

# Balfoort Consulting Ltd

## Presentation to Transparency International

“Building successful business partnerships in China”



24 November 2011

"Absence of evidence  
is not evidence of absence."



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*Be careful the environment you choose for it will shape you; be careful the friends  
you choose for you will become like them.*

**W. Clement Stone, Businessman and Philanthropist (1902 –  
2002)**



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Water quenches thirst and food sates our hunger, but no amount of  
gold will satisfy greed .

(水可以止渴，食物可以充饥，但无论多少的黄金都无法满足人的贪婪)

All good relationships are rooted in trust.

(所有良好的合作关系是源于信任)

Chinese proverbs



# Teknatool Historic Perspective (Timeline)



- ❖ Started as general Engineering company (1955)  
↓
- ❖ Commenced production of wood lathes in 1980's  
↓
- ❖ Commenced Switch Reluctance (SR/DVR) research (2001)  
↓
- ❖ Production of first commercial DVR units in wood lathes in NZ (2005)  
↓
- ❖ Moved offshore and set up production plant in China (2006)  
↓
- ❖ Conducted internal audit and review (2010)  
↓
- ❖ Restructuring of production company in China (2011)  
↓
- ❖ Preparation for strategic investment and Joint Venture (JV) (2011)



# QMT Historic Perspective (Timeline)



- ❖ Search for strategic investors (2009)  
↓
- ❖ Identified interest party (Scott Technology Ltd) (2010)  
↓
- ❖ Scott Technology Ltd was established 1913 and is NZX listed  
↓
- ❖ Due Diligence completed (June/ July 2011)  
↓
- ❖ Signed Joint Venture agreements (July 2011)  
↓
- ❖ Registration of China JV (QMT Machinery Technology (Qingdao) Co Ltd (Oct 2011)  
↓
- ❖ Integration into Scott China operations (operating in PRC since 2004) - (On going)  
↓
- ❖ Expansion of Production in China (2012)





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# Legal Environment and Rankings

- ❖ Transparency International Corruption Perception Index Ranking = 78 (2010)
- ❖ Bribe Payers Index = China ranked 21<sup>st</sup> out of 22 top exporting countries (2008)
- ❖ Impact of FCPA eg. Siemens investigations.
- ❖ UK Anti Bribery Act
- ❖ NZ Crimes Act s. 105
- ❖ New PRC legislation eg. 49 amendments to PRC Criminal Law (02/2011)
  - ❖ Amendment 8 criminalizes payment of bribes against non PRC officials and International Public organizations.
  - ❖ Penalties include jail between 3 – 10 years plus fines.
- ❖ PRC Security Review mechanisms for inward bound M & A (02/2011)
  - ❖ Concerns M & A Between local and foreign investors



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# Corruption

## Siemens

- ❖ Investigations started in Europe in 2006 into slush-funds to pay bribery for orders.
- ❖ FCPA infractions globally, penalties US\$ 800 m charged in 2008
- ❖ Total costs of clean up +/- US\$ 2 billion incl. development of anti corruption systems
- ❖ Included “improper payments” in China at its Chinese subsidiaries.
- ❖ “ Up to half of Siemens business in China was involved in bribery”
- ❖ “Up to 90% of Siemens business in China conducted through a third party/agent”
  - ❖ **Economic Weekly (Germany) 2007**
- ❖ Resulting clean up took 3 years. Heavy investments in training, anti corruption framework implementation.

