

Harnessing intellectual capital in China - the next major opportunity for UK businesses

Key findings

- China is becoming a major global research and IP centre, being the third highest patent-filer in the world, with businesses able to access 1.5 million science and engineering students graduating each year from Chinese universities
- increasingly, UK companies are accessing this capacity – in 2010 UK companies filed over 2,000 patent applications in China, and according to a recent survey, 59% of UK companies with a presence in China say that they want to increase the R&D activity there
- early investments were made by ICT, telecommunications and software firms, but the latest wave is in the pharmaceutical and energy (including green energy) sectors, with SMEs playing an increasingly important role
- the key to successfully harnessing the capacity is to ensure structural, regulatory and IP protection matters are properly addressed at the outset, and undertaking thorough due diligence.

For many years now, UK businesses have understood the benefits of operating in China, both for low cost manufacturing, and to access sales in one of the world's largest and fastest growing markets. More and more UK companies, both large multinationals and smaller privately held businesses, are taking their operations in China one step further, and accessing the intellectual capital of the region. This includes setting up research functions to access the region's increasingly sophisticated talent pool.

We highlight below the actions being taken, and key steps to help businesses manage the development of their intellectual capital in China.

What are the UK businesses doing?

Already the world's manufacturing capital, China is now rapidly becoming a major centre for intellectual property and a research hub. In 2010 China was the third highest patent-filer in the world, just behind the US and Japan. It is equally active in granting patents. According to the latest full-year figures from the World Intellectual Property Organization, China granted more than 128,489 patents in 2009. By comparison, the UK granted just 5,428 – a steady decline from 10,541 patents granted in 2004.

UK companies are capitalising on China's new research and development-friendly environment. In 2010 UK companies made 2,087 patent applications, of which 1,164 were granted. The UK is among the top five most active European countries on this front.

China's own research spending is also rising by 21% a year, and the Royal Society, a UK-based fellowship of eminent scientists, recently forecast that as soon as 2013 Chinese scientists may be publishing more papers than US scientists.

To take advantage of that growing capacity, foreign investors have set up more than 1,200 research & development (R&D) centres across the country. While early investments were made by ICT, telecommunications and software firms, the latest wave is being driven by SMEs and the pharmaceutical and energy sectors.



British companies have taken the lead among European investors, and operate their R&D through autonomous R&D centres, units attached to other corporate functions, and joint ventures. Life sciences are a particular focus, because of lower costs and the rapid growth of the huge Chinese market. AstraZeneca, for example, has invested more than \$100m in an innovation centre currently focused on cancer therapy. However, investments are not confined to pharmaceutical research. Unilever has also invested more than \$60m in a Shanghai research centre, where nearly 450 professionals from 22 countries focus on global R&D for brands as diverse as Dove and Lipton.

And that's only the beginning: 59% of British companies say they want to raise their R&D stakes in China, according to a recent survey by the China-Britain Business Council. The British government is keen on facilitating this. In the recently concluded fourth UK-China Economic and Financial Dialogue, the two governments agreed to press forward on scientific cooperation in a variety of fields, particularly sustainable cities and clean energy. In addition to pledging to make it easier for British and Chinese researchers to collaborate, the two agreed to approve 15 joint low-carbon projects. An indication of the value both countries see in further scientific cooperation is the Royal Society's decision to bestow – and Premier Wen Jiabao's decision to accept – the King Charles II medal, which is given to foreign heads of state or government who have made an outstanding contribution to furthering scientific research in their country.

However, building R&D capacity and developing intellectual property in China often presents challenges on multiple levels, many of which will be unfamiliar even to old China hands.

The 'must-do list' to succeed

While investments should be considered on a case-by-case basis, four items should top the agenda for companies wishing to expand their intellectual property in China, whether through setting up research centres or transferring intellectual property into China:

1 Determining the optimal structure

Harnessing intellectual capital in China can be achieved in a number of ways:

- setting up research centres
- entering into joint venture arrangements with Chinese third parties
- conducting due diligence

It is important for companies to review their supply chain and determine the precise levels of activity to be

transferred to China, due to the significant operational, financial and legal implications.

For example, some companies have developed novel ways of combating intellectual property (IP) theft, such as spreading procurement among a number of vendors, which makes it more difficult to rebrand or reverse-engineer an original product. Others have created business models that discourage theft. Microchip designer ARM Holdings, for example, takes some of its fee on a royalty basis, reducing the incentive for piracy.

2 Managing the regulatory environment

Bureaucracy and regulatory issues have been identified as the biggest challenges facing businesses expanding in China. If not managed correctly, these issues can result in delays in the transmission of funds at best, and fines and expulsion from China at worst. Conversely, there are some excellent incentives.

