Financing in China

Export Development Canada

Chris Evans, Ontario Region

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Canada

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Realize a World of Opportunity

About Export Development Canada (EDC)

- Canada's Export Credit Agency
- Crown corporation wholly owned by Government of Canada
- Financially self-sustaining
- Operates on commercial principles
- Conducts its activities in a socially responsible manner

EDC's Role

- To support and develop Canada's export trade and Canadian capacity to engage in that trade and to respond to international business opportunities
- Financing and insurance solutions for exporters and investors
- **2011 Performance Highlights:**
  - **Supported $24 billion of Canadian trade in the Asian markets and $10.8 billion in Greater China alone**

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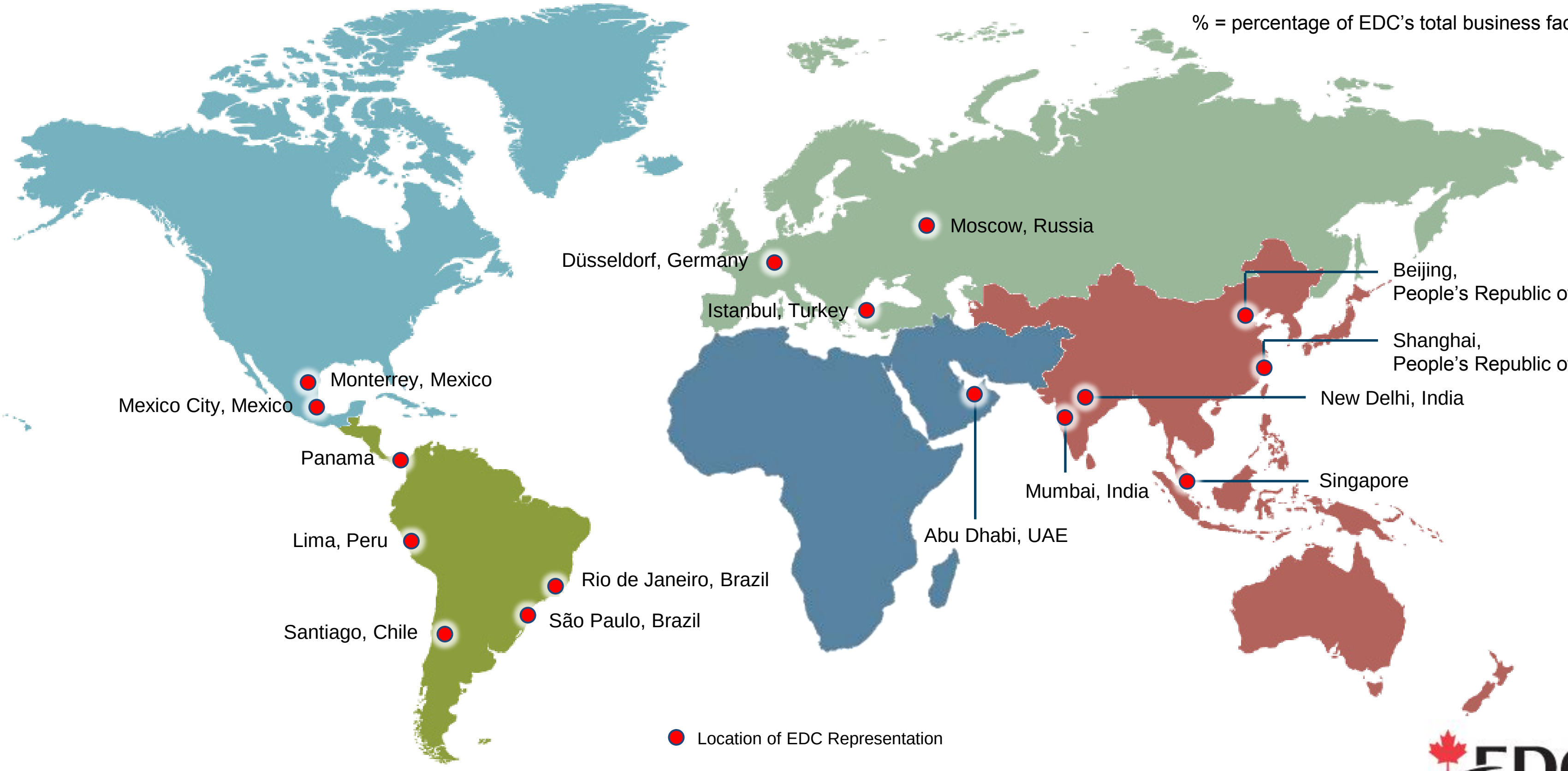
Supporting Business Worldwide