**Conclusion:**            **Prevention is better than cure**

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# Fraud

## Danone

- ❖ Started JVs with Wahaha in 1996, rising from 5 to 39 over time.
- ❖ JV underperformed prompting a Danone investigation which found:
- ❖ Illegal establishment of mirror businesses by founder of Wahaha, Zhong Xinhou.
- ❖ Mirror companies used JV distribution networks, sales strategies and technology.
- ❖ 2007 litigation attempts resulted in high profile brawl incl. French, PRC governments.
- ❖ A 3 year investigation identified extent and complexity of the web of companies.
- ❖ Settled out of court, with Danone selling its 51% stake in the JV to Wahaha

**Conclusion:**        Know your partner.



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# Financial Misreporting

## Bank of America/ Merrill Lynch report. (2011)

- ❖ 32 reported Chinese accounting fraud cases involving listed companies.
- ❖ Fraud occurs on:
  - ❖ Sales (overstated sales),
  - ❖ Total Assets (overstated)
  - ❖ Cash/Bank Loans (used to keep up appearances and black payments)
- ❖ (FB: Add Procurement (fictitious suppliers), scrap sales and inventory theft)
- ❖ Fraudulent activity detected by:
  - ❖ Bank Statement review and confirmations;
  - ❖ Reconciling company accounts with regulatory filings;
  - ❖ Field checks
  - ❖ Peer review (segregation of duties)

**Conclusions:**        **China investments require hands on approach,**

**Responsibilities cannot be abdicated to third parties.**

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# Fraud Red Flags

## Gulf Resources (GRFE) - NASDAQ listed

- ❖ Chairman of GRFE owns a rival conglomerate that apparently owns all assets of GFRE. → International investors own shares in a shell company.
- ❖ GFRE's largest customer is a company owned by the Chairman of GFRE.
- ❖ Expensive capital investment projects were awarded to two contractors who do not exist to assist in transferring cash out of GFRE.
- ❖ Physical company sites (factories) are far smaller than advised to the SEC in filings. Reported production figures are much higher than physically possible.
- ❖ CEO of GFRE was previously CFO of a fraudulent company touting investments in small cap Chinese companies.
- ❖ Auditor was changed 3 times in 4 years. Current international audit firm has been related to a number of fraudulent companies.

**Conclusion:** Be alert to fraud red flags.

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# Credit Bubble

## Lending practices

- ❖ Quantitative easing in China was materially by way of state owned banks or Local Government Financing Vehicles (LGFV).
- ❖ Local government debt and loans to the property sector were the result.
- ❖ In 2010 35% of China's around 1 m millionaires were involved in property and shares. (More than half of the PRC millionaires are looking to leave China.)
- ❖ Lending practices are likely to have been biased, and often based on guan xi.
  - ❖ Weak credit assessments;
  - ❖ Lending on Guan Xi
  - ❖ Market stimulation via "ghost cities".
  - ❖ Lack of collateral
  - ❖ Weakening property prices
- ❖ Latest news reports in China report a month on month continuation of low prices and a tsunami if reports on "rich" businessmen skipping town.



# Impact on Business Environment

## Impact on Chinese society and operating environment

- ❖ To get rich is glorious (Deng Zhou Peng)
- ❖ Growing income inequalities, gini coefficient has increased dramatically over acceptable limit of 0.4 (2010 – 0.47, 2011 - .
- ❖ Confucian and Taoist ethics and morals are practised extensively, predominantly by middle classes.
- ❖ Confucianism and Taoism form an essential part of Chinese Law (Fa Lu).
- ❖ The Golden Rule: Never impose on others what you would not choose for yourself Confucius (551 – 479 BC)
- ❖ Unfortunately “No amount of gold will satisfy greed”

**Conclusions:**        Recent economic changes affect trust  
                              Values and ethics have been eroded  
                              Essential to take time to build relationships

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# Culture

## Cultural dimension of time

- ❖ “As you all know, China is an emerging market with highly regulated and complex policies therefore timeframes relative to our home markets are much longer.” Recent quote from China based banker.
- ❖ “The timeframe is totally unacceptable to us. The overdraft needs to be in place immediately.”
- ❖ Fons Trompenaars seven dimensions of culture
- ❖ Sequential versus synchronic attitude to time
- ❖ Sequential = Seeing time as a series of connected sequential events with defined timing. Time is money.
- ❖ Synchronic = Events have a past, present and future. These are interrelated and create need for action. Time and action are based on relationships

