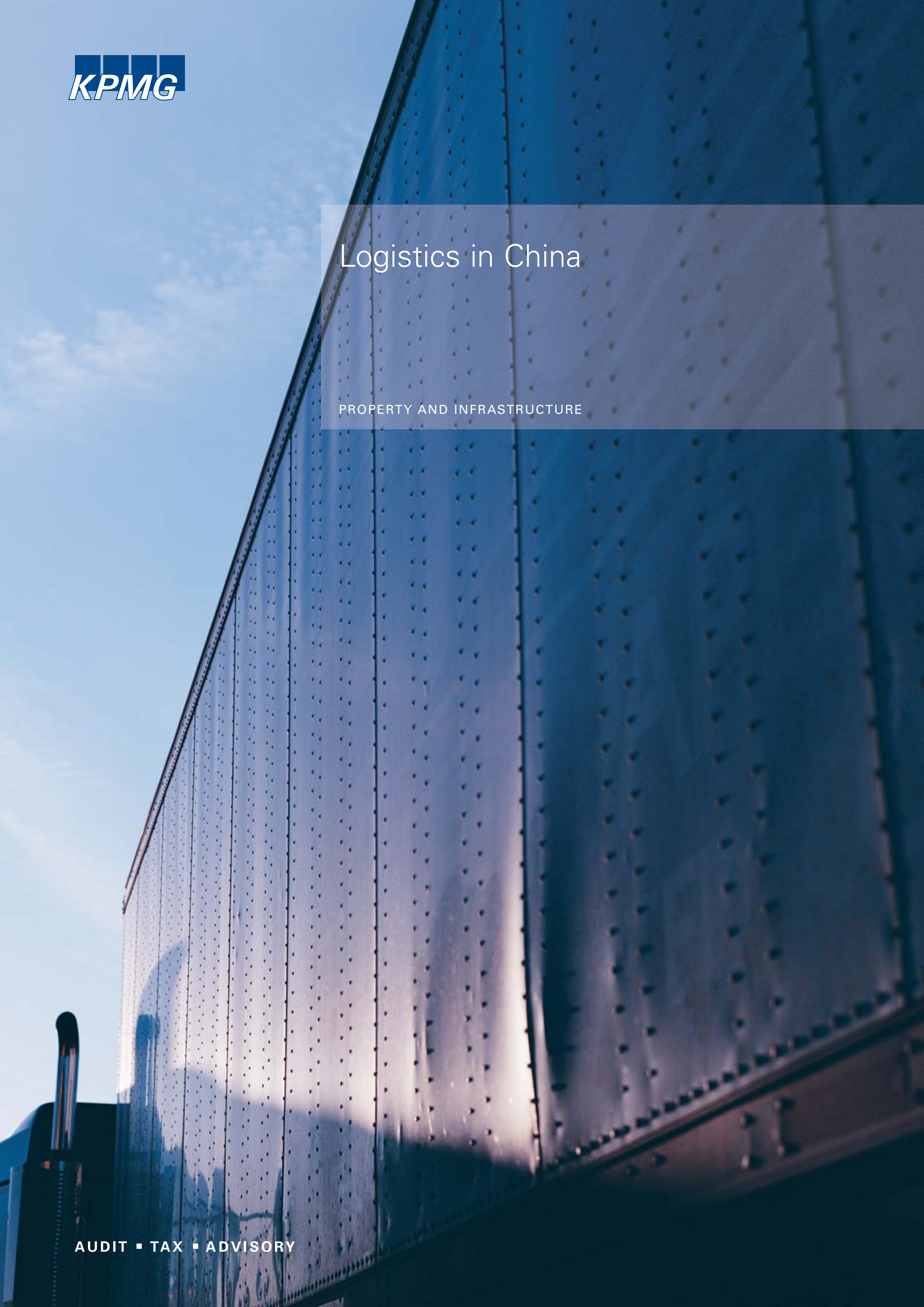

# Logistics in China

PROPERTY AND INFRASTRUCTURE

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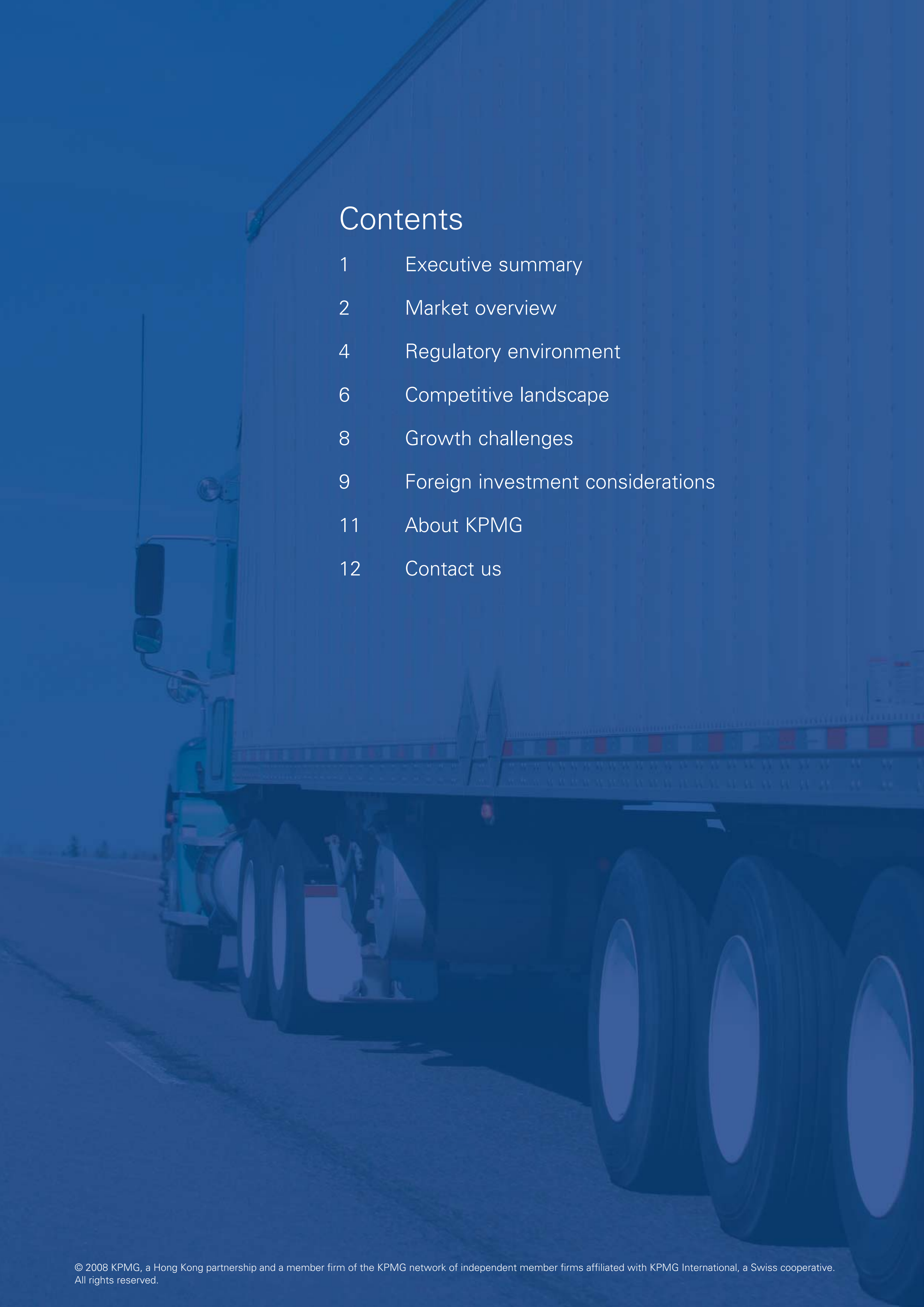


# Contents

# Executive summary

China's logistics sector is growing at an extraordinary rate, thanks to the rapid expansion of the country's industrial base and the rise of domestic consumer markets. Essential to the development of China's economy, the logistics sector has received considerable attention from policy makers and is attracting growing volumes of both foreign and domestic investment.

