

## KLINK & CO., INC.

Your Global Risk Management Partner

# Klink & Co., Inc.

## Global Risk Advisory

### #2 In a Series

### Target - China

Klink & Co., Inc. - Your Global Risk Management Partner

September 2009

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[G-20 Summit in Pittsburgh, PA](#)

[Global Due Diligence China](#)

**The G-20 Summit is coming to Pittsburgh, Pennsylvania Sept 24-25, 2009**

CEO Jeffrey Klink is acting as an advisor to the G-20 Planning Committees

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#### Dear Client,

This is the second in a continuing series of advisories in which we will examine risk factors for multinational corporations and investment funds when conducting business in a particular country. **China** is the subject of this advisory. We will examine Brazil and India in upcoming advisories.

### Global Due Diligence - China

[Klink & Co., Inc.](#) has offices in Hong Kong, New York, London, and Pittsburgh. We offer specific and general information about the risks associated with doing business in mature and emerging economies. In short, we provide detailed reports on the people, businesses, and countries that will make or break your investment capital.



**THE RISKS: CORRUPTION, GOVERNMENT INTERFERENCE, LACK OF NATURAL RESOURCES, POLLUTION, WEAK COURT SYSTEM**

**LEVEL OF RISK: \*\*\*\* 3.5 out of 5 stars**

\* ONE IS SAFE

\*\* TWO IS SAFE WITH SOME RISK

\*\*\* THREE IS MODERATE RISK

\*\*\*\* FOUR IS HIGH LEVEL OF RISK

\*\*\*\*\* FIVE IS UNSAFE (ABSENT SPECIFIC DEMONSTRABLE CIRCUMSTANCES AND RESEARCH)

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**BRIEF ANALYSIS:** Trying to rate the overall risk factor for a country as diverse and complex as a centrally planned China is akin to analyzing teenagers, but clearly there are overall trends worth reviewing and discussing. First, and worth repeating, is that China is a huge country and an engine of growth that will have more impact on the world economy in the next 25 years or more than any other nation, and therefore, it is vital to try and gain some perspective on this behemoth.

Doing business in China or with China or otherwise being engaged in some manner with the Chinese economy will likely be as necessary in the near future as having access to the Internet and having a mobile telephone is today. The long and short of China is that the rewards are entirely too large to ignore, despite the obvious risks associated with doing business in a Communist nation, which means erratic central decision-making and no reliable court system.

China's growth will be fueled by a lack of debt, an improving technology base, and increased research and development, cheap labor, poor working standards, high internal demand for goods, and a plethora of sophisticated Chinese and foreign experts able to capitalize on the markets made available by the government. Quantifying risk in China is tough, but be on notice that the central Chinese government is not timid, and will achieve its goals without undue deference to global pressure or prior commitments made to foreign investors and multinationals. Few will be able to avoid China as a market, but investors and multinationals must be vigilant and be wary about what is promised to them by the government and its "Chinese Capitalists."

Perhaps a starting point in trying to understand China is that pronouncements from the central government must be viewed at all times with some skepticism. What is said is often not real, and what is unsaid perhaps is most real. The Chinese government will keep its word where it appears to be beneficial to the nation and will not where keeping its word is not beneficial. This is not as harsh as it may sound. It is fair to say that the Chinese government will have its hands full over the next 100 years, with a growing and increasingly demanding citizenry, a relative lack of water and natural resources, and pollution that could undo all of its gains.

What of the growth, both real and imagined? Double digit growth rates may be real, but on the other hand, they may be goals of the government and not actual numbers; it may be that this engine of growth is a 4 or 6 cylinder model, and not the 8 cylinder racing version being proclaimed. No matter the real numbers, China will offer foreign investors multiple geographic and industry markets and real opportunity for gain. We do not offer special insight into specific opportunities, retail or metals, for example, at this time, but extensive market research and due diligence is especially critical in China, and speaking to people on the ground is most valuable.

Despite having a history of corruption, we view China as an improving state with respect to governance and compliance. Unlike in Russia, where corruption is often part and parcel of the soul of the country, or in India, where corruption is perhaps present at all levels of the government and economy, the Chinese business environment is beginning to show improvement largely due to internal pressures being brought to bear by the Chinese people, not international calls for transparency. When a factory makes a defective product or treats workers with disdain in China, the locals are beginning to rise up and demand change. When a provincial leader is accused of bribe-taking, the locals are demanding change, and they often get it. This trend will likely positively impact overall governance trends in the future, in our view. This does not mean, however, that the country is suddenly without corruption. To the contrary, corruption is still rampant and pervasive. But there seems to be a real trend towards improving governance. Each individual opportunity requires diligence in order for the

investor to have a reasonable chance of success and to understand the risks.