**Conclusions:**      Different cultural attitudes to time affect business practice

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# Trust

## Rule based versus principle based

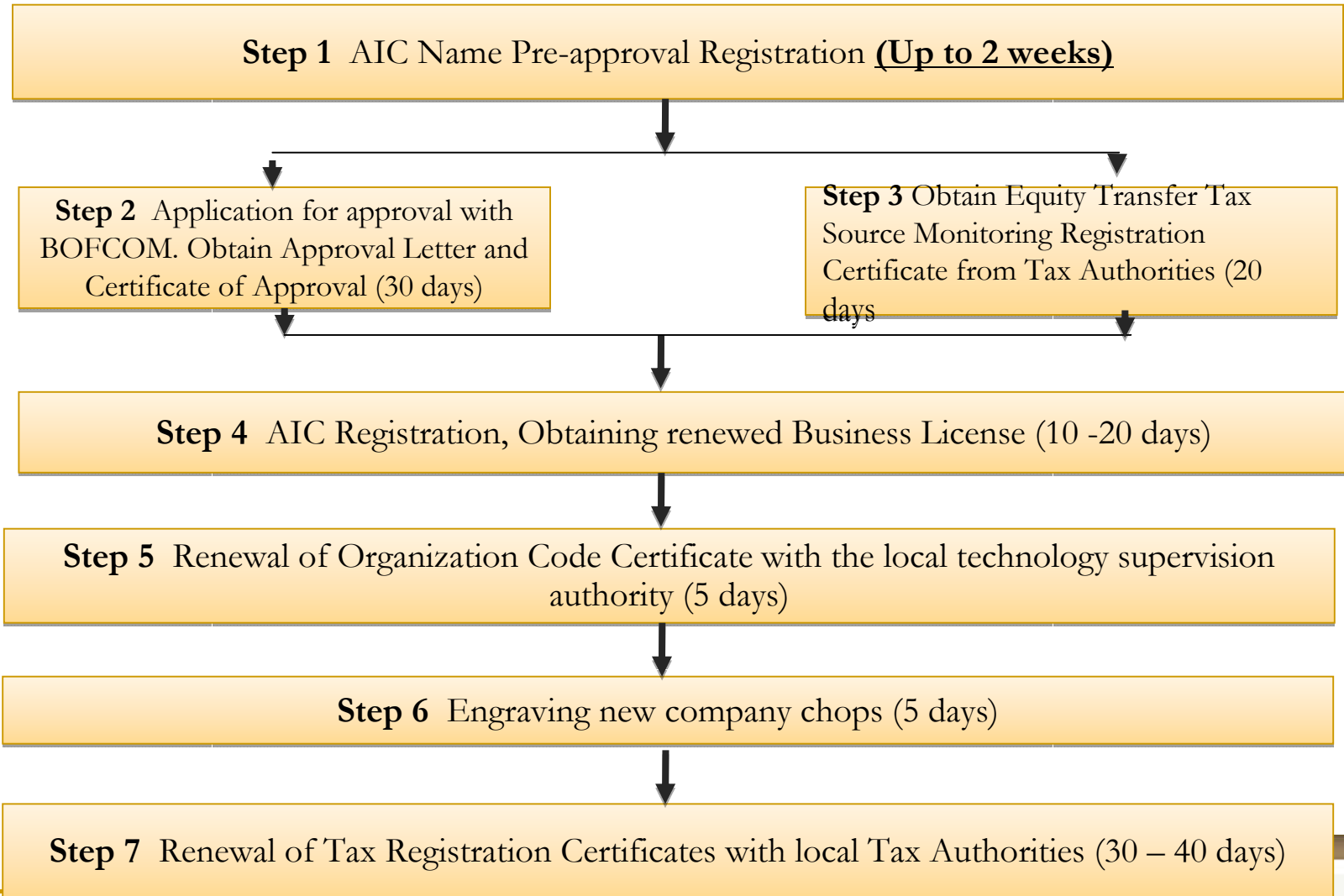
- ❖ Trust (Xinren or 信任.) Literally “Word” and “Responsibility”, “Keeping your word”
- ❖ “The heart-and-mind confidence and belief that the other person will perform, in a positive manner, what is expected of him or her, regardless of whether that expectation is stated or implied.” (Business relationships in China: Lessons about deep trust” A Kriz, 2010)
- ❖ Trust is built via relationships (Guan Xi) rather than via law, regulations and contracts. This highlights importance of “social credit rating” to build trust.
- ❖ Role of Guan Xi as a Confucian concept related to familial ties. Has expanded to wider society.
- ❖ Trust requires mutuality and honesty in practice. Importance of sincerity
- ❖ Trust is built via Bangzhu or 帮助(help) and reciprocal help (Huzhu or 互助)

