Impact of China's New VAT Rebate Policy

Survey Results

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Survey Background

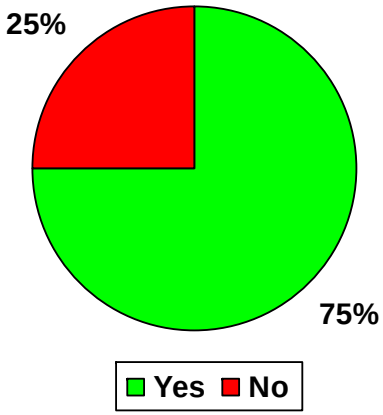
The new VAT refund rate policy was announced on June 19th by the Chinese government.

- In essence, the new policy will reduce the amount of VAT refund currently enjoyed by exporters in China.
  - The scope of impact will depend on both the exporter's corporate structure as well as the type of product it exports (a product's classification determines the level of export rebate available).
  - It is clear that this policy change could have a direct impact on the competitiveness of Chinese exports (from both foreign and Chinese firms) as well as the strategies of western firms using China as an export source for foreign market consumption.
- The purpose of the survey is to gauge the potential impact of this new policy on foreign firms sourcing from China as well as their intended response to mitigate the negative consequences.
- The survey was conducted in the month of July, 2007

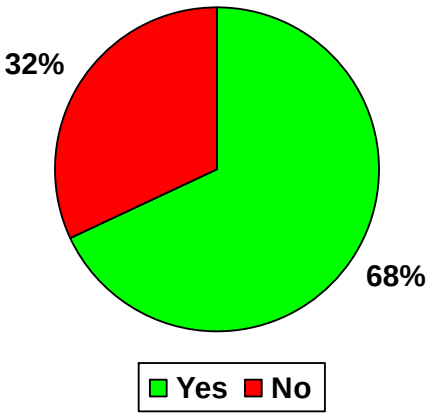
Survey Background

82 qualified companies responded to the survey:

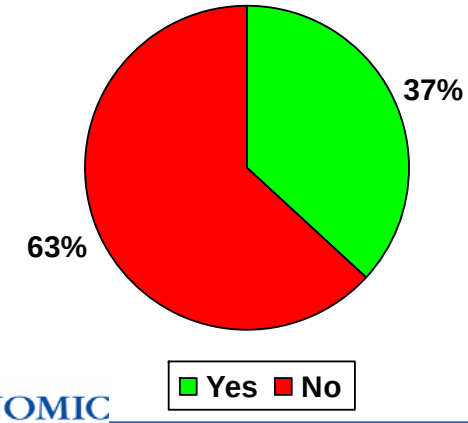
Currently Source From China: Via Independent Vendors



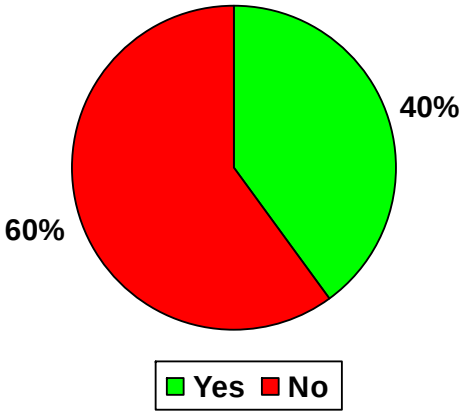
Compete with Chinese Companies Exporting to the West



Own a Manufacturing Operation in China That Exports



Own Operation is Primarily for Exports



Survey Background

Responding companies deal with a wide range of products and some services…

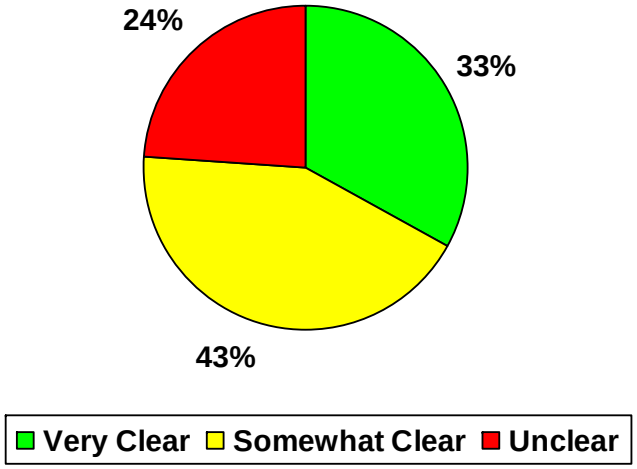
- Metal fabrications
- Automotive components
- Electronics
- Musical instruments
- Plastics
- Bicycle parts/accessories
- Bearings
- Toys
- Furniture
- Medical devices
- Food/beverage
- Fasteners
- Steel components
- Window treatments
- Polymers
- Wood millworks
- Rubber/molded parts
- Stampings
- Motors
- Plumbing products
- Kitchen products
- Dental products
- Solvents
- Resins
- Fiberglass
- Automotive equipment
- Seals
- Compressors
- Services

