3), but in second instance the EJV laws. Hence, where the WFOE laws are silent or vague (and even where they are not but because of clarity, experience or knowledge) it pays to stick within the EJV legal boundaries. This, of course, also implies that if the EJV laws constitute the prevailing legal paradigm even for WFOEs, why not consider a WFOE if it is not strictly prohibited. Corporate lawyers and legal advisors will often point to the track record of and experience with the EJV laws to justify an EJV; however; if that law is the prevailing guideline for other legal entities as well, why restrict oneself to an EJV? To bring the criticality of this question to bear, more than the legal issues have to be considered.

Why Wonder about a WFOE?

There are a number of issues contributing to the current interest in WFOEs. As discussed above in some detail already, the legal framework is not that different from the more common
EJV apart from sectors where WFOEs are prohibited. Hence, in those sectors where they are
allowed, the legal regime is similar and, indeed, the EJV framework is commonly used as
reference even for WFOEs.

Another contributing factor to the interest in WFOEs is the accumulated experience on EJVs.
Overall, the experience has been mixed; most studies that have looked in some detail at EJVs
report that a large number are dissatisfied with the performance (in a study of 72 operating
EJVs, Pan, Vanhonacker and Pitts (1995) report that 44% even contemplated dissolving the
partnership). A large number of reasons underly the dissatisfaction and some have been
documented extensively elsewhere, but the overall mixed evaluation together with many
anecdotal stories in the popular press (often negative) have raised the question of whether the
EJV framework is workable in China.

Even if one pursues an EJV, it is a fact that in many industries in China good partners are
more and more difficult to come by. Many companies that entered China early “picked the
cherries” and late-comers find themselves with questionable potential partners (heavily
debted; no valuable assets; no political support; far away from resources and customers, etc.).
Such has become a problem particularly when one is pursuing some consistent partnering
strategy. In order to maintain control over multiple operations, some companies partner with
the same Chinese entity (or its affiliates) all over China. Coca Cola, for example, together
with its foreign partners (the Kerry Group of Malaysia and Swire of Hong Kong) partner only
with CITIC, China National Cereals Oils and Foodstuffs Import Export Corporation, and
affiliates of the Ministry of Light Industry. As there are few Chinese entities that can provide
such an opportunity for national coverage and most (if not all) have been signed up, the
question immediately arises if one would not be better off having no partner at all.

One factor also fueling the interest in WFOEs is the issue of control. More and more foreign
partners are trying to get a better (and bigger) handle on their China operations. Operational
control has always been considered a key issue in getting production operations off the
ground in China, but more and more companies are pursuing management and strategic
control. Such moves are often influenced by the increased competitive environment in China
and, hence, the need to control distribution in some industries and/or costs given falling
prices, and/or a desire to integrate (or develop a capability to do so in the longer run) the
China operations in a broader (Asian or Worldwide) framework (and, hence, the necessity to control quality such that its meets the companies worldwide standard).

Although not the only way to exert greater control, an increased equity position often helps. Pepsi Cola, following Coca Cola, is in the process of acquiring majority stakes in all its bottling plants in China in order to assume management control and, as such, direct control over distribution to improve logistics, efficiency, and customer service. The tight monetary policy by the Chinese government in the last couple of years has helped foreign partners in increasing their equity stakes as necessary operating capital could often be obtained only from foreign partners in return for an increased equity stake. The political fallout has been that this pattern has occurred at a time when many high-profile EJVs have become profitable. In the pursuit of control, WFOEs become an attractive alternative to EJVs.

Although partnering strategies have changed over time to limit intra partner competition (such as acquiring stakes in existing Chinese manufacturers instead of establishing an EJV with part of a Chinese manufacturer), divergence of objectives is becoming a serious obstacle to further development in many ventures. First, many Chinese partners are highly focused on their home region and are not interested in national expansion. Such creates problems for foreign companies pursuing national expansion; setting up a WFOE holding company doesn’t necessarily solve the problem as holding companies can only provide services with the explicit agreement of the EJVs. Second, many Chinese partners are not eager to invest in expansion. Foreign companies are more willing to forego present gains and invest in the future to accelerate growth and expand investment in order to maintain and augment the lead in face of increasing competition. Third, Chinese partners often operate with short-term goals in the belief that China’s experiment with free-market capitalism will not last. Fourth, many Chinese partners are product focused. For example, Unilever has 7 EJVs that sell products through similar channels to arrive at the same retail outlets. Although consolidated selling would imply cost savings, its Chinese partners are hesitant to accept any loss of distribution control for their respective products. In sum, the “same bed, different dreams” issue has become a significant obstacle in many EJVs.

