Engineering & Construction

Building knowledge*

China's booming construction market

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Market background

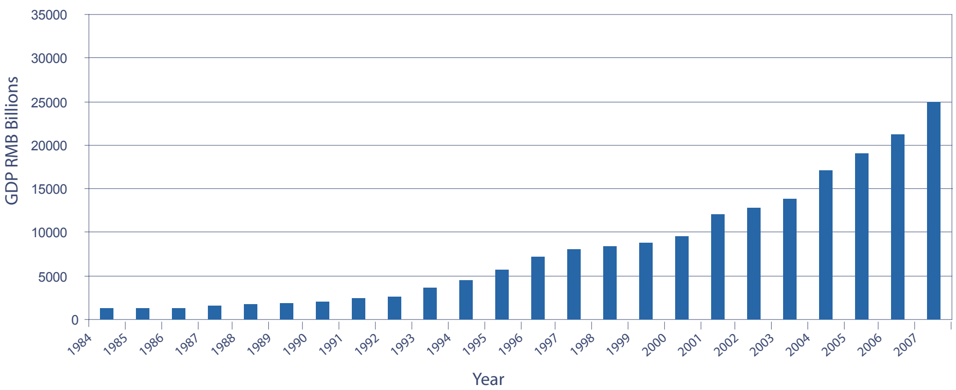
Based on Purchasing Power Parity (PPP), China is already the second largest economy in the world, second only to the United States (see Figure 1). As Asia's fastest growing economy over the past 20 years, China saw a six–fold increase in GDP between 1984 and 2004. This includes a region–specific growth rate up to 23% and a foreign direct investment (FDI) inflow of US$70bn. Figure 2 shows China's GDP from 1984 to 2007.

Figure 1: PPP GDP 2006 top 20 countries.

Rank	Country	US$m	Rank	Country	US$
1	United States	13,163,870	11	Mexico	1,269,089
2	China	6,091,977	12	Spain	1,264,047
3	Japan	4,081,442	13	Canada	1,198,654
4	India	2,740,066	14	Korea, Rep.	1,113,038
5	Germany	2,662,508	15	Indonesia	770,479
6	United Kingdom	2,003,433	16	Australia	735,879
7	France	1,959,745	17	Iran, Islamic Rep.	694,362
8	Russian Federation	1,868,980	18	Turkey	614,258
9	Italy	1,709,548	19	Netherlands	597,402
10	Brazil	1,694,335	20	Poland	565,699

Source: World Development Indicators database, World Bank

Figure 2: China's GDP from 1984 to 2007



Source: National Bureau of Statistics of China

Benefiting from this rapid growth of GDP, China's construction market has developed dramatically in the past years. The construction market will reach US$460 billion by the end of 2008 and construction spending in China is expected to grow at a rate of 9.7% annually through to 2010. Construction expenditures benefit from growth in government–funded infrastructure construction projects. These include the Three Gorges project, the 2008 Beijing Olympics, 2010 Asian Games and the Shanghai World Expo.

The Chinese government has realised the importance of developing transportation infrastructure as an key part in sustaining the country's economic growth and, to this end, the government has recently announced a budget of US$543 billion for transportation infrastructure projects in its eleventh five year plan. This includes roads, bridges, ports and railways. According to the plan, in the period 2006–2010, China will:

- Build 639 new deep water berths and 101 intermediate berths in coastal ports to increase total throughput by approximately 2.1 billion tonnes;
- Construct 380,000 kilometres of roads including 24,000 kilometres of expressways;
- Improve 5,200 kilometres of navigation channels;
- Invest approximately US$178 billion in 19,800 kilometres of new railway construction.

The central government also introduced the "Going West" policy in their recent five–year plan to give investors an incentive for investing in the west. In its tenth five year plan, the country injected more than £1.6 billion into 107 key infrastructure facility construction projects in west China.

Additionally, each year, 10 million people migrate from various villages to the larger cities in China. This has placed considerable demands on housing across the country, particularly in urban areas.

In summary, China's rising urbanisation, planned major infrastructure projects, the western development programmes and the revitalization of China's industrial north–east, represent significant market opportunities and, in turn, profits for both domestic and foreign contractors.

The risks and rewards

The investment environment for the construction industry in China has been greatly improved since the first foreign contractors entered the market in the early 1980s. By 2001, there were 274 foreign enterprises, employing a total of 42,900 people. The construction industry also benefited from loans provided by international financial organisations including the World Bank, Asian Development Bank and other investments from foreign countries.