EDC's foreign representation

North America / Caribbean $52.7B (51%)
Asia-Pacific $24.3B (24%)
Europe $13.1B (13%)
South / Central America $6.3B (6%)
Africa / Middle East $6.3B (6%)

% = percentage of EDC's total business facilitated



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EDC's Major Products

- Accounts Receivable Insurance
- Contract Insurance and Bonding
- Political Risk Insurance
- Financing
  - Foreign Buyer Financing
  - Canadian Direct Investment Abroad (Outbound FDI)
  - Domestic Financing (for Canadian exporters)
  - Inbound Foreign Direct Investment (Inbound FDI)
- Equity Investments

Insurance

- Accounts Receivable Insurance – ARI
  - Covers risk of non payment by your buyer – can’t pay /won’t pay.
- Contract Frustration Insurance – CFI
  - single contract insurance covering work-in-progress and receivables
  - suited ideally for Canadian exporters of capital goods or services and their Canadian suppliers
- Single Buyer Insurance
- Political Risk Insurance
  - Transfer/conversion, political violence, expropriation, arbitration award default, non honoring of sovereign obligation.

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Bonding Services

- Get bonds without tying up your working capital
- Meet the bonding needs of your export contract
- Get bonds issued without tying up your cash
- We provide guarantees to your bank so they in turn can issue guarantees to your customers and suppliers
- Protect yourself from wrongful calls
- EDC makes it easier to get surety bonds issued
- We share the risk with your surety company

Financing for China

- China restricts capital account transactions – meaning investment flows and foreign borrowings are tightly controlled
- The State Administration of Foreign Exchange (SAFE) is the Gov't body overseeing and approving borrowing in China
- Buyer financing to mainland Chinese owned companies is not very common due to tight borrowing controls imposed by SAFE
- A limited number of large state owned enterprises (SOEs) are able to get borrowing approval from SAFE (case by case)
- **Virtually NO small or medium sized buyer can access a foreign loan – very few exceptions made**
- **EDC can consider buyer financing for a Chinese company IF the company is approved to borrow by SAFE and is meets EDC's normal financing criteria**

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Financing for China

- Often when a Chinese buyer asks for financing they are merely asking for longer letter of credit or open account terms
- Or this can be a sign of possible credit weakness by the buyer that you should watch out for
- Or the business driver for your buyer is to try and get grants or “soft” money rather than actually wanting your goods/services
- Foreign companies in China have more flexibility to borrow outside of China but are still subject to restrictions on amounts and usage

Financing your affiliate in China

- Financing a company is a process with unique features
- Assuming that you have the same funding options in China as in Canada has been known to get companies into serious problems
- There are only three legal ways to finance an affiliate in China
  1. As the affiliate's “Registered Capital”
  2. Incur debt within the confines of China’s SAFE regulations
  3. Profits generated from the affiliate's business operations

Capacity to Finance using Debt

There are two key terms to understand when determining the debt financing capacity of your Affiliate

Total Investment = Registered Capital + Foreign Debt

- The value of the Total Investment of the affiliate is documented in the affiliate's Business License
- Total Registered Capital is a percentage of Total Investment
- Your Total Investment Amount will be determined in consultation with Chinese Authorities based upon size and business scope of your planned affiliate and Chinese industry norms

What is Registered Capital?

It is the <u>Required</u> equity investment in the Chinese affiliate

"Required" because there are legal minimums under Chinese law based upon the Investment Amount - <u>but the minimum is rarely sufficient to fund most companies</u>

- To minimize future financing constraints both the Investment and Registered Capital amount must consider future needs - accounting for growth and cash draw till the affiliate is profitable /self sufficient
- The Registered Capital amount must be paid into the company by the owners – usually in phases within 2 years
- Can take the form of cash, hard assets like machinery, technical transfer etc but there are limits to the amount of non-cash contributions - Chinese auditors determine the value and have to approve acceptability.