With increased levels of technology being transferred into China, foreign companies are becoming more and more concerned about security and avoiding leakage. Such issues
become central strategic concerns when proprietary technology is involved. The concern is whether Chinese partner(s) fully understand and protect the intellectual property rights and patents rights of their foreign partners. It is not always evident that transferred technology stays within the compounds of an EJV. Some foreign companies see a WFOE as a better vehicle (but no guarantee) to control technological spillover. As competitive considerations as well as government demands in investment approval require increasingly more advanced technology, more and more companies are likely to explore WFOEs as an alternative mode of entry because of the security aspect.

Another issue that plays in the hands of WFOEs is that JVs are essentially short-term partnerships. This, on top of the fact that JV partnerships are not easily dissolved in China, further contributes to the interest in WFOEs as perhaps a wiser, long-term strategic option. And given that there is overall a more favorable climate for WFOEs, why not consider it as a viable option.

Another issue raising interest in WFOEs is the question of what the value-added is of the Chinese partner. In a study by McKinsey on operating EJVs (Shaw and Meier, 1993), three areas were identified where the expected value-added of a Chinese partner was rated significantly higher than what was actually delivered. These areas, ranked in decreasing order of magnitude of difference between expected and actual, were: reaching the market (sales contacts, distribution access, guanxi), financial contribution (foreign exchange, investment), and operations (labor, plant and land, material supply). Interestingly enough, the EJVs interviewed for the study all considered a major decrease in value of a partner over time when it came to reaching the market (less so on the other two but less important dimensions). A striking example of a Chinese partner not being able to market the JV’s output is the Hualu Matsushita (Dalian) case (Ho 1996). Matsushita formed a JV with Hualu Electronics Corporation hoping to capitalize on the company’s extensive domestic sales network to tap the domestic market. Originally, the plan was for Hualu to buy 80% of the JV VCR components production for incorporation into VCRs to be sold in the Chinese market. Since the brand-new Dalian factory has been opened in 1994, most of the 45 production lines have been idle because Hualu is unable to absorb the JVs output. Hence, the question of value-added by a Chinese equity partner (or partners) is becoming increasingly relevant.
Finally, and perhaps the most significant factor in the current interest in WFOEs, is that foreign companies have been gaining experience in China. Many have come to grips with how things can and ought to be done and more and more of them are willing and able to go it alone. Companies that have been in China for a while have established and build their own networks and find less and less value in what Chinese partners can contribute; some even realize that Chinese partners' relationships - which are and can be relied upon but not controlled or easily influenced - can be assets in the short run but liabilities in the long run. Furthermore, foreign companies, as opposed to Chinese companies, always have an extra degree of freedom in Chinese business protocol: they are foreign which can always be used as a face-saving excuse for either (foreign or Chinese) side in a relationship. Perhaps most important is the realization that personal relationships (guanxi) are what China is all about and developing your own (instead of relying on those of your partner) is developing a critical competency (and strategic asset) in China.

A Strategic View

Whether or not a WFOE is indeed a realistic and practical option needs to be assessed in a broad framework. Strategic as well as operational concerns need to be addressed both in the short and the long run. Those can best be formulated in the form of three basic questions (see Table 5). First, what are the strategic and operational objectives in China? Second, what is needed to achieve those? Third, would a Chinese partner (or partners) help (or hurt) in getting those?

The first question is fundamental and relates to the reasons why the company is in China. Despite being an obvious question, the answer for many companies is not always clear. Knowing firmly and concretely why the company is in China is very important and increasingly so. First, not being clear on the China mission makes it difficult to signal confidence and commitment; the latter are important to receive recognition and support from Chinese partners and officials, to motivate the staff (expatriate as well as local) on the ground in China, and to attract scarce managerial talent in China's labor market. Second, lack of clarity in mission and how progress and its achievement will be measured in concrete objectives results in opportunities (and threats) being considered on a case-by-case basis without a consistent yardstick and without a sense of priority; this makes it harder (if not
impossible) to develop and portray a consistent corporate presence and image in China. Third, and increasingly so, lack of clarity in the China mission will result in costly distractions by inevitable headlines such as corruption scandals, Taiwan, Tibet, Deng Xiaoping’s death, etc. Fourth, success in China (as in any country) very much depends on knowing “where reality stops and fiction starts”. Such requires a rational and fundamental understanding of the realities of China and a firm grasp on what the company can and should achieve there.

