Resort, Restaurant & Recreation Practice Group

Hospitality RRReport

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# Acquisition of a Hotel in the PRC

*by Rick Kirkbride & Linda Ngan*

## I. Background

Hotel Investment Company ("HIC") intends to purchase the Hotel in the PRC[1]. The Hotel is currently owned by Hotel Owner ("Hotel Owner"), a single purpose FIE set out by a Hong Kong company. The Hotel will be sold free and clear of all liens and encumbrances, and that all hotel management and operating contracts will be terminated as of the closing date, leaving the purchaser free to re-flag the Hotel. However, the purchaser will be required to employ the Hotel's existing employees at their current salary levels. The Hotel will be structured as an asset sale.

HIC wants to insulate all parent company entities from employer and operator liability with respect to the operations of the hotels. HIC has requested our advice as to how it may best structure the acquisition and operation of the Hotel in view of these objectives.

## II. Ownership of Land and Buildings

*A. Ownership of Land Buildings*

In acquiring a hotel in the PRC, HIC should establish an FIE in China as the Purchaser of the Hotel by obtaining the following approval and licences:

a. COFTEC approval is required for the establishment of the Purchaser, if the total investment of the Purchaser is USD30 million or below.

b. The regional SAIC must issue the Business License to the Purchaser.

c. The regional SAFE must issue the Certificate of Registration of Foreign Exchange to the Purchaser.

d. The regional State Administration of Taxation of The People's Republic of China and Local Taxation Bureau must issue Certificates of Registration of Tax to the Purchaser.

*B. Procedures and Estimated Time Involved for Obtaining Approvals and Licences*

a. HIC shall decide the registered/legal address of the Purchaser. The location of the Purchaser's registered address is relevant in determining the geographical location of government departments that have jurisdiction to grant approvals and licenses to the Purchaser for its establishment and operation of business. Usually, government departments such as COFTEC, SAIC and SAFE at a municipal, provincial or autonomous region level have exclusive regional jurisdiction over all the FIEs that have their registered addresses located in that region.

b. HIC shall apply to the regional SAIC to reserve the name of the Purchaser (approval expected within 2-3 working days from application).

c. HIC shall prepare and submit to the regional Planning Commission for approval of the project proposal and feasibility study of the Purchaser. The regional Planning Commission will then submit the project proposal and feasibility study to MOFTEC and STB at the national level for review, and to the Planning Commission at the national level for approval; if the total investment (Hotel acquisition costs as well as the working capital expected for putting the Hotel into full operation) exceeds RMB200 million, the project proposal and feasibility study shall also be endorsed by State Council (equivalent to the federal government of the USA). The project proposal and feasibility study describes the project that the Purchaser intends to carry out, estimates the total investment (Hotel acquisition costs as well as the estimated working capital for putting the Hotel into full operation) required for such project and the return to be generated from such project.

d. HIC shall submit to the regional COFTEC, to obtain approval for the establishment of the Purchaser, the following documents in the Chinese language: (i) the feasibility study and approval thereof by Planning Commission and, as the case may be, by State Council, (ii) the Articles of Association, (iii) a list of the members of the board of directors of the Purchaser, (iv) the real property certificate for the registered office of the Purchaser, (vi) a set of certified copies of the constituent corporate documents of HIC, (vii) a power of attorney (if any) of HIC, (viii) in relation to HIC, a bank reference letter

[1] Defined terms, not defined in the text itself, can be found on the last page of this Hospitality RRReport.

that supports its financial ability to put up its subscribed capital in the Purchaser, (ix) duly signed application forms of the regional COFTEC and (x) such additional documents as the regional COFTEC may consider necessary based upon the particular circumstances of the proposed transaction.

e. The regional COFTEC will approve in writing the Articles of Association and also issue a Certificate of Approval to the Purchaser. Usually, the approval will be obtained within 30 working days from delivery of a fully completed application.

