

# **KPS China Looks to Australia for First Offshore Manufacturing Facility**

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This case was developed with the cooperation of KPS China, solely for educational purposes as a contribution to the Project entitled “Capacity Building for Investment Liberalization and Facilitation” conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.



## Executive Summary

*This case study describes the investment experience of KPS China. It outlines the company's reasons for coming to Australia and the processes involved in setting up a business in there. It details some of the challenges faced by the company and how they were resolved. The case study also describes the roles played by National and State government agencies in facilitating the investment.*

Founded in 2001, KPS China was based in the high-tech zone of Wuxi in Jiangsu Province, China. The company developed a patented technology which transformed leftover wool into a fire-resistant material that could be used for insulation and sound absorption, providing an alternative to solutions made from mineral or chemical-based substances such as asbestos. This made the material safer to produce and minimized environmental damage during the manufacturing process.

In recent years, the increasing demand for “green” products that were sourced, produced and distributed with minimal impact on the environment benefited KPS China’s business. The company’s wool-based products had found a market among construction companies and automotive manufacturers who wanted to ensure that their materials would be safe for the environment and for the workers who manufactured them.

As a result, KPS China experienced rapid expansion, achieving annual growth of up to 30% each year after its establishment. The 35-person company exported to Japan and expected its annual revenue to exceed RMB 80 million (US\$ 10 million) in 2007.

Its business growth prompted KPS China to look overseas for raw materials and new markets. The company was searching for an investment destination that offered the vast amounts of wool it needed to support existing and future manufacturing requirements. It also considered the presence of a market for its products in the host economy, as well as ease of expansion to other locations in the region. There was a need to reduce transportation costs, so it made sense to be close to both suppliers and customers. In addition, the company wanted to do business in a location that offered economic and political stability and provided a welcoming environment for foreign investors.

Besides Australia, KPS China considered investing in the United States. However, it selected Australia as its first overseas investment destination because of the quality and quantity of raw materials, access to a skilled and multilingual workforce, established manufacturing infrastructure, and a business culture that facilitated trade with key markets in Europe and the United States.

The chairman of KPS China, Mr Shen Ping, was also familiar with Australia, having visited there for the first time during the Sydney Olympic Games in 2000.

“I visited Australia seven or eight times since 2000, and felt like I knew the place quite well. During these visits, I met several Australian wool suppliers and researched the building materials market. I was reassured that there would be a reliable supply of wool and customers to sustain our investment. I felt very comfortable doing business in Australia.”

## Australia-China Trade Relationship

Australia was an attractive business destination for foreign investors. According to AT Kearney, Australia was the eighth most popular destination for foreign direct investment (FDI) worldwide and the third most attractive FDI location in the Asia-Pacific region, after China and India.<sup>1</sup> Total FDI stock in Australia amounted to AU\$ 331.4 billion in 2006-2007, a 14.3% increase on the previous year.<sup>2</sup>

Australia's major sources of FDI were Japan; the United Kingdom; and the United States. However, it was also experiencing strong growth in FDI from developing economies such as China and India. While Australia was known for its resources and agribusiness industries, its sophisticated services sector, which accounted for 77% of the economy, was also attracting attention. The Australian biotechnology and nanotechnology industries were also drawing significant interest.

Australia and China had a long-standing investment relationship. In 2006, China and Hong Kong, China, combined, made up Australia's fourth largest source of foreign investment.<sup>3</sup> The total value of the stock of foreign investment from China and Hong Kong, China in 2006 was AU\$ 41.9 billion. China's Ministry of Commerce estimated that Australia was the seventh most popular destination for Chinese outward FDI.<sup>4</sup> Yanzhou Coal Mining, Huawei Technologies and Zensun (Shanghai) Science & Technology Co., Ltd were some of the companies that had investments in Australia.