China has further opened up its construction market since joining the WTO in late 2001, which resulted in many market access restrictions being abolished. This allowed foreign investors and contractors to have broader access to the rapidly expanding construction market.

Many private and foreign constructors are now rapidly developing in the region. For example, one of the world's largest engineering, construction and project management companies based in the US, entered the Chinese market at the end of the 1970s. In around the last 20 years, the group has completed more than 100 projects in China in a variety of fields including infrastructure, energy, engineering design and construction. The size of the projects ranged from power plants with values of over US$1 billion to small and mid-sized projects in the manufacturing sector.

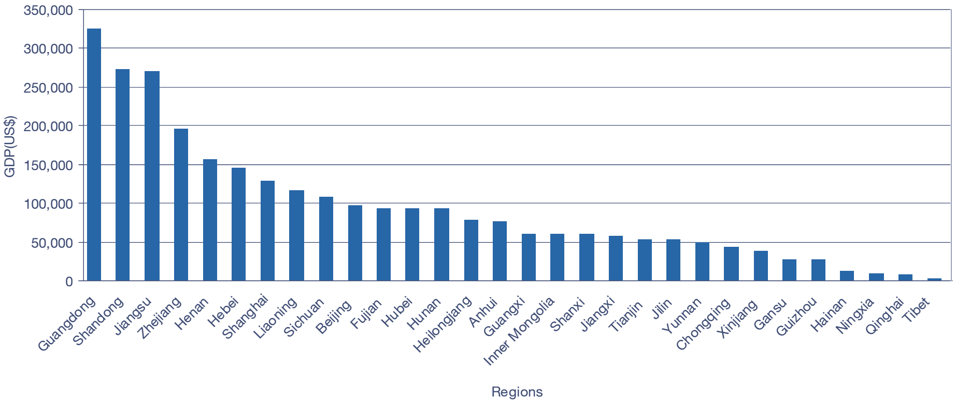
In certain provinces, special economic zones have been initiated to attract foreign investment. It is common for foreign investors to be offered a range of incentives in order to encourage them to establish themselves in a particular province. Local government may also provide a "one–stop–shop" approach in order to assist foreign firms in working through the bureaucracy more quickly.

Foreign contractors may also face some risks due to differing market and culture including differences in accounting, the legal system and the complexity of the market.

A complex country

Although China is a single nation, it is a huge and complex one. It consists of numerous distinct markets and administrative regions, characterised by different economies, cultures and languages. China's eastern coast for example, is well developed compared to the western region. Please find a comparison of GDP in different regions of China in 2006 in the Figure 3 below. Therefore foreign contractors should first of all choose the region that they would like to work and then tailor their activity according to the market and economic of that region.

Figure 3: Comparison of GDP in different regions of China in 2006



Source: National Bureau of Statistics of China

Some practical issues

Foreign contractors directly investing in China or setting up office there may encounter a wide range of practical problems, for example recruiting experienced staff with the right set of skills for international business, managing and motivating the local staff, and winning work as sometimes the selection process is not transparent – we will discuss this later in this paper. Foreign contractors will also have to come to terms with Chinese tax, accountancy and employment law. China is going through rapid change and its regulations, legislation and institutional structures are in a state of continual transition. It is important to seek advice from companies providing legal and professional services to get the most up to date information and advice tailored to the particular circumstances and needs of the company.

Engineering & Construction

There are a number of specific requirements and considerations engineering and construction companies should make ahead of making any new or growth investment decisions in the region:

- Licensing

All contractors in China require permits or licences to undertake construction business operations and any loss, termination or non–renewal of these permits or licenses could have a significant and adverse impact on business.

- Dealing with State–owned companies

Foreign contractors operating in China will come across state–owned construction companies sooner or later, be it as partner, subcontractor or competitor. State–owned construction enterprises are still the main players in the industry. Some apparently private companies often turn out to have an element of state influence. Therefore, it is important to understand how the State and the Communist Party control and influence the sector and its investments. The decision making process is not always transparent. A foreign contractor should be aware of the wider political issues and constraints, and get better understanding of the Chinese partner's position/decisions.

- Dependency on government budget/policy

As most transportation infrastructures are invested in by the government at different levels, customers of many construction companies are usually government departments or agencies or businesses with strong government affiliations. The performance of construction companies in China largely depends on public spending on transportation and other infrastructure projects. The construction projects are sometimes subject to changes or postponement arising from factors such as change in government budget and policy considerations.

