China's agricultural sector: the big opportunity

Contents

The sustained growth in China's primary sector[1] means for many international companies it is no longer a question of "*should we go to China?*" but rather "*how to face the Chinese market?*"

This newsletter provides a brief outline of China's primary sector and relevant regulations, as well as highlighting important risks and opportunities.

1. China's primary sector

The potential for further growth in China's primary sector is immense: of China's 1.3 billion population, over 900 million live in rural areas. China currently produces 70% more than the entire agricultural output of the European Union, 150% more than India and 205% more than the US.

Agriculture accounts for approximately 15% of China's GDP and the sector closely follow China's economic development, growing approximately 8% annually. Both China's population and the average caloric consumption continue to grow. However, in the last 20 years China has suffered severe losses of arable land. As a result, China has changed from being a net exporter to being a net importer of major agricultural crops.

Chinese agricultural technology is slowly improving, but the overall efficiency continues to lag behind developed countries. The Chinese authorities are putting substantial efforts and funding in improving agricultural techniques and technologies. In order to achieve its grain self-sufficiency targets, China needs to increase its use of biotechnology and has to do it fast.

The recent impressive growth of China's primary sector is therefore not only quantitative but primarily qualitative. As a result, significant opportunities are available to foreign companies in this area.

Some of these opportunities have been discussed by Chinese and Italian representatives of research centres, universities and companies during a bilateral forum held at the Chinese Academy of Agricultural Sciences in Beijing on March 18, 2011. The conclusions of the forum can be summarized as follows:

- China's primary sector is developing as fast as Chinese economy in general, with some sectors (*e.g.*, fertilizers, water saving projects, wines) growing even faster;
- The Chinese government is making enormous efforts in the field of food safety. Moreover, efforts are increasingly being made with regards to food quality;
- Italian companies have leading technology and experience in both food quality and safety;

[1] For the purpose of this article, we have used a wide definition of "primary sector" inclusive of agriculture, aquaculture, forestry, husbandry, food processing, the manufacturing and sale of machineries and products (*e.g.*, seeds, compost, fertilizers) to be used in such activities and the sale of food & beverage products.

- Italian companies and institutions have a strong interest in selling Italian food and beverage (F&B) products and technologies overseas;
- The attitude of Chinese consumers toward Italian F&B products can be defined in terms of curiosity more than as a strong commercial interest. However, opportunities for Italian companies in the F&B and food processing sector already exist with regard to the sale/development of technologies and machineries, particularly for those necessary for testing food safety and quality. Many Italian companies already operate in the sale, development and production of agricultural and zootechnical machineries.

2. Regulations governing foreign participation to the Chinese primary sector

Given the sensitivity in respect of agriculture in China, it is not surprising that foreign investors wishing to invest in the primary sector are subject to stringent regulations and procedures. At the same time, however, some projects in the primary sector are eligible to qualify as “encouraged investments” and, as such, can be subject to a more favourable tax treatment (*e.g.*, tax holidays and lower corporate income tax rates). A list of the main restricted and encouraged activities is included in the Annex.

Possible restrictions to investments in China may also derive from (a) antitrust issues, on the basis to China’s *Anti-monopoly Law*, and/or (b) national security concerns, according to the regime recently introduced by the *Interim Provisions on Mergers and Acquisitions of Chinese Enterprises by Foreign Investors.* It should be however noted that both sets of regulations are limited to M&A projects and do not apply to greenfield investments.

Except for such restrictions, however, investments are relatively free and it can be affirmed that China generally welcomes foreign investments, especially if they involve advanced technologies and contribute to the creation of jobs and/or the improvement of China’s primary sector.

The approval process of investment projects varies significantly on the basis of a series of elements, such as the type of investment, its structure and overall value or the location of the project. In general, the following authorities are involved in the approval process, either at a central or local level:

- National Development and Reform Commission (NDRC);
- Ministry of Agriculture of the People’s Republic of China (MOA);
- Ministry of Commerce of the People’s Republic of China (MOFCOM).

3. Critical issues

The business opportunities offered by the Chinese market are widely known: ranking 1st globally in terms of both total population and size of its middle-class and 2nd in terms of total GDP, China in recent years ceased to be a promise and has become a reality that cannot be easily ignored.

Based on our experience, we believe that companies wishing to invest in the primary sector in China should take into crucial consideration the following two issues:

(a) Intellectual Property

Differently from what is widely thought in Europe, IP in China is not an oxymoron. However, foreign investors need to be take measures to protect their brands and trademarks in China. Increasingly Chinese versions of their brands are equally important with the English versions. As far as the primary sector is concerned, a series of recent cases should give to foreign investors confidence in the enforcement of IP rights in China (such as the recent successes by Ferrero and Starbucks in important litigation procedures brought against Chinese counterfeiters). With regards to F&B, it should be noted that Chinese regulations on geographical indications, patenting of new varieties of seeds/breeds and, more in general, protecting IP rights peculiar to F&B products do not reach the European standards of sophistication and protection. As a result, additional IP profiles of risk should be taken into consideration by companies willing to invest in China in this sector. It is strongly advisable to consult legal counsels prior to structure and implement an investment in China, in order to evaluate and adopt the most appropriate solutions to protect the company's IP rights.