**Conclusions: Building trust is essential for success**

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# Example – Company Registration



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# Example – Company Registration

## Conclusions/ Observations:

- ❖ There are an additional 4 steps in the process, total 11 in the full process.
- ❖ To prepare all documentation in correct format prior to submission takes 1 month.
- ❖ Changes in documentation delay process further since re approval to be obtained.
- ❖ Total time to registration is about 3 – 4 months
- ❖ Speeding up the process is possible in the correct way but takes time and investment.
- ❖ Appoint one key person to manage and drive the process.
- ❖ Interpersonal relationships and communication is key.
- ❖ Risk of unacceptable business practices must be recognized and mitigated against.



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# Business Environment in China

## Conclusions/ Observations:

- ❖ Risks of importing corruption, possible fines under PRC and international legislation.
- ❖ Rising costs of operating eg. Labour costs
- ❖ Hidden costs of doing business
  - ❖ eg. work injuries that cost up to 20 months salary
  - ❖ Cost of corruption
  - ❖ Efficiency and productivity
  - ❖ Delays in bureaucratic formalities
- ❖ Greater intra regional competition due to de-centralized government
- ❖ PRC focus on attracting specific industry related FDI
  - ❖ PRC to focus on 7 key industries including energy saving and environmental protection, new energy, biology, new energy cars, new generation IT
  - ❖ CPC proposal for formulating the 12<sup>th</sup> 5 year plan. (10/2010)



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## Possible Solutions/ Risk Mitigation

- ❖ Find appropriate and suitable partners and intermediaries.
- ❖ Document clearly expectations eg.
  - ❖ JV agreements,
  - ❖ Shareholder agreements,
  - ❖ position descriptions,
  - ❖ Delegations of authority.
  - ❖ Articles of Association
- ❖ Make Investments up front eg. Investigative Due Diligence
- ❖ Use effective and professional advisors eg. Avoid inappropriate thrift
- ❖ Effective networking and building of trust
- ❖ Understand the market and the culture
- ❖ Establish effective HR policies including recruitment
- ❖ Maintain effective oversight and monitor regularly



# Investigative Due Diligence

- ❖ Identifies concealed related party transactions or stories behind stories (Refer GRFE)
- ❖ Confirms veracity of representations made by counter parties
- ❖ Identifies unconfirmed financial issues/ status and any difficulties
- ❖ Identifies potential risks in individuals
  - ❖ Misrepresentations about qualifications
  - ❖ Litigation history
  - ❖ Unethical or illegal transactions and behaviours
- ❖ Both primary and secondary information collection
- ❖ Corporate governance issues
- ❖ Financial reporting issues
- ❖ Essentially a “red flag” review – Est. investment around US\$ 5,000 for init