Of all the statistics being bandied about in China, the one that is most startling is that the country has over 100 cities of 1 million or more people. The sheer size of China, the strong work ethic of the people, and continuing foreign investment and internal support will produce innovation, wealth, and opportunity, and this will lead to internal and global growth. In short, China has and will continue to dramatically impact the rest of the world.

In sum, we rate China as a 3.5 Star Risk for foreign investors at the present time. Massive growth in China and in Asia, generally, is a positive. We view governance as improving. An unpredictable central government, a limited court system, the lack of natural resources, and environmental problems may negatively impact investors in the years to come, however, and it bears repeating that the government tends to often surprise in ways both pleasing and discomfiting.

#### **WHAT ARE SOME OF THE OTHER RISKS?**

Back to the growth numbers in China. If we are really seeing 10% annual growth, then the train has left the station, and investors worldwide will be trying to jump on board. GDP growth rates as announced by the Chinese central government are in our view, however, exceeding real growth, and this poses a special risk. If the real numbers are only 60% of the stated numbers, then this is not as attractive a market as it is believed and would be yet another example of how the government's words and reality can diverge. In China, regional economies are expected to keep pace with unrealistic expectations and goals, local governments are expected to keep up with their targets, and so on. The end result with respect to growth is that no one is really sure where the real numbers are, but the country is indeed in growth mode, and that much cannot be denied. Accurate forecasting, therefore, is going to be challenging, and due diligence of specific opportunities will be vital.

The Chinese as a nation have limited education, often live and work in unsafe places, and it is these souls who have fueled growth and opportunity with their cheap labor. Work standards are overall, poor, and those who complain are often branded as dangerous to the state and end up in a jail. So, for the next 10 years or more, China's best resource will be its uneducated masses, who will be the ones going into factories producing goods for internal consumption and export. They will continue to be underpaid, overworked, and subject to a harsh life for some time.

It is a question worth posing: How long will the Chinese people suffer in relative silence? While the media reports confrontations between activists and government, it is apparent that most Chinese are content to live life as best they can with what they have. Will there come a time when more people will demand that the government change or do better? Will citizens accept dangerous pharmaceuticals, unsafe buildings, and incompetent doctors forever just to avoid confrontation? Stay tuned.

#### **LACK OF NATURAL RESOURCES AND POLLUTION**

As just one example of limited natural resources, China suffers from critical water shortage problems, and this will be a major problem in the years to come. This is perhaps the single biggest threat to Chinese growth. According to experts, the country lacks enough clean water today, and as the country grows, it appears that a major crisis is just around the corner. Consider this from the World Bank: China has about 1/5 of the world's population and less than 7% of the world's water. Water shortages abound in over 300 cities. Pollution affects groundwater, lakes, and rivers. Over 700 million Chinese today are drinking and getting sick from polluted water.

Despite better technologies and a government commitment to improve the environment, air, water, and land pollution will increasingly be a major challenge for the government.

## COURT SYSTEMS AND RECOURSE

The Chinese court systems do not offer much in the way of protection for foreign investors, despite the occasional headline heralding the end of counterfeiting in China. International tribunals like the WTO or arbitration tribunals that work outside the country are probably the only judicial resources available to a foreign company when it is outfoxed by a Chinese company. The Chinese courts, like all government agencies, act on the instructions of the politically connected. Chinese businesses, Chinese courts, and all Chinese people from every walk of life report to the government first and their foreign business partners last.

## CONCLUSION

Despite noted risks, we cautiously like the Chinese markets. We had an interesting experience recently, where Chinese provincial government representatives advised us about the corrupt activities of a Middle Eastern principal doing business in a Chinese industrial park. These helpful (and we found completely accurate) comments from Party Officials likely saved our client quite a bit of money.

Invest in China, but do so with great due diligence efforts. There are as many different scams and risks in China as there are in other emerging economies. Be cautious and be wary. Do not accept as face value anything you are told. Do a lot of homework before committing to a plan of action.

For more information about our advisories, due diligence capabilities, or FCPA compliance services, please contact Dave Nolan in New York at 212.292.5116, Howard Jones in London at 44 (0) 207 016 9734, or another Klink & Co., Inc. professional at 1-800-836-8916.

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