Headline Findings

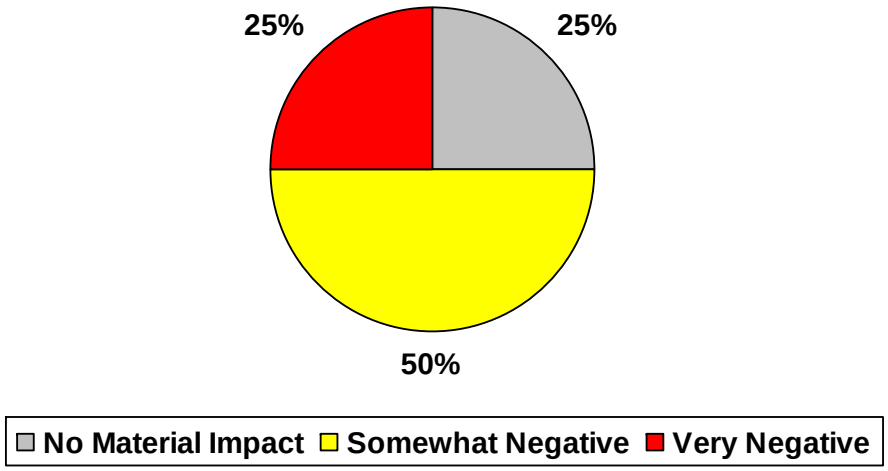
- Almost 70% of respondents were not fully clear on the expected impact from the new VAT policy.
- Most anticipate some negative fallout but only 25% would define it as "very negative" economic consequences.
- Virtually all respondents expect their current suppliers to raise prices—over 60% of respondents expect prices to go up by 3-5% or more.
- 60% of respondents believe the VAT change will have greater consequences than the appreciation of the RMB this year.
- Only 10% intend to shift supply sources to other countries, though ~40% are still uncertain.
- Few who intend to establish manufacturing in China will alter their strategy as a result of the VAT refund change.
- A number of different countermeasures will be used to off-set the impact of the VAT policy—more than half intending to "share the burden" with existing suppliers.
- Some respondents see potential advantage over competition as a result of policy change, notably over low end Chinese exporters.

Survey Results—Business Impact

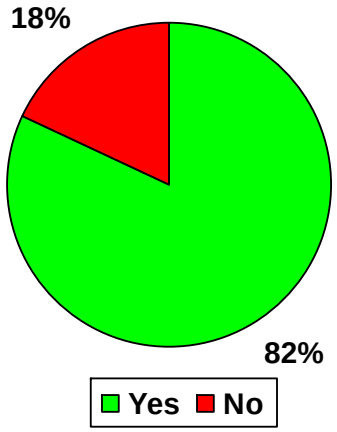
Understanding of VAT Policy Impact on Business



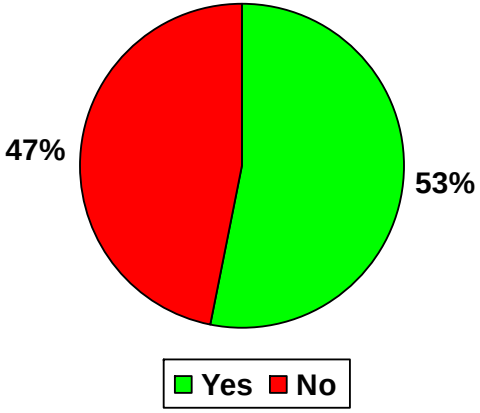
Expected Impact on Your Cost Competitiveness



Do You Expect Suppliers to Raise Price?



Have You Been Notified of Price Increase?