- Winning work

Developing new business in China normally depends on "Guanxi" (special personal relationships). This may be difficult for a foreign contractor who has just entered the market or is planning to enter the market. Knowing the key Chinese local officials is likely to make doing business much smoother, but this can be a lengthy process. Changes of local government officials might also affect the incentives or agreements offered by the previous administration. It is also important to note that occasionally government officials have been arrested in the past for corruption, which is known to be rife in the Chinese construction industry. Regardless, governments have major roles as clients, regulators, and owners of construction companies.

- Health & safety issues

Health and safety practices in China are lagging behind international standards. Foreign contractors may find it difficult to train staff and implement the health and safety practices that they had previously used in their home country. Chinese firms and partners who do not have a similar health and safety culture may find that certain safety measures are strange and regard them as unnecessary thus providing little support to foreign contractors.

- Risk in payment

Contractors that engage in BT ("Build–Transfer") and BOT ("Build–Operate–Transfer") projects risk that the customer may delay or even be unable to make payment upon completion of the project. BT projects in China are relatively short-term and usually there is little competition in the market meaning contracts can be concluded largely through direct negotiations. Normally, the government owner will provide repayment guarantees to the investor (typically contractors). Contractors pay the start-up funding, with the sub-contractors and suppliers sharing part of the funding responsibility. For the 1-5 year period after project completion, the government will typically repay the construction and financing costs. However, as the term of any Chinese government is 5 years, current officials - in a keenness to start up multiple BT assignments (often seen as easy wins or "achievement projects") - could risk over-commitment. This may leave significant debts for the subsequent government and present credit risk to the contractors. Therefore, the risk should be adequately addressed up front and controls put in place to guarantee against severely late or even non-payment in projects.

China's booming construction market

A competitive market

Contractors typically face significant competition in certain markets (i.e. roads and bridges, residential and commercial constructions). Foreign contractors, however, have some advantages compared with domestic firms. Due to the historical centrally planned and controlled activity, many domestic firms focus on providing tailored or niche services. Reputable international firms have the capability to provide integrated services and to deliver big turnkey projects. Foreign firms are usually able to deliver on quality as well as other important issues such as safety, time and budget. Foreign contractors may have the cutting edge construction technology that is not often available in China, for example, technology in relation to the construction of high speed train networks and tunnelling construction. For example, in 2006, Siemens won a railway station project with a total value of €160 million.

China has improved its investment environment and market access especially after joining the WTO in 2001. However, foreign contractors may face some risks and challenges, as discussed earlier, in this complex and competitive market.

Ways of investing

Foreign contractors who wish to establish themselves in China and take a sizeable share of the construction market have two ways of entering the market.

Foreign contractors may set up Sino–foreign equity or co–operative joint ventures enterprise: an organisation jointly owned by a Chinese and a foreign partner. The advantage ('JV') of this form is that the foreign contractor can benefit from his Chinese partner's contacts and local knowledge which they in turn benefit from technology transfer and international project management techniques. The industry regulations also give wider market access to JV companies. However, JV has the risk of mismatching in expectations, clashes in business culture and practice, as well as simple communication breakdowns.

From 1 December 2002, foreign contractors can also set up a Wholly Foreign Owned Construction Enterprises ("WFOCE") in China. WFOCE is an enterprise that is 100 per cent–owned by foreign entities. The foreign contractor has complete control over the business, direction and profits of the enterprise, enabling the parent company to implement its worldwide strategy in China without needing to consider the involvement of a Chinese partner.

Measuring up

Benefiting from the country's rapid GDP growth and the government's focus on developing transportation infrastructure, China's construction market has grown massively in recent years and the trend will certainly continue over the next decade. The country's rising urbanisation, planned major infrastructure projects, and other major development programmes represent significant market opportunities and profits. China now has a much improved investment environment and the construction market has become increasingly accessible since the signing of the WTO in 2001. However, foreign contractors are likely to face certain challenges around cultural differences, accountancy, legislation issues, licensing issues and the complex nature of the construction market. Foreign firms, however, have their own advantages compared with domestic contractors which may help them in getting a share of the booming construction market. Whilst the Chinese construction market is without doubt an attractive one, foreign contractors who wish to enter the market successfully and profitably should be well prepared for the risk and challenges that they may face there.