In April 2005, negotiations began for a Free Trade Agreement between Australia and China. If successful, it could produce substantial increases in trade and investment between the two economies. Independent economic modeling suggested that an FTA covering all sectors would increase output and employment for both Australia and China. Under full liberalization, Australia's real GDP would receive a US\$ 18 billion (AU\$ 24.4 billion) boost in present value terms over the period 2006-2015, and China's real GDP would increase by up to US\$ 64 billion (AU\$ 86.9 billion) over the same period.<sup>5</sup>

## Local Partnerships

By setting up a manufacturing facility in Australia, KPS China could liaise directly with suppliers and draw on the resources and services of Australia's well-established wool producers and industry organizations.

Australia accounted for one-quarter of global wool production in 2005-2006, making it the world's largest wool producing economy. Around 461 million kilograms of greasy wool were produced in 2005-2006 from 107 million sheep. Wool exports were valued at AU\$ 2.64 billion in the same period, with China, Chinese Taipei, and the European Union as the main export destinations.<sup>6</sup>

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<sup>1</sup> AT Kearney, *2005 Foreign Direct Investment Confidence Index*.

<sup>2</sup> Invest Australia, <http://www.investaustralia.gov.au/News/2007/Inflow19art1.htm>

<sup>3</sup> Combined flows are measured because a substantial amount of Chinese outward FDI is channeled through Hong Kong, China. Data source: ABS, July 2007.

<sup>4</sup> MOFCOM, September 2006.

<sup>5</sup> Department of Foreign Affairs and Trade, [http://www.dfat.gov.au/geo/china/fta/modelling\\_benefits.pdf](http://www.dfat.gov.au/geo/china/fta/modelling_benefits.pdf)

<sup>6</sup> Australian Bureau of Agricultural and Resource Economics, 2007.

Mr Shen noted, “Our products make use of wool remnants that would otherwise be discarded by mills. A major reason for setting up operations in Australia was the presence of plenty of wool waste. Victoria is a major wool-producing state so locating our operations here is very cost-effective for our business.”

Victoria accounted for approximately 93 million kilograms of greasy wool produced in 2005–2006.<sup>7</sup> Several Australian wool companies, such as Southern Wool Exports and Victoria Wool Processors, were headquartered in the state, making it easy for KPS China to meet their potential business partners.

“The opportunity to partner with local suppliers was very attractive,” said Mr Shen. “We have signed contracts with three local suppliers, including Dynon Wools Australia and Aulison Australia Group, and expect to source up to 2,000 tons of wool waste in the first year of production.”

KPS China had invested US\$ 3.5 million in a factory in Laverton, about 18 kilometers southwest of Melbourne, the capital of Victoria. Once it goes into full production, the company could expect to manufacture 2.4 million square meters of insulation materials a year.

Should its business experience rapid growth, sourcing more raw materials would be relatively easy for KPS China. The company could link up directly with wool producers in other states, particularly New South Wales, which produces 33% of Australia’s total wool production. Also, KPS China had the option of having its Victorian suppliers source additional wool waste from producers in other states.

## **A Bridge to Western Markets**

KPS China planned to invest an additional US\$ 14.5 million over the following three years to ensure that it would achieve a sales target of US\$ 25 million, of which US\$ 15 million would come from exports.

According to Mr Shen, establishing a production plant in Australia would help KPS China meet these goals. He believed that Australia’s Western business culture and established links with Europe and the United States would make it easier for the company to enter these markets.

“One of our biggest contracts with a US client was signed through our Australian company. Due to differences in language, culture, business model and legal systems, some clients from North America are more comfortable dealing with a Western company or one that operates in a Western economy, even though we offer similar products, prices and services. As Australia has strong business links with the European and North American markets, our Australian factory not only serves as an offshore production center, but also as a shopfront for KPS China, opening us to a wider world market.”

The Australian office was securing half of KPS China’s orders from Europe, and almost all its orders from the United States. Mr Chen explained that “once our products pass the final examination by the regulatory authorities of these markets, we expect our annual turnover from these two regions to total US\$ 30-50 million within three to five years.”

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<sup>7</sup> Australian Wool Innovation, 2007.

## Sourcing Local Workers

KPS China aimed to employ around 95 local technical management staff and frontline workers within three years of establishment. The company planned to hire native English speakers for sales and marketing to make it easier to build relationships with customers. Also, it wanted to employ Chinese-speaking staff to facilitate communication with colleagues in China. The company engaged a recruitment agency to assist in sourcing these two types of employees.