The increasing number of foreign firms establishing holding companies in China is perhaps an encouraging sign of the realization of the need to have a comprehensive and coherent China strategy. Although control and consolidation may drive the need to establish holding companies, they also form the necessary foundation to build a China strategy on.

The China mission and strategy also sets the parameters for the second question: what do we need to achieve those goals? Here, it is very important to think in terms of what is generally needed in the industry one operates in and in terms of what is additionally needed in China. On the latter, it is advisable to look at investment projects in a much broader context than one would typically do outside China and to carefully consider, for example, the administrative structure of the industry one operates in (as well as administrative structure on the sourcing side and the customer side).

Once one has a sense of what is needed, then the obvious question is whether a Chinese partner (or partners) can help in getting those. In a typical EJV setting, the Chinese partner will bring as capital investment: land-use rights, Renminbi cash, and other assets. What foreign companies are also looking for in Chinese partners are relationships (guanxi), access to suppliers and markets, market intelligence and knowledge, and ability to work the Chinese bureaucracy (“how to get the chops”). All of these are competencies that might be critical to getting things of the ground, but what about the long run? Increasingly, it is already possible to acquire some of those competencies from agents that can be contracted separately and do not take a share or control (and as such one avoids the indefinite “marriage problem” of equity-sharing partners). Sophisticated foreign investors increasingly rely on agency agreements with Chinese parties to liaise with relevant authorities on their behalf, and to help in procuring land, materials, and services. Furthermore, overseas Chinese partners could be
as good as (or even better than) mainland partners in terms of value added where it is needed. Clearly, one has to carefully assess whether potential partners can and will contribute (and continue to do so) what is needed and consider and evaluate alternative ways of getting what is needed.

Once the will and ability to contribute has been established, one has to step back and evaluate, in the context of the China mission and strategy, at what price the potential Chinese partner(s) will make the contribution. As discussed above already, commonality in objectives and future direction between partners is important in this context.

A Comparison: EJV versus WFOE

At a generic level the advantage of a WFOE is that no Chinese partner(s) are involved; that’s probably also its disadvantage. Similarly for an EJV: its advantage is that Chinese partner(s) are involved, which is probably also its disadvantage. It pays to go beyond such a generic view and discuss the distinct options in a broader perspective. A structured overview of pluses and minuses of either option are given in Table 6. A deeper discussion of each follows.

Advantage of a WFOE

As alluded to above already, WFOEs can be set up relatively quick. On one hand, the approving authorities have, relative to those for EJVs, shorter time periods to react to proposals; on the other hand, and perhaps more significantly, potentially long negotiations with Chinese partners are avoided.

The second advantage is flexibility and control. As sole owner and proprietor, one has full control over human resources, management, etc. Hence, one has the liberty at installing processes and procedures used elsewhere by the company. Because of this, it is easier to integrate the operation into a broader geographic (China Asian or Worldwide) framework. The control aspect not only covers the operational side (day-to-day control) but also security of intangible (trademark) and tangible (technology) assets. Hence, potential leakage is better
Table 5

Key Questions

1. With respect to China, what are your objectives?
   - Strategic?
   - Operational?

2. What do you need to achieve those?
   - In general in your industry?
   - In China (what are the necessary “extras”)?

3. Would a Chinese partner (or partners) help in getting those?
   - Help (or hurt)?
   - Alternatives?
controlled. On the operational side, tensions (and the associated time/energy consuming meetings and discussions) with partners are avoided.

**Disadvantages of a WFOE**

One of the obvious disadvantages is that WFOEs are prohibited in certain industries. Another disadvantage is that one potentially creates an “island” in a rather different and rapidly evolving Chinese context. Another possible concern is that WFOEs are perhaps not perceived as “helping China” by China’s bureaucrats and politicians; such might lead to a stricter enforcement of regulations and greater scrutiny in auditing and supervision. There are, however, encouraging signs particularly with new laws coming on the protection of private firms (expected Spring 1997) which will also apply to foreign firms; nevertheless, ideological concerns are warranted in the current political environment.