(b) Regulatory changes

The Chinese regulatory environment is very dynamic and can represent a challenge for foreign investors. Compliance – new laws, selective enforcement, political dimensions all mean that compliance is a crucial issue for all foreign investors. The challenge is to stay ahead by knowing what compliance requires but also knowing how to react in the event of an investigation by the authorities.

Although not as obvious as the physical infrastructure, the development of China's legal infrastructure is no less important. New laws, regulations and policies affecting foreign investors are being released on a continuous basis. The primary sector will be particularly subject to regulatory changes in light of the attention it received in China's 12th Five-Year Plan, ratified by the National People's Congress last March. In China's most important policy planning document, the improvement of food safety (especially due to the recent series of scandals in this field) is indicated as a top priority. Such policy guidelines have been immediately implemented by Chinese authorities, making their determination in improving the food safety immediately evident: on March 31, approximately 45% of China's 1,176 dairy producers were shut down after they failed to obtain new production licenses aimed at preventing a repeat of the 2008 melamine scandal that sickened thousands, killed at least six children. However, as far as foreign investors are concerned, we believe that this hard-line approach will have extremely positive effects, creating additional opportunities for companies selling technologies related to food safety and contributing to create a more level playing field.

4. Suggestions

China's primary sector is likely to continue its current trend of sustained growth, both at quantitative and qualitative level. Such growth will provide foreign investors with an increasing number of investment opportunities. Through an attentive analysis of the Chinese regulatory framework and the main profiles of risk for the company (especially with regards to IP issues), as well as an attentive planning and structuring of the investments, a company can achieve the twofold goal of minimizing the risks and increasing the opportunities of success.

Annex - restricted and encouraged activities

List of main restricted activities

Sector	Restriction
Precious species lumber processing.	Foreign investor can only operate through a joint venture with a Chinese party.
Development, breeding and production of new varieties of crops and seeds.	Foreign investor can only operate as minority partner of a joint venture with a Chinese party.
Processing of soybeans, edible oil rapeseed; Production of biological liquid fuel (fuel ethanol, biodiesel), rice wine, famous liquors and carbonated beverages.	Foreign investor can only operate as minority partner of a joint venture with a Chinese party.
Cotton (raw cotton) processing; Deep processing of corn.	Foreign investors shall be subject to shareholding restriction or stricter examination requirements for investment in such specific areas.
Wholesale and retail distribution of grain, cotton, vegetable oil, sugar, medicines, tobacco, motor vehicles, pesticides, plastic sheeting, chemical fertilizer.	In case of the set up of more than 30 outlets with sales from a number of suppliers of different types and brands of commodities, the outlet chain is to be controlled by a Chinese partner.
Breeding and planting of China's rare precious breeds (including fine genes in plants industry, husbandry and aquatic products industry); Transgenic plant seeds, livestock and poultry species, aquatic breeds development, production; Fishing in Chinese jurisdictional waters; Processing of green tea and special tea with China's traditional crafts (famous tea, dark tea, etc.).	Foreign investors are prohibited from investing in these industries in China.

List of activities considered as "encouraged"

1. Improvement of low and medium yielding field;
2. Planting technology, without social effects of pollution, of vegetables (including edible fungus and melon-watermelon), fruits, teas and serial development and production of these products;
3. Development and production of new breed varieties (excluding those gene-modified varieties) of fine quality, high-yielding crops such as sugar-yielding crops, fruit trees, flowers and plants, forage grass and

For any further clarifications or research please contact:

Milan

Stefano Beghi
Tel. +39 02 763741
sbeghi@gop.it

Shanghai

Edoardo Agamennone
eagamennone@gop.it

related new techniques;

4. Production of flowers and plants, and construction and operation of nursery base;
5. Reusing in fields and comprehensive utilization of straws and stalks of crop, development and production of resources of organic fertilizers;
6. Planting of forest trees (including bamboo) and cultivation of fine strains of forest trees;
8. Planting of caoutchoucs, sisals and coffees;
9. Breeding of quality varieties of breeder animals, breeder birds and aquatic offspring (excluding precious quality varieties peculiar to China);
10. Breeding of famous, special and fine aquatic products, as well as cage culture in deep water;
11. Construction and operation of ecological environment protection projects preventing and treating desertification and soil erosion such as planting trees and grasses, etc;
12. Breeding of aquatic products and deep water net breeding, industrialized aquatic breeding, ecological oceanic species aquaculture.