Having grown annually by around 14 percent over the past four years, expenditure on logistics services, encompassing transport, storage and management functions, reached RMB 3.8 trillion (USD 506 billion) in 2006.[1] This expenditure is equivalent to 18 percent of China's Gross Domestic Product (GDP) — twice that of most developed countries.[2] As a result, one of the key issues facing the industry is operational inefficiency. The market is fragmented in terms of the number of operators and their geographical remit. Operators have an opportunity to realise competitive advantage by improving coordination at the national level between transportation, storage and stock control functions.

These inefficiencies are exacerbated by a number of other factors, including transportation bottlenecks, regulatory constraints and local barriers to entry. Together, these factors have placed a strain on new and existing operators and have led to a continued rise in costs. Although these issues won't be resolved overnight, the government has taken positive steps, including opening up the market to foreign logistics companies and simplifying the necessary licensing procedures.

Foreign investment has helped to bring about operational improvements, which have in turn driven domestic companies to follow suit in order to remain competitive. Foreign companies have tended to focus on higher value segments, with many enjoying revenue growth of 30 percent or more.

1 "Possession of Private Vehicles," China Statistical Yearbook 2007, published by the National Bureau of Statistics.
2 The 11th Five Year Plan of the People's Republic of China.

# Market overview

The efficient distribution of goods and finished products is one of the biggest challenges associated with China's rapid growth. Greater strain has been placed on its transport, storage and distribution networks.

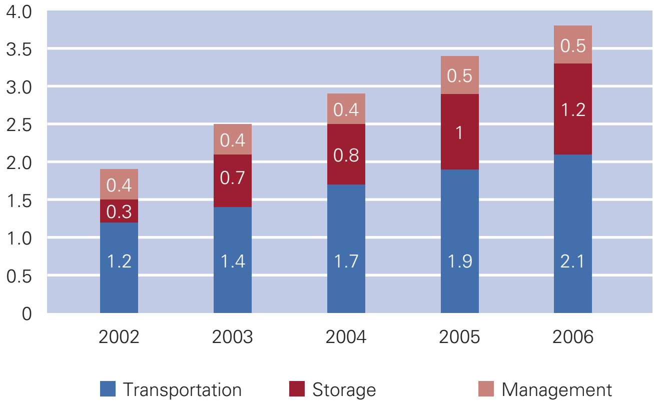
The growth of the logistics sector has been fuelled by rising demand for products and services. China's spending on logistics reached RMB 3.8 trillion in 2006 (USD 506 billion), having grown by 13.5 percent over the previous year.[3] The China Federation of Logistics and Purchasing (CFLP) estimates that the market grew by a further 11 percent in 2007 to reach RMB 4.23 trillion.

The vast majority of business for logistics companies comes from the movement of industrial products, accounting for around 87 percent of the value of goods moved in 2006. Imported products account for slightly more than 10 percent, a figure that may rise further in the years ahead.

Transportation accounts for the largest component of total logistics costs, with around 55 percent (RMB 2.1 trillion), followed by inventory storage costs (RMB 1.2 trillion) and management costs (RMB 500 billion).[4] Third party logistics (3PL) costs are included in the management component, which as a proportion of overall costs have only grown slightly over the past five years.