f. Upon the issuance of the Certificate of Approval for the Purchaser, HIC needs to present items (a) to (e) above to the regional SAIC and submit these documents to the regional SAIC together with application form of the regional SAIC and apply for a Business License for the Purchaser. The Business License shall specify the scope of business that the Purchaser is permitted to carry out during its business operation period. The Purchaser will be considered legally incorporated from the first day of the business operation period set out in its Business License. It usually takes 3-4 working days for the Business License to be issued after the regional SAIC receives a fully completed application.

g. The Purchaser will need to present items (a) to (f) above, submit application form of the regional SAFE, and obtain a Certificate of Registration of Foreign Exchange issued by the regional SAFE. It is usually obtained within one week of submission of a fully completed application.

h. The Purchaser will need to present items (a) to (g) above, submit application forms of the regional State Administration of Taxation of The People's Republic of China and Local Taxation Bureau and obtain from them each a Certificate of Registration of Tax. It is usually obtained within one week of submission of a fully completed application.

*C. Taxes Involved for Hotel Acquisition*

Unless otherwise specified below, the following taxes are payable by the Hotel Owner and HIC should remember that these will invariably be absorbed in the Hotel purchase price.

a. Stamp duty payable on each of the executed documents

0.05% of the contract value for contracts in connection with transfer of title to property, copyright, the exclusive right to the use of a trademark, a patent, the right to use proprietary technology, etc; 0.03% of the sale price for contracts in relation to sale of inventory, fixed assets, or used motor vehicle and motorcycle.

b. Business tax

Business tax at 5% of the sale price is applicable to the seller if the transaction involves the sale of the intangible assets (including land use rights, patent rights, non-patented technology, trademark rights, copyrights and goodwill) or immovable property (including buildings and other attachments to land) of the company.

c. Value-added tax

17% VAT for sale of inventory, 4% VAT for sale of used fixed assets, and 4% for sale of used motor vehicle and motorcycle at price higher than its original value.

d. Deed tax payable by the Purchaser

3%-5% of contract price for transfer of land use right and real property.

e. Land appreciation tax

30%-60% on an increase of value of the land. (30% tax is charged if increased value of land is not more than 50%, 40% tax is charged if increased value of land is between 50-100%, 50% tax is charged if increased value of land is between 100-200%, 60% tax is charged if increased value of land is more than 200%.)

f. Pay-back of custom duty and VAT exemption benefits at original applicable rates on disposal of duty-free imported equipment.

## III. Overview of Acquisition Process

*A. Preliminary Negotiations*

HIC and Hotel Owner will negotiate the terms. While negotiations or preliminary discussions are conducted, HIC will be shown the Hotel and given access to information with respect to the Hotel. HIC may also elect to conduct a physical inspection of the Hotel with an outside inspector. In some, cases, where HIC wishes to conduct a more comprehensive physical inspection, it is only permitted to do so once it provides an assurance that it is committed to the purchase by entering into a letter of intent with the Hotel Owner.

*B. Delivery of Non-Binding Statement to Purchase*

A letter of intent/non-binding statement to purchase the Hotel is presented to Hotel Owner.

*C. Due Diligence*

Lawyers representing parties to the transaction conduct due diligence investigations. The investigation should cover information on the Hotel as Hotel address, construction type and legal restrictions imposed upon the Hotel such as zoning, building restrictions and whether it is subject to city plans for developments (for example, a planned widening of city streets). The Purchaser may request the Hotel Owner to give representations and warranties these matter and make the Hotel Owner liable for breaches of inaccuracy in the statements.

*D. Execution of Purchase Agreement*

A preliminary purchase and sale agreement is entered into pursuant to

which the HIC delivers a non refundable deposit, which is capped to 20% of the purchase price according to the PRC laws. If Hotel Owner terminates the transaction, the custom is that Hotel Owner pays a cancellation fee equal to double the above deposit amount. HIC may also cancel the transaction by giving up its deposit. Such cancellations, generally, may be made up until the closing.