With nearly one quarter of its population born overseas, Australia is the most multicultural economy in the Asia-Pacific region. Almost three million Australians or 15% of the population speak a language other than English at home. Sourcing Australian workers who can communicate with colleagues in China should be relatively easy for KPS China as around 400,000 Australians speak Mandarin, Cantonese or another Chinese dialect.<sup>8</sup>

The Australian workforce is also highly educated. Australia is one of the economies in the world with the highest general literacy.<sup>9</sup> On average, one-third of the workforce across all industry sectors has tertiary qualifications.<sup>10</sup>

In addition, Australia has one of the most productive workforces in the world. Australia's average annual increase in productivity of 2.1% between 1991 and 2004 outpaced the OECD average of 1.8% for the same period.<sup>11</sup> An Australian Government report found that between 1986-1987 and 2005-2006, labor productivity in Australia increased by 36% while unit labor costs decreased by 10%.<sup>12</sup>

## Infrastructure Needs

Extensive, reliable infrastructure was a key requirement for KPS China. The company which intended to ship its goods back to China—as well as to customers in Europe and the United States—was attracted to Australia's elaborate global air and sea network. Australia's comprehensive freight and logistics services and efficient road and rail networks ensured that goods could be transported easily and affordably.

Mr Shen found the Australian logistics system efficient and the transportation infrastructure extensive and reliable. Furthermore, Mr Shen further said, "Although the manufacturing industry is small compared to China, it is more mature and hence more experienced in all aspects of the production process. Having said that, I believe there is potential for us to replace some low-grade products here."

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<sup>8</sup> *Ibid.*

<sup>9</sup> *IMD World Competitiveness Yearbook 2006.*

<sup>10</sup> Australian Bureau of Statistics, 2006.

<sup>11</sup> *OECD Economic Outlook 79*, 2006.

<sup>12</sup> Australia's Treasury, 2006.

## A Coordinated Approach to Investment Attraction

KPS China's entry into Australia was made easier with the assistance of Invest Australia, the Australian Government's inward investment agency.<sup>13</sup> The agency was represented in major American, Asian and European markets, with offices in 18 locations including Beijing, Guangzhou and Shanghai. Between July 2002 and June 2007, Invest Australia played a verified role in attracting or facilitating 387 projects worth approximately AU\$ 55.8 billion, with the potential to create more than 27,900 jobs and generate AU\$ 12.6 billion in export earnings.

In the past, the efforts of the Australian Government in pursuing FDI had been hampered by the lack of a national strategy and an uncoordinated approach to investment promotion and attraction. In its 2002-2005 strategy, *Global Returns*, and its subsequent 2006-2008 strategy, *Advancing Australia*, Invest Australia made a clear commitment to develop constructive partnerships between National agencies, State and Territory governments and industry representatives.

Invest Australia was driving a coordinated approach to investment promotion and attraction by establishing and providing ongoing support to a number of forums which brought stakeholders together, including the National Investment Advisory Board (NIAB).

The NIAB was chaired by the Chief Executive Officer of Invest Australia and comprised the heads of State and Territory investment agencies or their representatives. The NIAB members had contributed significantly to a number of key activities such as setting priorities for cooperation in investment attraction (including investment-related research and marketing), inter-government protocols on investment leads, conduct of site visits, investor facilitation services and aftercare programs.

The close working relationship among the different levels of government was evident when dealing with KPS China. Invest Australia worked closely with Invest Victoria—the government agency charged with attracting investment to the state of Victoria—to facilitate KPS China's entry into Australia. The two agencies jointly provided KPS China with information about investing in Australia and set up meetings with National and State government officials and industry representatives. Mr Chen related that Invest Australia did not “recommend” any specific state or city, but left the choice to KPS China after giving them the necessary information.