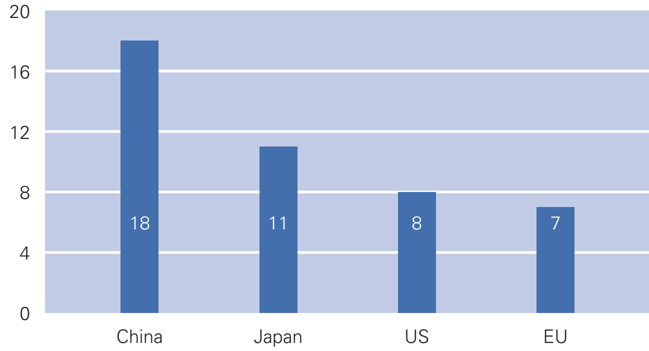
China's logistics numbers may be large, but they reveal one of the key problems with the sector. As a percentage of GDP, logistics costs are over 18 percent, and have been around this level since 2001. This is high compared to other developed countries, where logistics costs are typically below 10 percent of GDP.

**Total cost of logistics, 2002-2007 (RMB trillion)**




Source: China Federation of Logistics and Purchasing, 2007

**Logistics costs as a percent of GDP of select countries, 2006**

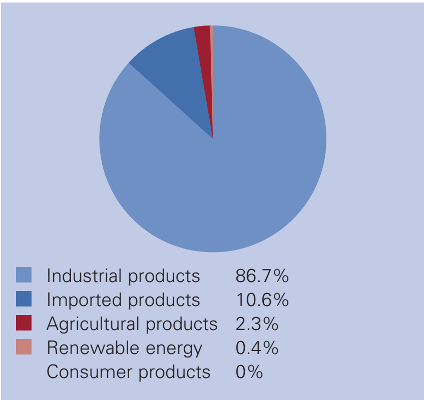



Source: EIU, ARC Advisory, CLSA

3 China Federation of Logistics and Purchasing, 2007.
4 China Distribution & Trading, *Li & Fung Research Centre*, May 2007.

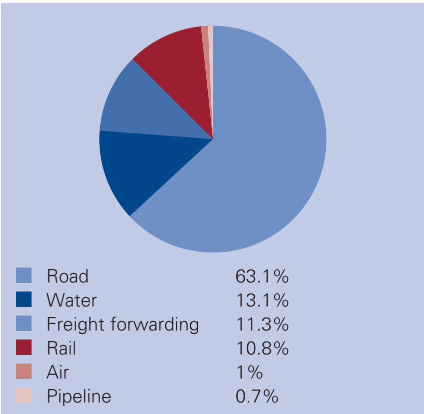
This high figure suggests some operational inefficiencies exist throughout the market. Although China's GDP is dependent on manufacturing to a larger extent than most developed countries, transportation bottlenecks, regulatory constraints and operational problems have all contributed to higher costs for operators.

**Logistics value by category, 2006**




Source: China Federation of Logistics and Purchasing, 2007

**Transportation logistics costs by type, 2006**




Source: China Federation of Logistics and Purchasing, 2007

# Regulatory environment

The government is fully aware of how possible inefficiencies in the logistics sector are impacting wider economic growth, and is in the gradual process of addressing these through a combination of regulatory measures.

The government's 11th Five Year Plan, running from 2005 to 2010, sets out key investment areas for transport infrastructure projects. A number of papers, notably the State Council's 2004 and 2005 reports Promoting the Development of China's Logistics Industry and The Development Plan for National Logistics Standards, 2005-2010, provide an outline for the direction of the industry, and in particular, help to establish the tone for developing a favourable environment for growth.

Alongside these approaches, providing favourable operating conditions for foreign investors will be important to the long-term reduction of inefficiencies in the market. China's ongoing commitment to meeting WTO requirements has been a starting point to address this issue while the government continues to relax regulations governing the activities of foreign companies.

For example, the introduction of foreign-invested commercial enterprises rules has helped by allowing foreign companies to establish wholesale and retail businesses without geographic restrictions, and allowing local authorities to grant application approvals, thus speeding up the investment process.