The agreement terms are usually very simple, Hotel Owner's representations and warranties are limited and an early closing is provided for.

*E. Closing*

Although not common, escrows are acceptable in the PRC. The following events shall take place at or after closing:

a. The Purchaser, the Hotel Owner and the Bank enter into an account supervision agreement pursuant to which the Purchaser shall deposit the remaining balance of the Hotel purchase price with an account opened with the Bank, and upon the Purchaser's satisfaction of conditions precedent to payment of Hotel purchase price (including the issue of Real Property Title Certificate recording the Purchaser as the owner of the Hotel), the Bank shall transfer the remaining balance of the Hotel acquisition costs and interest, if any, to Hotel Owner; if the conditions precedent fail to satisfy the Purchaser in accordance with the account supervision agreement, the remaining balance of the Hotel purchase price and interest, if any, shall be paid to the Purchaser.

b. The Purchaser and the Hotel Owner shall enter into a sale and purchase agreement of the Hotel building and land use right covering such building and register such agreement with the LRPMB. In some regions, the LRPMB may only register a sale and purchase agreement that adopts the model agreement of such LRPMB, or that has been notarized by a local notary entity. The Purchaser and the Hotel Owner shall ascertain with the LRPMB as regards the proper form of sale and purchase agreement and the requirement of notarization. If a model agreement of an LRPMB is used and does not cover all the essential terms agreed by the Purchaser and the Hotel Owner, the Purchaser and the Hotel Owner shall negotiate with the LRPMB for registration of a supplemental agreement that records other terms and conditions of the sale and purchase.

c. Purchaser and the Hotel Owner shall execute power of attorney, as the case may be, for the execution and use of Company chops on the sale and purchase agreement, and on the LRPMB registration application forms, for the Hotel. The power of attorney executed by the Purchaser shall be duly legalized by the Chinese embassy/ambassador located in the region in which the Purchaser was incorporated. The legalization is usually a time-consuming process and can consume a period from weeks to months.

d. The Purchaser and the Hotel Owner shall submit items (a) to (c) above to LRPMB for title transfer. LRPMB will issue a receipt on the day of receiving the filing and estimate the taxes payable as a result of the sale and purchase as well as the outstanding land use right premium. LRPMB will not process the title transfer unless such taxes and outstanding land use right premium are fully paid. As a term of the sale and purchase agreement, the Purchaser and the Hotel Owner shall agree on the payment of taxes arising from the sale and purchase of the Hotel building and land use right and the outstanding land use right premium. The title transfer is perfected when the Purchaser is recorded as the owner of the Hotel building and the land use right covering the building in the records of LRPMB, the Purchaser will be issued a Real Property Title Certificate as evidence of its title. Such certificate is normally available about two-three weeks after the application is filed.

*F. Mortgage Financed Hotel Purchase*

If the Purchaser requires finance for the Hotel acquisitions costs, it may consider borrowing funds either in RMB or foreign currency. If it borrows funds in foreign currency from a bank that is not incorporated in the PRC or that has a branch in the PRC licenced to carry on foreign currency lending, it shall comply with the following procedures:

a. It shall enter into a foreign debt loan agreement with the lender.

b. It shall register the loan agreement with the regional SAFE and obtain a Foreign Debt Registration Certificate; the registration allows the Purchaser to convert the borrowed funds from foreign currency into RMB for payment of the Hotel purchase price and to subsequently convert, and remit outside the PRC, the Purchaser's RMB income into foreign currency for repayment of loan and interest to the lender.

c. If the lender requires the Purchaser to provide any security over the Hotel project, the Purchaser shall also enter into a security document with the lender and firstly, duly file the document with the regional SAFE and obtain a Foreign Debt Security Registration Certificate. Secondly, the Purchaser should register the security document with the regional LRPMB and SAIC which have jurisdiction over the land use right, building, machinery and equipment to be charged and obtain Land and Real Property Encumbrance Certificate and Movable Assets Charge Registration Certificate. The filing and registration at the regional SAFE, LRPMB and SAIC validate the security interests created in favour of the lender.