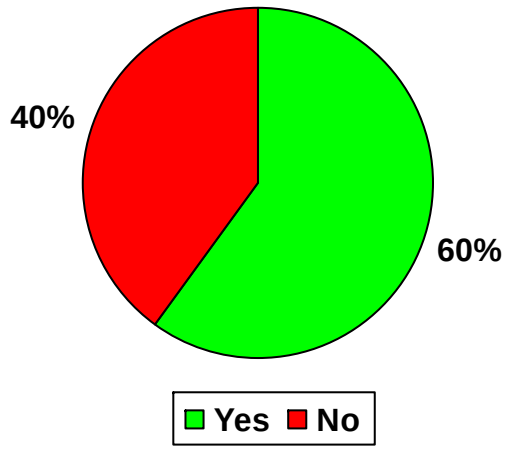
% of respondents that expect a price increase…

< 3% increase	**<2%**
3% to 5%	**28%**
More than 5%	**38%**
Don't Know	**33%**

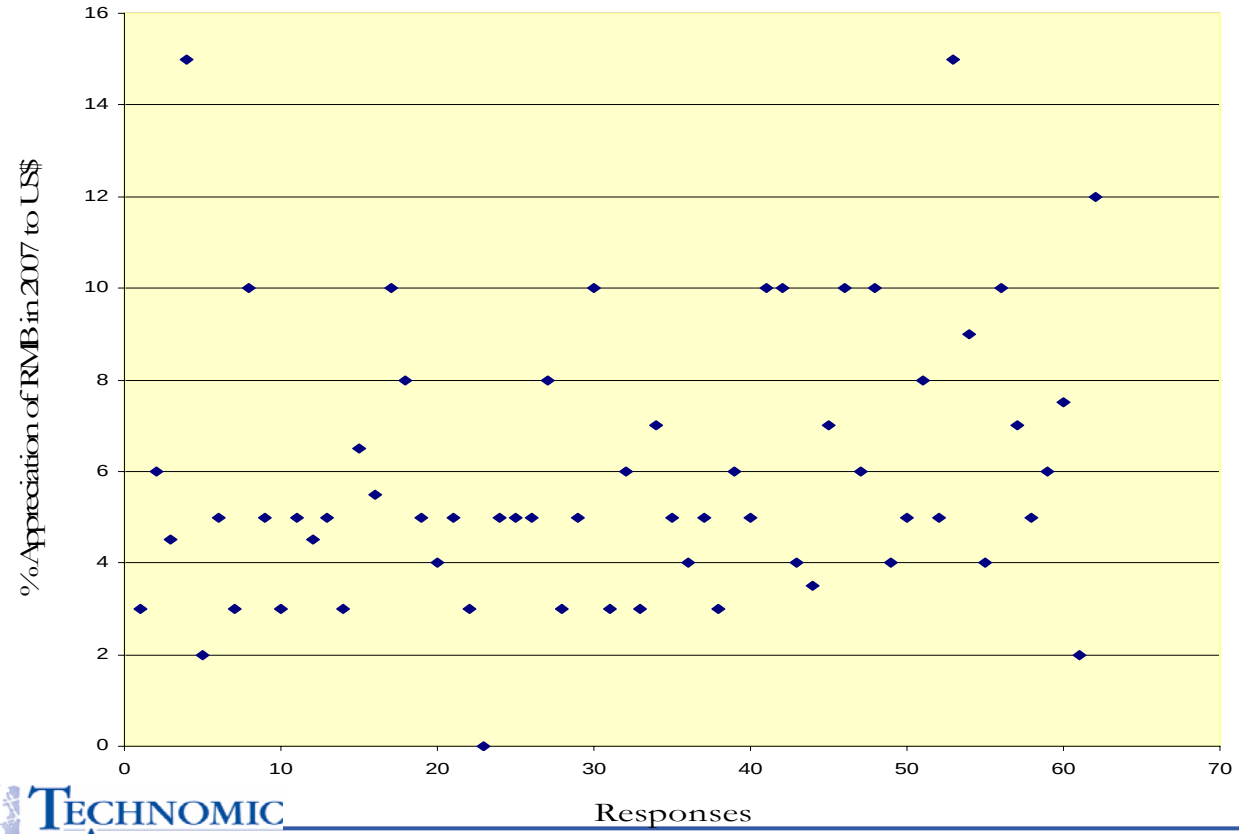
Survey Results—VAT vs. RMB

Do you believe the VAT policy change will have greater impact on your business in the next year than will the appreciation of the RMB?

VAT Policy More Impact than RMB



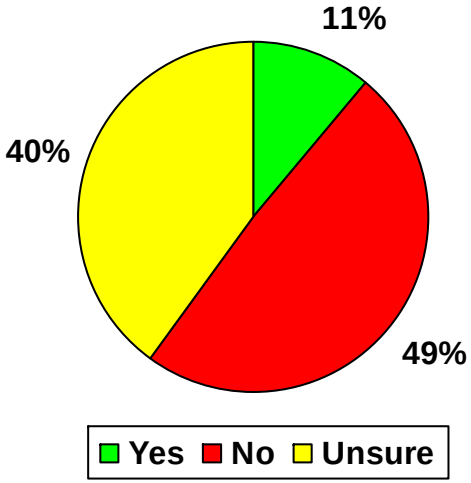
Respondents' estimation of RMB appreciation against the US$ in 2007



Simple average of ~6% appreciation anticipated by respondents this year.