**A phased timetable for foreign investment**

On 11 November 2001, China formally signed the protocol on China's accession to the World Trade Organization (WTO), marking a new phase of reform and opening-up of the China market. Several clauses and contents are related to logistics industry. A clear timeframe was agreed upon for establishing wholly foreign-owned enterprises (WFOEs) in logistics.

**Timeframe for establishing WFOEs in logistics services**

| | Under WTO |
|---|---|
| Freight transport by road | January 2005 |
| Storage and warehousing | January 2005 |
| Courier services | January 2006 |
| Freight forwarding | January 2006 |
| Freight transport by rail | January 2008 |
| Maritime transport related services* | Joint venture with foreign majority ownership allowed |
| Maritime agency services | Joint venture allowed with foreign ownership not more than 49% |

*This includes maritime cargo-handling services, customs clearance services for maritime transport, container station and depot services.

Source: Hong Kong Trade Development Council

Overall, China still has further to go in easing regulatory constraints. Several government departments are responsible for different aspects of the logistics sector, making coordination at the top level more complicated. Meanwhile, local operators often have secure positions in their specific market, slowing consolidation in the industry and limiting the development of national footprints for operators.

While investment in hard infrastructure continues to be important, regulatory attention to operational issues, such as streamlining licensing requirements and continuing to encourage consolidation in the market, will be crucial to improving the business environment in the sector.

# Competitive landscape

The concept of logistics management is new in China. Logistics has traditionally been viewed as a transportation service, and the majority of State Owned Enterprises (SOEs) continued to handle this as an in-house function.

As a result of self-management and localised operational footprints, transportation and logistics operations are highly fragmented. The top 20 transport and logistics companies in China had total revenues of around RMB 260 billion in 2006 — less than 7 percent of total logistics costs for that year.[5]

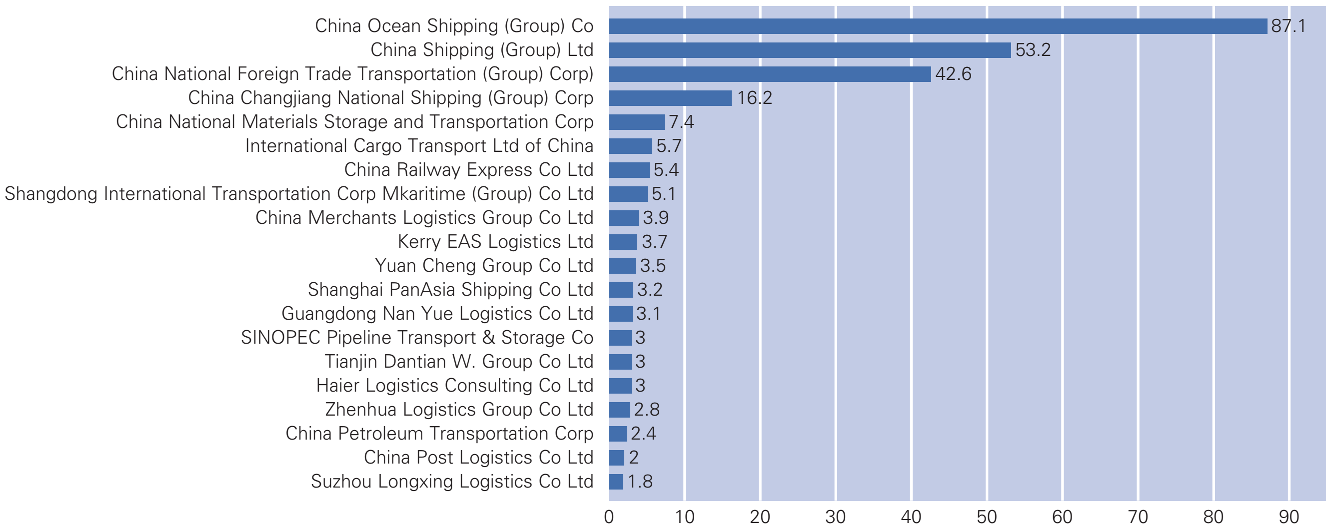
The emergence of 3PL providers will be a step to improving efficiency in the market, but it is happening slowly.