If the Purchaser borrows funds in RMB from a PRC bank, it shall enter into a loan agreement, and, as the case may be, security document, with the bank. Foreign Debt Registration and Foreign Debt Security Registration with a regional SAFE are not needed but registration is necessary, in relation to the security document, with the regional LRPMB and SAIC which have jurisdiction over the land use right, building, machinery and equipment to be charged. As evidence of registration, the Purchaser should obtain Land and Real Property Encumbrance Certificate and Movable Assets Charge Registration Certificate. The registration at LRPMB and SAIC validate the security interests created in favour of the lender.

## IV. Due Diligence

In order to conduct a meaningful due diligence investigation of the Hotel, Hotel Owner's cooperation and HIC's free access to Hotel and information are necessary.

*A. Title Search*

HIC should obtain from the regional LRPMB a record of the Hotel building and land use right covering such building. One would expect that the record shows all title matters, such as the record owner, all encumbrances of record (such as charges and tax seizures), payment of land use right premium as well as the boundary and size, with respect to the Hotel building and the land use right; it is however quite common that the record does not contain all such information and it is essential for the PRC lawyer representing HIC to conduct other form of due diligence , inspect corporate and title documents and, if necessary, request the Hotel Owner to give representations and warranties.

HIC should obtain from the regional SAIC a record of the Hotel Owner. The record should show key incorporation matters (such as the date of incorporation, the registered office, registered capital and total investment, and business scope of the Hotel Owner), encumbrances of record (which are limited to charge over movable assets) and court seizure orders. It is common that the record does not contain all such information and it is essential for the PRC lawyer representing HIC to conduct other form of due diligence, inspect corporate and title documents and, if necessary, request the Hotel Owner to give representations and warranties.

It is worthy to note that there isn't a comprehensive public filing system in the PRC which records encumbrance over all forms of assets of the Hotel Owner or which records litigation and insolvency matters. It is essential for the Hotel Owner to give representations and warranties.

A preclosing is recommended to confirm that all documents necessary to effectuate the transfer of a clean fee title to the Purchaser will be delivered on closing by Hotel Owner.

*B. Visual Inspection*

According to the PRC Civil Law General Code, there is a concept that is equivalent to easement, which requires an owner of a building or land use right to provide its neighbour with convenience and facility of water sewage, water dam, free flow of air and light, and free access. A visual inspection of the Hotel should be conducted to assess the risk of easement. For example, does the subject Hotel block access to public roads for the adjacent Hotel owners? If anything from a visual inspection suggests the existence of an unrecorded encumbrance or potential boundary dispute, then interviews of adjacent land owners may be warranted. In this regard, it is also desirable to require Hotel Owner to obtain agreements from the adjoining Hotel owners to ensure that there are no boundary disputes. Hotel Owner's cooperation is essential in such processes.

*C. Physical Inspection*

In the PRC, HIC relies upon Hotel Owner's warranty, express or implied by law, for the condition of the improvements on the Hotel and should conduct a thorough inspection to confirm the condition of the improvements on the Hotel.

HIC should consider the need of a physical inspection report, including engineering report.

*D. Environmental Searches*

The PRC environmental laws do not impose a land owner automatically with liability for environmental clean-up unless it is found to be the cause of the problem. Therefore, environmental surveys are generally not conducted for commercial properties.

If such a survey is nevertheless desired, a consultant may be engaged to investigate on the historical use of the subject Hotel and current use of adjacent Hotel owners will be surveyed.

*E. Leases/Tenant Estoppels*

Hotel Owner typically prepares a lease schedule or rent-roll, including a schedule of deposits on hand, and warrants to the accuracy of the information contained therein. Copies of leases should be analyzed prior to closing to confirm the information provided therein.

Visual inspection of the premises to make sure the occupancy of the building conform to the tenants listed on the rent roll and a background check on tenants may also be warranted in order to ensure that the tenants are trouble-free.