Our expertise in China

PricewaterhouseCoopers is the leading professional services organisation in China, with a total staff strength of 9,000, including close to 330 partners. Our offices in China are located in Beijing, Hong Kong, Chongqing, Dalian, Guangzhou, Qingdao, Macau, Shanghai, Shenzhen, Suzhou, Tianjin and Xian.

Our China E&C group support companies with issues relating to initial entry and subsequent establishment of operations, mergers and acquisitions in China. We have the expertise in assisting Chinese state–owned enterprises during their initial restructuring exercises and subsequent listings in domestic and overseas exchanges. We are the leading accounting firm in introducing International Accounting Standards, as well as best corporate governance practices to Chinese and multinational companies. We are well positioned to advise clients on both their entry to the Chinese market and their subsequent expansion by employing our cross–industry experience and understanding of the regulatory environment.

Across the region, PricewaterhouseCoopers is auditor to more than 11,000 domestic and multinational companies in China. We are market leaders in deals advice, having worked the highest volume of deals in 2006 across Asia–Pacific, according to Thomson Financial. We have consistently been named 'Asia Tax Firm of the Year' by International Tax Review – ranked first amongst leading advisers in eleven of the last twelve years.

Our work with companies in the E&C sector includes:

- Assisting a major Chinese construction group with it restructuring and initial public offering (IPO) on the Main Board of the Hong Kong Stock Exchange. The group was ranked 10th amongst the Top 100 Chinese listed companies published by FORTUNE Magazine and ranked in the amongst the largest international contractors in the world by ENR.
- Assisting a Chinese state-owned enterprise, one of the largest providers of cement equipment and engineering services in the world, in its restructuring and IPO on the Main Board of Hong Kong Stock Exchange.
- Providing assurance and advisory services to a number of Chinese contractors, engaging in areas such as port machinery manufacturing, construction of non-residential buildings and shipbuilding.
- Our Transaction Services (TS) team is acting as the financial advisor during the privatisation process of a state-owned provincial leading construction company. In addition, the TS team also acted as the financial advisor in finding the partners to fund a private company, which is engaged in offshore heavy machinery equipment manufacturing and engineering services, to further grow its business in China.
- Our Tax team assisted a number of foreign contractors and architects in their engineering and construction projects in China, including Halliburton, Westinghouse and Shaw, Stone & Webster, ThyssenKrupp Technology, Bombardier, Foster Wheeler and Anglian Water. Our solutions included assisting in setting up appropriate business structures to carry out engineering and construction activities in China; the review of various contracts of business transactions and providing advice to mitigate the adverse impact of turnover and income taxes; the provision of corporate tax and individual income tax compliance services; advice on necessary corporate tax implications resulting from the change of accounting standards; advice on custom duties and import VAT and customs compliance for imported equipments and raw materials and other tax advisory services.

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Global network of China Business Centres

Our market investment philosophy is simple. We focus on the key emerging issues that we identify through interaction with our clients or our surveys and industry analysis. We invest in the development of new thinking, and the exchange of insights and best practices across geographic and industry boundaries. We also equip our people to respond to changing conditions in each industry sector by applying Connected Thinking to serve clients.

Each of our China Business Centres comprise a team of specialists who are experienced in a wide range of business issues related to the China market.

At every stage in the process of investing in China, our network of China Business Centres can support you and your business. Examples of assistance provided include advice on:

- market entry options and strategies;
- location requirements such as planning, tax, legal, human resources and project management;
- deal support and post-deal integration;
- planning and structural advice relating to the commercial requirements of your business; and
- the practical aspects of doing business in China.

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PricewaterhouseCoopers Engineering & Construction industry practice is comprised of a network of more than 2,000 industry professionals located in over 50 countries around the world.

The practice – recognised for its industry credentials and extensive expertise – is focused on providing services to contractors, house builders, building products companies, professional and support services companies, governments as well as to private and public sector clients of the industry.

The firm has more than 140,000 people in 149 countries in the fields of assurance, tax, human resources, transactions, performance improvement, public private partnerships (PPPs) and crisis management. Our specialised services to the sector include contract dispute resolution, acquisitions, PPPs, cost reduction and structuring.

An in–depth understanding of key industry issues and practical experience of working with our clients are central to the delivery of our services to E&C companies. Many of these issues drive our programme of publications and thought leadership for the sector.

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