Although the majority of multinational corporations use 3PLs in China, only 15 percent of domestic companies use outside firms. 3PL's share of China's logistics market is estimated to be around 20 percent, which is considered low when compared with 35 percent in the European Union, 57 percent in the United States and 80 percent in Japan.[6]

Nevertheless, improvements and consolidation in the industry is occurring, driven by the following trends:

- Foreign players accelerating their expansion in the wake of market liberalisation and particularly China's WTO accession
- Domestic players upgrading facilities and improving their services to compete with foreign entrants
- Foreign-invested manufacturers looking to improve operating efficiency along their supply chains.

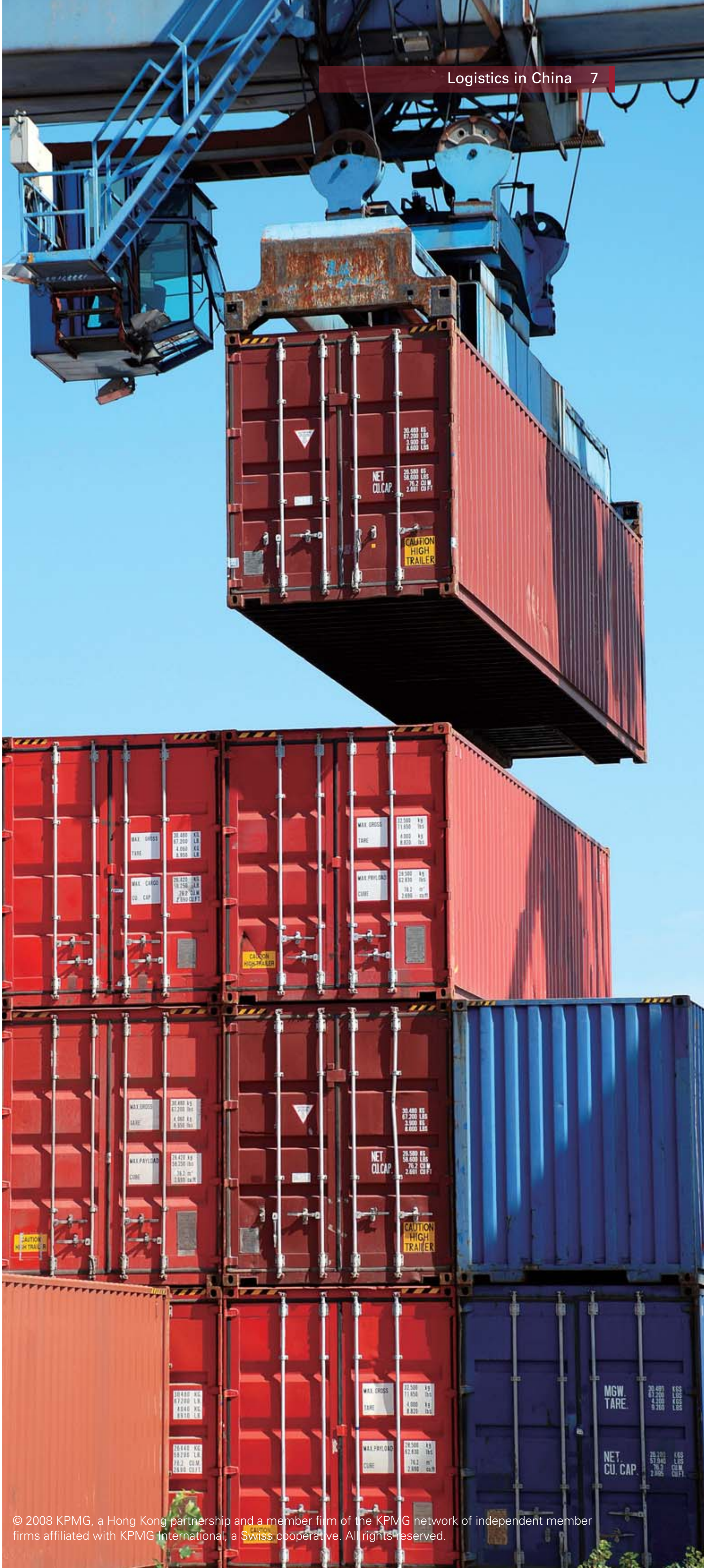
**China's 20 leading transport and logistics businesses, 2006 (revenue, RMB billion)**