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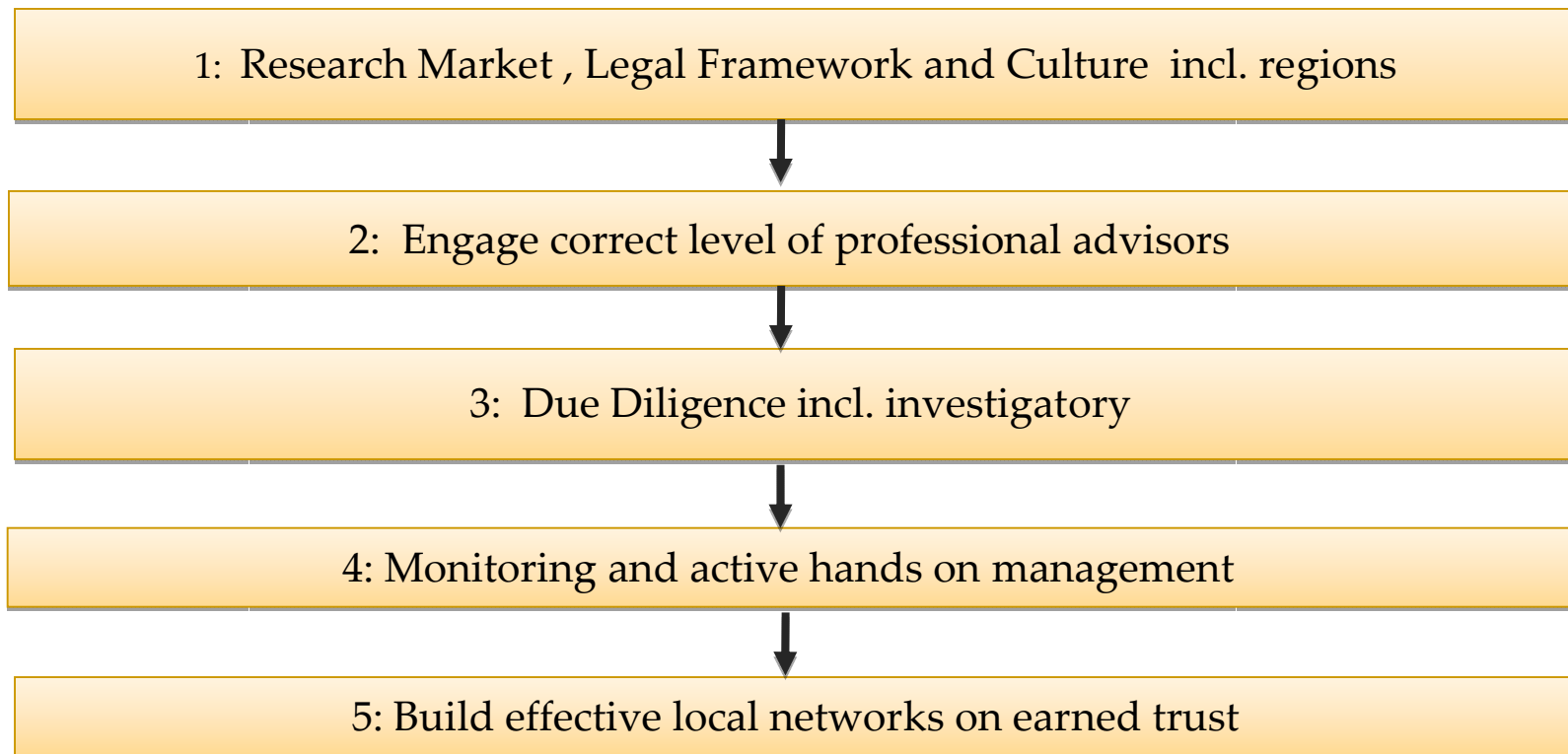
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# Effective Change Management in China

- ❖ Conduct audit/ review for red flags, financial, operational/ HR
- ❖ Identify key actors and develop strategies for exit and change
- ❖ Identify key network components and establish alliances eg. MOFCOM/ BOFCOM
- ❖ Obtain effective and accurate professional advice and support eg. legal advisors
- ❖ Collaboration/ communication with NZ government agencies eg. NZTE and MFAT
- ❖ Conduct thorough due diligence/ investigations
- ❖ Establish back up procedures
- ❖ Ensure effective internal communications
- ❖ Improve existing systems of controls incl. financial reporting and anti corruption
- ❖ Maintain trust and consistency at all times.



# Conclusions





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**Thank You**

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