Survey Results—Counter Measures

Intend to Move Sourcing to Another Country

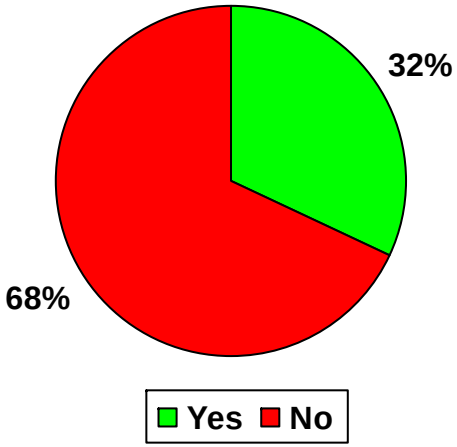


Other Countries Mentioned…

- Dominantly…**Vietnam, India**
- Scattered mention…Thailand, Malaysia, Cambodia, Eastern Europe, Mexico, Turkey

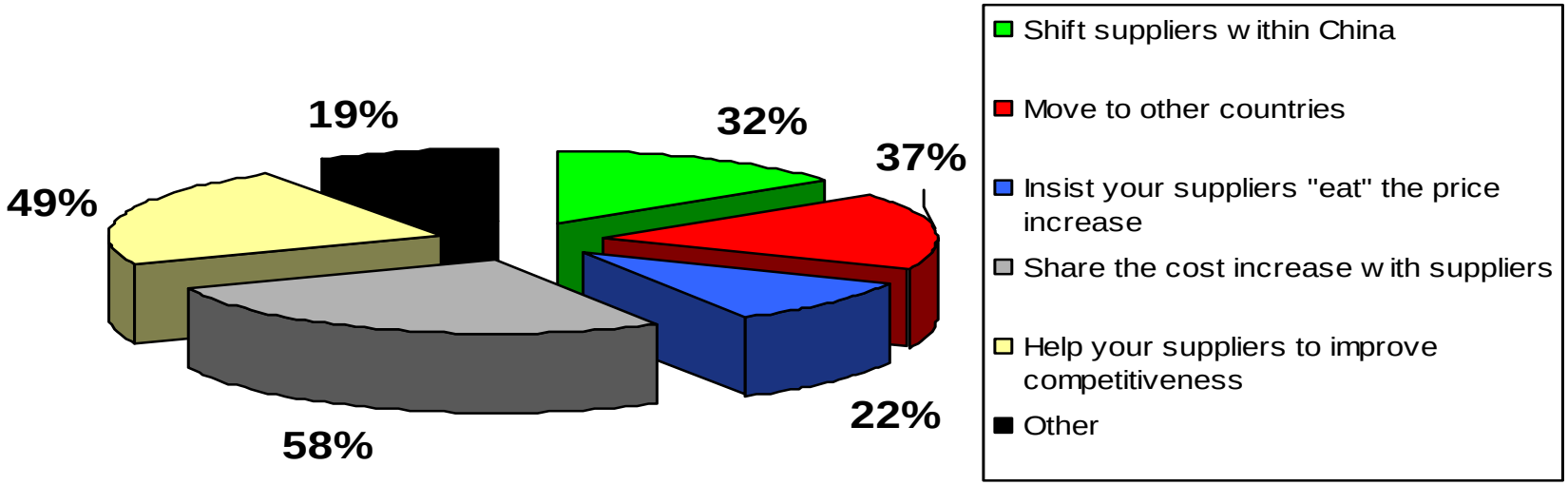
Will the VAT policy change directly affect your future decision to establish or expand a manufacturing facility in China (whether via wholly-owned or acquisition or JV)?

Change in China Manufacturing Strategy



Survey Results – Counter Measures

Counter Measures to VAT Policy: % of Respondents



Other counter measures mentioned…

- Negotiate aggressively and raise prices to customers
- Cut out US middlemen customers, go direct to their customers
- Focus on demand within China
- Move into higher value added assembly
- Increase production in EPZs
- Continue to maximize bonded purchases

Survey Results – Counter Measures

About 40% of respondents believe that competitive advantage can be gained as a result of the VAT refund change. Some comments included…

- "Because of the nature of our business model, we can implement strategies based on our buying [approach] to minimize the impact. We can be more versatile and creative in thinking/logistics to offset more than an individual company"
- Will "increase need for consultative and training services".
- "From our domestic US operation, we are also able to produce products which seem to be less expensive relative to Chinese products after the VAT policy change".
- "Will increase my competitive edge against Chinese products".
- "For all products made outside China, competitive advantage is increased".
- "It will force end customers to cut out the current importer middle men, in doing so we will increase our profit and value substantially".
- "China sources who aren't well established are just passing the cost on to the customer."
- "It also encourages China sources to dig in deeper and not just supply parts, but sub-assemblies and finished products with more value added".
- "We lose in some areas, but will gain in other areas where we have production outside China".