5 China Federation of Logistics and Purchasing, 2007.
6 China Hand, *Economist Intelligence Unit*, November 2007.

Three major local transport and logistics players are now emerging: China Ocean Shipping (Group) Company, China Shipping (Group) Corporation, and China National Foreign Trade Transportation (Group) Corporation. However, unlike some other sectors in China, the emergence of major local players is not hindering foreign investment and success.

Foreign and foreign-invested companies have typically cornered the express delivery, sea freight forwarding and specialised logistics services and have gained a strong presence in a number of cities across China. As a result, many have seen sales grow by as much as 30 percent over the past few years.



# Growth challenges

China's logistics sector has a number of challenges to overcome in order to improve efficiencies. However, with continued government support, these challenges present opportunities for foreign companies to succeed in this rapidly developing market.

## Logistics management

With many state enterprises managing their transport and logistics in-house, a three-tier distribution system has emerged at the national, provincial and local levels. Most state-owned transport companies still only operate in their immediate regions and have little incentive to develop more comprehensive regional networks.

Most do not outsource their logistics management, and as they generally only cover the basic activities of transportation, handling and warehousing, they often have less exposure to coordinating logistics requirements on an inter-provincial level.

## Regulations

The pace of regulatory change has been affected by the fact that many government departments are involved in regulations relating to the sector. Coupled with the competitive advantages of local players, foreign investment is taking time to gain wide spread traction.

China, meanwhile, continues to make positive moves to improve the regulatory environment, from the basic level of China's WTO accession agreements, through to directives from the state government not to enforce regulations that contravene those of central government.

## Transport and operations

Transport facilities have been improving to be able to handle consumer and high-tech goods, but quality can vary between operators. China's rapid economic growth has inevitably led to some infrastructure bottlenecks. Overall, transportation networks are certainly improving; however, further integration between modes of transport is still required.

Operating costs have steadily been increasing due to a number of factors, including the rising costs of hiring and training experienced logistics staff. In such an environment, opportunities to reduce costs could be realised through improved inventory and customer tracking controls.

# Foreign investment considerations

## Market entry considerations

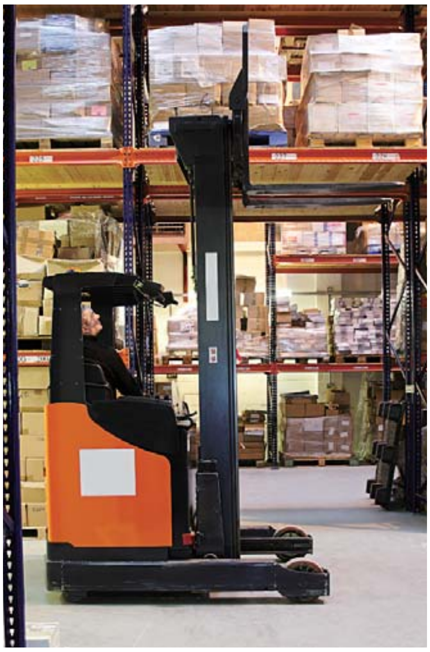
When considering an investment in China's logistics sector, attention to tax structuring options can help identify, address and, where possible, minimise tax leakages, enhancing returns to investors.

The choice of investment holding structure may be affected by the investor's home country tax treatment and investee country's imposition of withholding tax on profit repatriation. Efficient structuring can help to minimise tax leakages on repatriation of profits and minimise capital gains tax when exiting an investment, while addressing cash trap issues.