Tenant estoppel certificates are not utilized in the PRC, If desired, HIC may negotiate it, but it is a concept unknown in the PRC and may disturb

the tenants or create uneasiness on tenants about the prospective new owner.

In order to enforce the existing leases, the Purchaser should require the leases to be registered with LRPMB and to be paid with stamp duty.

*F. Buyer's Acquisition Entity*

HIC should ensure that the Purchaser, an entity that it intends to use to acquire the Hotel, is in place for closing. The incorporation system is time-consuming and HIC should allot sufficient time to complete the incorporation process, including the appropriate capitalization and purchase price funding. For details of incorporation procedures, please refer to Part II of this article.

It is necessary to note that the following items are essential to the incorporation of the Purchaser and should be recorded in the Purchaser's Articles of Association. Any subsequent change of these items require the regional COFTEC's approval and SAIC's amendment of Business Licence. As amendment of any of the following items are as time-consuming as the incorporation of a new FIE, we recommend that HIC will set up an FIE for each of the hotel project that it carries out in the PRC; in addition, a single purpose FIE will separate the project risk that each hotel project entails:

a. Total investment and registered capital

According to the PRC regulations, if an FIE's total investment is USD3 million or below, its registered capital shall be at least 70%.

If HIC wishes to increase the total investment amount of the Purchaser in future, it shall increase proportionally the registered capital; in order to effect such increase, the approval from the regional COFTEC will be required. If the increased total investment amount shall exceed USD30 million, MOFTEC's final approval is required after obtaining the approval of the regional COFTEC.

b. Timing for payment of registered capital

According to the PRC regulations, at least 15% of registered capital contribution by each party shall be paid within 3 months of the issuance of the Business License of the Purchaser, and the remaining 85% of the registered capital contribution can be paid within one to two years, depending on the exact amount of the registered capital involved.

c. Registered/legal address

An FIE shall have a registered/legal address specified in the Joint Venture Contract and the Articles of Association. The location of the FIE's registered address is relevant in determining the geographical location of government departments that have jurisdiction to grant approvals and licenses to the FIE for its establishment and operation of business.

d. Scope of business

HIC shall specify the scope of business of the Purchaser in the Articles of Association. The scope of business permitted by the regional COFTEC will be reflected in the Certificate of Approval issued by COFTEC and the Business License issued by the regional SAIC.

e. Business operation period

HIC will specify the scope of business of the Purchaser in the Articles of Association. The business operation period of the Purchaser shall not be shorter than the ownership period recorded in the Land and Real Property Certificate for the Hotel, which is usually 50 years from the date of the issuance of the certificate.

*G. Seller's Authority*

All of Hotel Owner's corporate formalities should be verified. These include Hotel Owner's corporate registry in the regional SAIC, Hotel Owner's corporate resolutions and certificate of registered company seal.

*H. Appraisals*

The PRC real estate appraisers may adopt any of the following methodologies in valuing properties: market comparable, replacement cost, cash flow or income analysis. Thus, it is for the Hotel Owner and HIC to agree on the methodology.

In sum, HIC relies heavily upon Hotel Owner's express and implied warranties with respect to the subject Hotel. HIC's due diligence investigation of an income producing Hotel focus primarily on the economic aspect of the Hotel.

## V. Operation of the Hotel

The Purchaser would presumably enter into an agreement with ManCo for the "flagging" and day-to-day management of the hotel. Typically, such agreements obligate the Purchaser to furnish the Hotel premises and all furniture, fixtures and equipment, supplies and labor necessary, in ManCo's judgment, to operate the Hotel in accordance with ManCo's standards for the flag chosen, with ManCo providing only the general manager and perhaps a few key management personnel with authority to manage the Hotel on a day-to-day basis. The Purchaser could employ the labor directly, or contract with a third party for some or all of the required labor.

## VI. Minimizing Employer Liability

Since Hotel Owner requires the Purchaser to employ the Hotel's existing employees at their current salaries, HIC has sought advice as to how to minimize potential liability with respect thereto.