Other disadvantages are in the area of benefit expectations by the Chinese employees. Housing, social security, medical care etc. have typically been provided for by the work unit (and, hence, company) to which Chinese personnel were assigned and belonged. Hence, Chinese partners have a whole system and infrastructure in place to provide these benefits and, as such, can make a valuable contribution in this area in an EJV context. For a WFOE, however, one will have to provide those benefits directly which can be difficult (as there are no comprehensive private plans/systems in place in China today) and expensive (e.g., providing housing in the major cities).

Finally, as labor and management talent has to be recruited and build up, some time and effort will be required to put a cohesive workforce together that operates efficiently and effectively.

**Advantages of an EJV**

The advantage that EJVs have is their legal regime. Relative to WFOEs, the EJV laws and regulations have been around longer and have been developed better and more extensively; it has become a legal framework that is known, well understood, and as such used as the reference point. Because of the track record, foreign companies also feel more comfortable with it.
Apart from the legal and regulatory considerations, it is fair to say that a JV partnership in many ways is a microcosm of Chinese society and fits with the Chinese culture. Hence, one could see the JV context as a “test ground” (to some extent controlled) to experience and learn the realities of China in terms of how things are done, how the culture operates, and what the business protocol is.

In an ideological context, EJVs are seen as more directly benefiting China’s economic and industrial development. Hence, willing to enter an EJV partnership with Chinese partner(s) might be interpreted (and, hence, help the chance of approval and support) as a corporate commitment to China’s cause.

Disadvantage of an EJV

The main disadvantage of an EJV is that a Chinese partner (or partners) is (are) involved. Problems of divided loyalties, changing objectives, interference, etc. are all likely to occur with potential adverse affects to the operations. Concerns are warranted here as in many instances it appears that one will have the partner(s) indefinitely. Although EJVs are an attractive entry mode, when is the “entry” accomplished? Some foreign companies have been able to buy out their partner(s) but it is not evident how one does this in China without loosing face or creating political badwill.

Potential conflicts with partners can create a lot of lost time and effort. Although one typically refers to lengthy contract negotiations to illustrate potential difficulties in blending approaches and styles, it is fair to say that managing an EJV in China is an ongoing negotiation process even after the contract has been signed.

One recent concern about EJVs is that because of increasing unemployment and concern for social stability, foreign companies are now often required to take part of the Chinese partner(s) labor force where before direct recruitment starting from scratch was possible. The advantage is that one can rely on the Chinese partner to provide some social services (housing, medical care, etc.) but there are concerns about qualifications, work ethic(e.g., “state-owned” mentality), and a social structure and cohesiveness which might not fit with the requirements of the venture.
Structuring a Project: Is it necessarily “either/or”?

The decision between a WFOE and on EJV is not necessarily an "either/or". Indeed, it might be advisable to combine both in a foreign direct investment project as to benefit most form their respective advantages. It is possible to configure a production operation which is a WFOE surrounded by EJVs that market and sell the products. Such a structure would be advantageous if Chinese partner(s) are essential in the marketing (accessing channels, e.g.) and proprietary production technology is transferred into the production operation; structuring the latter under an WFOE would guarantee some control over possible technology spillover. Hence, it pays to think about an investment project in terms of its components and evaluate the investment options (with their advantages and disadvantages) for each separately.

The other possibility is to consider an EJV and a WFOE as a natural sequence: initial entry and operation as an equity JV with a fixed time period at the end of which the foreign partner takes over the assets from the Chinese partner and continues to run the operation as a WFOE. This is certainly an attractive alternative if the added-value of the Chinese partner is significant and limited to the early stages of the EJV. As discussed above already, some EJVs have integrated this option in the termination clause of the EJV contract. Even if the option is not integrated by design in the contract, it is possible to buy out Chinese partner(s) as some companies have done recently.