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So why is setting the Registered Capital value critical?

The amount of debt an affiliate can have in China is predetermined - defined as the “Borrowing Gap”

Example :

- An affiliate with a Total Investment of < USD 3 million requires, by law, a minimum registered capital percentage of 70% leaving 30% of allowed debt load

In simple terms,

Borrowing Gap = Total Investment Amount minus

- Registered Capital

And minus

- Existing Short and Long Term Debt

Registered Capital cont…….

- As a company takes on more debt its borrowing gap (capacity to borrow) decreases
- Once a company has set its level of total investment and registered capital it is very hard to increase this amount - investing new equity isn't easy allowed
- You can seek to amend your business license but this is a costly (time and money) new approval and if regulations pertaining to your business location, environment permits, labour or other factors have changed you may find problems getting relicensed

SO WORK WITH EXPERIENCED LEGAL COUNSEL AT THE OUTSET OF SETTING UP AN AFFILIATE IN CHINA TO CHOOSE THE RIGHT AMOUNT OF INVESTMENT AND REGISTERED CAPITAL REQUIRED

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Financing Sources?

Early on, most affiliates in China have limited ability to access long term loans so must finance themselves from local debt markets and their paid in registered capital

Debt Financing from Inside China

- Generally there are 3 sources of financing from within China:
  - Loans from Chinese banks (tenors can be constrained)
  - Loans from China based foreign bank
  - Intercompany loans (may affect the Borrowing Gap)

All banks will ask for collateral but not all collateral is treated equally or of the same value as back in Canada

- Under developed security registration systems, heavy monitoring requirements, higher risk of frustration when called
- Parent guarantees or LCs are often needed until an affiliate's history is established

InterCompany Sources

Limited options:

1. Intercompany “sales” - generate cash flow from ongoing contract for services or products sold to parent
   - Needs to be authentic business and not just done to circumvent debt regulations
   - Authorities can audit
   - Not meant as a long term funding option
2. Cash pooling – pooling surplus funds from other China based affiliate under a holdco in China to allow your bank in China to pool and redistribute potential surplus cash within the same group
3. Shareholder loan – if from outside China it is subject to same SAFE approvals and risk that it is seen as equity if long term

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Where does EDC see a role for Financing and China?

- In support of Canadian Direct Investment Abroad through partnership with Canadian banks
- In providing working capital financing for exporters here in Canada to create the capacity to engage in trade
- Through creation of trade opportunities by using EDC loans to gain access to the procurement channels of Hong Kong based strategic corporations
- Very limited buyer financings options with key SOEs in China that have SAFE approval
- Sale lease back financing for working capital support for affiliates through EDC's relationship with International Far Eastern Leasing Company (IFE).

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Canadian Direct Investment Abroad (CDIA)

- There are currently over 500 known investments involving Canadian companies in China (of all sizes and industry sectors)
- The stock of Canadian investment in China has increased by 16% annually since 1998, reaching $4.78 billion in 2010
- Actively promote CDIA with Canadian Investors
- EDC can help create financial capacity for Canadian investment into China through our Export Guarantee Program with Canadian banks
- Accounts Receivable cover for the China domestic sales by a 100% owned Canadian affiliate may be possible

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Working Capital through Sale-Lease Back

远东国际租赁有限公司
INTERNATIONAL FAREASTERN LEASING CO., LTD.

International Far Eastern Leasing is a Sino-foreign joint venture company which deals with financial lease holding businesses in medical appliances, printing, construction, industrial equipment, and education

The EDC relationship allows Canadian companies to supply qualified capital goods to IFE for leasing to Chinese companies

This also presents the opportunity for Canadian companies with affiliates in China to take advantage of sale leaseback arrangements of capital equipment to generate working capital for the affiliate

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Be sure to download the Doing Business in China Guide from the Knowledge Centre at

www.edc.ca

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