Survey Results – Counter Measures

Some comments…continued:

- "It helps American-made brands. A two pronged approach to the market with Chinese and American made product"
- "It creates a more competitive environment in the market place. Best product and the lowest cost wins".
- "More pricing discipline by Chinese producers, i.e. getting into the mode of raising prices to maintain margins".
- "We have a factory in USA which has been losing products to China. The policy change may allow our factory to be more competitive".
- "At present, we have overstocks and some much older product (although slightly dated), pre RMB appreciation, raw material increase, etc. that has become more and more competitive".
- "We could get a head start on our competitors at sourcing from a country that would now be a lower cost supply".
- "It will reduce competitiveness of Chinese suppliers who compete against us in the Middle East, Europe and the US".
- "Make our overseas companies more cost effective in their home markets".
- "More stable trading nation on our product for US markets".
- "Cost increases are similar for all competitive sources in China;. What other choices are there in low cost countries that can meet built up production capacity in China - none!".

Financial Impact of VAT Refund Change

Due to the confusion about calculating the impact of the VAT Policy change, the following insights are presented as a guide.

- For example, a change from 13% to 5% refund rate will have a direct 8% cost to the exporter, all other things being the same. The simple example below illustrates the change:
  - Assumes raw material **(RM)** costs of 80, all sourced domestically.

	OLD Policy	**NEW Policy**	**Formula**
Paid VAT =	11.62	11.62	Domestic RM value x 0.17/1.17
VAT Due =	4.00	12.00	(EP – Imported RM value) x (17% - VATR)
Net VAT refund or (due)	7.62	(0.38)	Paid VAT – VAT due
FOB Export Price **(EP)**	100	100	-
VAT refund rate **(VATR)**	13%	5%	-
Margin	27.62	19.62	EP – (Domestic + Imported RM) + Net VAT refund

Financial Impact of VAT Refund Change

To off-set this cost increase, companies are looking to make changes "within the system" if they can, in addition to some of the strategies mentioned by survey respondents, e.g.:

- Re-classify the code used for the product, including making some assembly modifications to do so.
- Reduce the export price by shipping to an owned or "friendly" off-shore trading company and picking up the margin there. Many trading companies are looking at this option.
  - Of course, it is a delicate area and the government will be monitoring transfer pricing.
- Shift material source to import (assuming that you have optimized domestic sources already)

Financial Impact of VAT Refund Change

The computation to shift to imported raw materials reveals some potential opportunities. The example below indicates this exporter could now pay ~10% more for imported raw materials to reach the same level of margin. Anything less he would be ahead versus buying locally.

- OLD 1 illustrates a cost of imported material of 71 to be able to reach breakeven at old VAT refund rate
- NEW 1 illustrates a cost of imported material of 78 to reach breakeven at new VAT refund rate

	OLD Policy	NEW Policy	OLD 1	NEW 1	Formula
Paid VAT =	11.62	11.62	0.00	0.00	Domestic RM x (0.17/1.17)
VAT Due =	4.00	12.00	1.16	2.64	(EP – Imported RM value) x (17% - VATR)
Net VAT refund or (due)	7.62	(0.38)	(1.16)	(2.64)	Paid VAT – VAT due
FOB Export Price **(EP)**	100	100	100	100	
VAT refund rate **(VATR)**	13%	5%	13%	5%	
Margin	27.62	19.62	27.84	19.36	

Background on Technomic Asia

Technomic Asia's mission is to assist globally expanding companies to grow their China and Asian businesses through high quality market assessment and strategy assistance.

- Company started 38 years ago in Chicago and operating in Asia since 1982
- Multi-ethnic/lingual "east-west" employees with offices in Singapore and Shanghai plus 25-30 associates in other countries
- Over 600 assignments completed in China for 200+ multinational companies such as Ford, Dupont, GM, Schneider Electric, Delphi Automotive, 3M, Emerson Electric, Citicorp, Brunswick, Sara Lee, Caterpillar, etc.
- Extensive experience in market assessment, competitive analysis and SWOT, distribution strategies and acquisition strategy and due diligence.
- Broad industry coverage including automotive, building materials, chemicals, FMCG, health care, packaging, industrial products, electronics, telecommunications and others.

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