China's new Corporate Income Tax (CIT) Law has leveled the playing field between domestic and foreign companies, creating a uniform corporate income tax rate. Many preferential tax policies offered to foreign investors have been removed, but some industry-focused tax incentives do still exist. Investors should remain aware of local tax practices and consider where it is necessary to register for, and pay, income and turnover tax under different business models.

The imposition of a dividend withholding tax under the CIT Law has resulted in many foreign investors considering Hong Kong as a suitable location for an intermediary holding company for China investment. Provided certain conditions are met, this allows the PRC dividend withholding tax to be reduced from 10 percent to 5 percent under the PRC-Hong Kong Double Tax Arrangement.

Investors should also ensure that any holding structure adopted has commercial substance. Otherwise, the anti-avoidance provisions under the CIT Law can be applied by the PRC tax authorities to cancel out the tax benefits obtained.



## Transfer pricing

When a foreign company deals with the movement of goods and transacts between a number of related parties in the process, the management of its transfer pricing structure will become important. Companies that structure transactions to manage income tax liabilities in the PRC or have intertwined structures between different group companies potentially giving rise to non-arm's length transactions, may be exposed to transfer pricing risks. Ensuring these arrangements are properly structured and documented is essential, as a company may be required to justify its transfer pricing structure to the tax authorities.

## Operational issues and tax implications

Tax considerations should form an essential part of managing cost in the supply chain. Specific and distinct operational issues exist with transportation, warehousing and management functions of logistics companies. For example, a logistics company may store or transfer goods without taking title, but it may still need to facilitate the tax obligations of its customers by providing appropriate tax invoices and records for tax deduction or tax credits. Business tax may be applicable to logistic operators such as warehousing, transportation or logistic consulting companies. These businesses should ensure that compliance obligations are met.

# About KPMG

KPMG is a global network of professional firms providing audit, tax and advisory services. We operate in 145 countries and have more than 123,000 professionals working in member firms around the world.

**KPMG China**

In 1992, KPMG was the first international accounting firm to be granted a joint venture licence in China, and our Hong Kong operations have been established for 60 years. This early commitment to the China market, together with our unwavering focus on quality, has been the foundation for accumulated industry experience that is difficult to rival.

With our expanding number of offices and more than 7,000 professionals, our single management structure across China and Hong Kong SAR allows efficient and rapid allocation of resources wherever you are located.

**Industry focus**

KPMG's global network of Transport and Logistics industry professionals combines global capacity with experience and local knowledge to help organisations deal with difficult commercial issues and find new attractive business opportunities.

KPMG member firms can help in the following areas:

- Audit: KPMG firms' risk-based audit approach recognises the specific risks facing these sectors and can help address them in the audit process. KPMG member firms are some of the leading audit providers in the Transport and Logistics sectors in their respective markets.
- Managing tax strategically: KPMG's Tax practice provides tax advice to a wide range of transport and logistics clients. Services include tax compliance and planning, indirect taxes, transfer pricing, superannuation and pension funds, international executive services, tax management technology, and R&D tax concessions.
- Creating value through transactions: KPMG firms' finance and transaction professionals help realise the potential of mergers, acquisitions, divestments and other capital transactions through financial and commercial due diligence, and by formulating, structuring and implementing cost-efficient financing strategies.
- Managing risk to create value: KPMG firms can help organisations establish robust internal controls and to take an enterprise-wide approach to identifying, prioritising, managing and monitoring risk.
- Improving performance: KPMG firms can help organisations enhance their strategic and operational performance and manage their operational costs.

**Global awards**

In 2007, KPMG was awarded the 'Global Transportation and Infrastructure Financial Adviser of the Year' and 'Public Private Partnerships Adviser of the Year' for the second year running, at the prestigious 2007 *Infrastructure Journal* Awards.

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