Companies should pay particular attention to the following issues:

- Businesses should ensure they use the most appropriate type of legal entity, and that the business licence matches the activity being undertaken.
- They should assess the optimal holding structure for their Chinese operations, as it can offer significant commercial and tax benefits. Recent changes to the double tax agreements between the UK and China and Hong Kong have changed the landscape markedly.
- They should check that appropriate documentation is in place and agreed in advance with the Ministry of Commerce, tax bureaux and financial regulators to ensure easy flow of capital to and from China.
- Companies should plan to take maximum benefit from the numerous tax and other incentives for high-tech activity, ranging from reduced tax rates and tax holidays, to beneficial business rates and favourable capital requirements.
- Businesses should take a local rather than national approach to building research capacity in China because the Chinese IP market is so large, varied and fast evolving. In fact, some analysts advise thinking of investing in a Chinese lab as more like making an investment in one of the European Union countries instead of a single market. For example, special incentives exist to encourage companies to invest in the poorer western provinces. Last spring, the Chinese government announced that it would spend \$154m to develop a 10sqkm cloud computing centre for high-tech and start-up firms in Chongqing, a metropolis with a population of nearly 32 million in southwestern China.



3 Conducting due diligence

Human resource issues and language barriers are identified as another key challenge to successful implementation of a China strategy. It is important to do proper due diligence on potential partners and key employees. The terms of any joint venture agreements or employment contracts should be carefully drafted, as they may be difficult to change. It is critical that key employee and partner rewards are aligned with the global goals of the organisation, for example through long-term incentive plans or shared ownership.

4 Protecting your IP

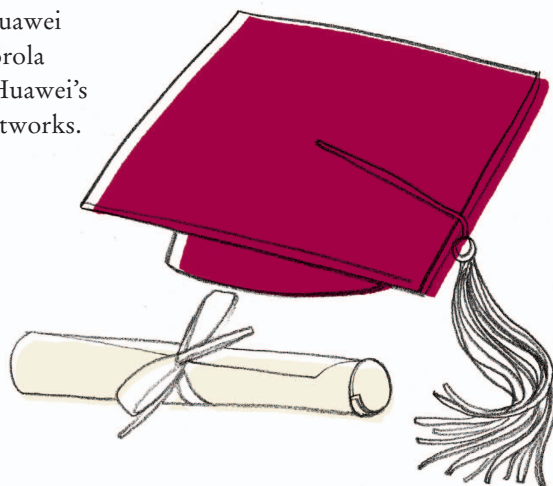
A final significant concern is protecting IP, which involves careful due diligence and appropriate structuring. Although protections have been strengthened in recent years, intense competition, the fragmentation of the legal system and the sheer brazenness of some infringers mean protecting IP demands extreme vigilance. IP laws do exist and court actions against infringement are frequent – more than 30,000 IP-related cases were filed in 2009, making China the most IP-litigious country in the world – but the courts seem to be particularly hard on multinational corporations. For example, in February 2011, Huawei won a temporary restraining order to stop Motorola from divulging confidential information about Huawei's technologies to a third party, Nokia Siemens Networks.

Seize the opportunity

With so much complexity involved, it may be tempting to wait until China offers a more secure environment for IP assets. However, the opportunity cost could be high. The potential advantages are huge, and not only in terms of salary arbitrage and tax incentives. As China becomes the single largest world market for many products, companies able to develop products locally will have two advantages: they will be better at meeting consumer needs and they will be faster to market. Not only that, many companies say that the risks of doing R&D in China are becoming easier to manage.

Most importantly, China is a major source of R&D talent. The number of Chinese students graduating with bachelor's degrees in science and engineering may now exceed 1.5 million a year – about five times the number of graduates in the US and the UK combined.

Research often functions like a stock option – paying off unpredictably but multiplying the initial investment when it does. Waiting while the competition levers its research budget in China could put you at risk if one of its larger research teams makes that all-important breakthrough first.





Grant Thornton's China expertise

The key to harnessing research and development opportunities in China is to plan carefully and execute thoroughly to ensure successful implementation. Grant Thornton's China Britain Services Group (CBSG) has been established to help businesses with different challenges from identifying the optimal supply chain structure to managing the regulatory environment and undertaking due diligence. CBSG is well positioned to assist you in developing your intellectual capital in China.

A multi-disciplinary team located in the UK, mainland China and Hong Kong; the group includes bilingual staff fluent in English, Mandarin and Cantonese. They combine a blend of technical expertise with a deep understanding of the different business cultures, derived from extensive experience working between the two countries.

With a network of 10 offices, 65 partners and 1,500 professionals across China, Grant Thornton is well versed in helping clients break into the Chinese market.



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