The Political Agenda

With foreign companies increasing their equity stakes in their China ventures, with an increasing number of WFOEs, and the increasing dominance of foreign companies in some sectors, foreign direct investment and the role of foreigners in the economic and industrial development is on the political agenda. The concern about "economic sovereignty" is real and particularly politically sensitive as China's government faces the increasing financial and social burden of the State-Owned Enterprises (SOEs). During the 1995 National People's Congress (NPC), a motion was put forward to restrict the expansion of Coca Cola (about 19% market share) and Pepsi Cola (about 7% market share) to 30% of China's carbonated soft drink market. The motion was defeated but with a more recent indication that both companies might not be allowed to expand beyond the current number of bottling plants they have in China, the political sentiment is clear. With economic sovereignty on the political
<table>
<thead>
<tr>
<th>Advantages</th>
<th>Wholly Foreign-Owned Enterprise (WFOE)</th>
<th>Equity Joint Venture (EJV)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>shorter approval time</td>
<td>legal framework better developed</td>
</tr>
<tr>
<td></td>
<td>flexibility and control (management/technology/labor)</td>
<td>track record (experience; &quot;bugs&quot; worked out)</td>
</tr>
<tr>
<td></td>
<td>easier to integrate in broader geographic strategy (own culture and procedures)</td>
<td>learning (microcosm of China: ways, culture, protocol)</td>
</tr>
<tr>
<td></td>
<td>avoid tensions with partner(s)</td>
<td>cultural fit; way things are done (cooperation)</td>
</tr>
<tr>
<td></td>
<td>no partner indefinitely</td>
<td>signal commitment to development of China</td>
</tr>
<tr>
<td></td>
<td>security (technology/trademark, intangible property)</td>
<td></td>
</tr>
</tbody>
</table>

| Disadvantages                    | prohibited in certain sectors (services)                                                               | partner (loyalty, changing objectives)                                                                               |
|                                  | isolated "island" in China                                                                              | lengthy negotiations                                                                                                 |
|                                  | Chinese perception: right signal?                                                                       | time/effort in managing tensions and conflicts (difficulty in blending very different management styles) |
|                                  | Cannot share HRM/labor problems (housing, social security)                                              | control?                                                                                                              |
|                                  | time needed to build cohesive workforce                                                                 | difficulty in integration                                                                                           |
|                                  |                                                                                                        | often have to accept labor (and its inherent habits and social structure) of Chinese partner |
agenda, one is likely to see new policies and regulations addressing the concerns and a stricter enforcement of those already in place (e.g., stricter enforcement of export quotas). In this context, the natural question arises whether or not this is an opportune time for a WFOE.

Despite the political attention, it is not likely that the Chinese government will single out WFOEs in its concern about economic sovereignty; such a move would be detrimental to its need for more advanced and high-technology a lot of which is currently being transferred into China under WFOEs. It is, however, clear that approval could be more difficult to get (which essentially implies that stronger support will be needed), and some restrictions might be imposed (scope of operation and export quotas). WFOEs will still be allowed, but the “price” will increase. Of course, and what is generally the case in China, the “currency” is more important than the price, and that requires an understanding of the economic as well as political agenda of China. As discussed above, the new foreign direct investment regulations clearly signal the relevant “currencies”.

What is perhaps a prudent strategy in the current political climate is to make foreign direct investment projects (WFOEs as well as EJVs) look Chinese instead of foreign. Such would enhance their chances for approval as well as reduce their political liability. Issues to consider here are local management, social responsibility, cultural/political sensitivity, corporate identity and brand image, nurturing local brands, etc. Underlying these would be an attempt to become more of an insider than an outsider. Perhaps the best way to describe it is: “don’t be the nail that sticks out. Be a piece of the puzzle”.

Conclusions

Establishing a WFOE is an option in China and should be considered as either a part or the whole of a foreign direct investment project. The implied increase in management control will, however, come at a price and this has to be considered carefully in a broader context particularly given the current political concern about economic sovereignty. This paper discussed a number of dimensions on which the price has to be assessed. More importantly, it gives guidance on the cultural and political “currency” in which the price should be paid as to limit the liability of the WFOE.
References


Please forward your requests for working papers to the following address:

Executive Officer  
Department of Marketing  
School of Business and Management  
Hong Kong University of Science & Technology  
Clear Water Bay  
Kowloon, Hong Kong

www:       http://www.bm.ust.hk/~mark/  
Enquiries:  Tel (852) 2358 7700  
                Fax (852) 2358 2429