KPS China first came to Australia in 2000 to have business discussions with building materials suppliers. The company visited Melbourne in 2004 to gather more information and determine the viability of setting up operations in the state. In 2005, it registered KPS Wool Insulation (Aust) Pty Ltd in Melbourne, Australia. The following year, the company made two visits to Melbourne. On these visits, Invest Victoria organized the company's meetings with industry representatives, wool producers, legal and finance firms, local councilors and real estate companies.

“The aim was to put KPS China in touch with people who could help the company set up its business,” said Mr Zhining Yang, the manager of International Investment, Invest Victoria. “The meetings gave KPS China a better understanding of the business and legal environment and the logistics and costs involved in coming to Australia.”

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<sup>13</sup> From 1 July 2008, the functions of Invest Australia have been subsumed by Austrade. See <http://www.austrade.gov.au/>

KPS China met with:

- the Victorian Department of Innovation, Industry and Regional Development to receive a briefing on the state's wool industry and investment opportunities;
- wool producers to discuss partnership possibilities;
- local council representatives in the area where it was considering a factory site;
- a transportation company to scope logistics and customs issues;
- a major Australian bank and legal, accounting and business consultants to sort out the technicalities of establishing a company; and
- a home products retailer to determine if there was a market for its insulation products.

"When we visited Australia, the local government was very friendly and happy to help out," said Mr Shen. "The officials welcomed and provided us with good accommodation and showed us around the local community. They even worked over the weekends to fit in with our tight schedule."

## Overcoming Visa Issues

KPS China was keen on bringing in key personnel from China to manage its Australian operations. At that time, Invest Australia was offering a Supported Skills Program which enabled foreign companies making a significant investment in Australia to bring key expatriate managerial and specialist employees from within the company who were essential in setting up operations.

Invest Australia worked closely with the Department of Immigration to explain the significance of KPS China's investment in Australia and the necessity for senior KPS China officials to be granted long stay visas in order for the investment to proceed. While there were some delays, KPS China was eventually granted visas for nine key personnel as a result of Invest Australia's representations.

According to Mr Shen, the Supported Skills Program was vital for the successful setup of KPS China's Australian plant. "Our critical people included the General Manager, who would serve as the CEO of the Australian operation, General Sales Director, Financial Director, R&D Specialist and Production Manager. These people would build up a core team to run the plant with assistance from local Australian staff, and ensure that the operation would be up to the standards demanded by head office."

Under the Supported Skills Program, applicants completed an investment application form and addressed the eligibility criteria. Applications were then forwarded to the Department of Immigration and Citizenship for comment and advice. If the application was acceptable, an Immigration Agreement was forwarded to the company for sign-off. The company could then begin applying for visas for the personnel it wanted to bring to Australia.

KPS China had supplied the necessary documentation to the Department of Immigration, and the actual visas for the nine personnel were already being processed.

As of 2008, the Supported Skills Program was no longer offered, but there were other visa categories that might be suitable for international companies.<sup>14</sup>

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<sup>14</sup> See Department of Immigration at <http://www.immi.gov.au/>



## **Resolving Energy Problems**

After signing the lease on the factory, KPS China realized that energy output available at the site was insufficient to support its planned large-scale production. The company required 500 kV of power for its machinery but the factory site only offered 250 kV.

To remedy this situation, Invest Victoria linked KPS China with Powercor, a local electricity distributor, who replaced the energy transformer at the site with a larger capacity machine. This prompt action enabled KPS China to proceed with the shipment of its manufacturing equipment to Australia so that it could begin production as soon as its key staff members from China arrived.

## **Expansion Plans**

Once the manufacturing operation runs smoothly, KPS China plans to establish a research and development (R&D) center in Australia. The center, scheduled to be opened in mid-2008, would be located within the factory to ensure easy access to materials and facilities. As explained by Mr Shen, “We need to conduct a lot of field experiments and testing, which cannot be completed in a separate laboratory. The objective of the R&D center is to develop our core technology and work on new products that meet the requirements of local, North American and European markets. We believe research is essential for the further growth of our business.”

KPS China also hoped to purchase land in Australia within the next three years to replace its rented premises with a larger production facility and more advanced equipment. Mr Shen said, “Australia holds great promise for us and we are looking forward to seeing our investment come to fruition.”