According to the PRC Civil Law General Code, a company shall be responsible for the acts of its legal representative and staff who carry on

business activities in the name of the company and who inflict economic losses on third parties. Other than the above-mentioned provision, the concept of employer's liability is not clearly defined in the PRC.

The Purchaser could either employ labor directly or contract with a third party to provide the labor, but to minimize the risk of uncertainty that may arise from employer's liability, we recommend that HIC set up another servicing co. ("EECo") which would not be majority owned by HIC entities to act as the employer, perhaps a service provider to HIC in the PRC would be willing to be the majority owner of EECo, with the Purchaser agreeing to pay the direct cost of the employees plus an appropriate margin to EECo. So long as EECo is formed in good faith (*i.e.* not for an illegal or immoral purpose), is adequately capitalized, observes corporate formalities, maintains its own corporate books and records and financial affairs separate from those of its shareholders, etc., EECo should be respected as an independent corporate entity, and HIC entities should not have "employer liability" with respect to EECo's employees.

Under the PRC employment law, employment may be terminated at the expiration of the employment contract or upon the occurrence of terminating event agreed by the employer and the employee. For any employee that serves an FIE for more than six months, the FIE should compensate him for living and medical subsidies. It is therefore beneficial to HIC to negotiate a six-month limit on any commitment toward the Hotel's employees.

If HIC is successful in limiting the initial commitment to six months, it will have six months to decide whether or not a particular employee meets its standard for permanent employment, and to establish its own salary and benefit policies. In the absence of an explicit six-month limit, the employees would enjoy a presumption that their employment would continue indefinitely at their existing salary and benefits. Whether or not HIC can succeed in negotiating such a limit will depend primarily on the strength of the employees' union and how the union views the financial strength of Hotel Owner versus the new owner. If the employees take the view that they have little job security with the current owner, they are more likely to comprise with HIC.

To the extent the employees realize the precarious state of their existing employer, they should be willing to cooperate with a new, financially capable owner. Any new owner of the Hotel would intend to manage the Hotel in accordance with its philosophy and standards, and would want to introduce its own employment rules and regulations and salary scale as quickly as possible. Furthermore, the employees' long-term job security and opportunity for promotion would be limited unless they are integrated into the mainstream of the new owner's workforce. Despite the strength of these arguments, Hotel Owner may not be able to obtain the employees' agreement to a six-month contract. In case no explicit six-month limit on employment terms and conditions can be negotiated, the issue of what entity will take the employer liability risk becomes much more significant, since the parameters of that risk are not very clear under the PRC employment law. If HIC can persuade a third party to be the majority owner of EECo, HIC could limit its employer liability to (1) the amount its pays for its minority interest in EECo plus (2) any payment or other benefit it agrees to provide to the third party to take a majority of EECo's shares. If HIC is unable to negotiate a firm limit on its obligation to the Hotel employees and cannot find another party to become the majority shareholder of EECo, HIC must consider whether it is prepared to accept the "reputation risk" associated with employer liability, since it may be very difficult for HIC's affiliated entity to "abandon" EECo (*i.e.* allow it to go bankrupt).

## VII. Business Licenses

The purchaser of the Hotel will not succeed as a matter of course a hotel Business License owned by Hotel Owner. HIC must set up the Purchaser as an FIE and apply for a Business Licence that permits the Purchaser to own and operate the Hotel business. For details of applying for such Business Licence, please refer to II of this article.

## VIII. Conclusion

In short, HIC should be able to acquire and finance the real property assets comprising the Hotel by setting up two FIEs: the Purchaser to own and operate the Hotel, and EECO to be the employer of the Hotel employees. Due to the rapid development of the PRC legal regime, it is recommended that HIC should structure the acquisition deal with the advice of its lawyers, accountants and other experts.

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## Definitions

"Articles of Association" means the Articles of Association of the Purchaser.

"ASA" means the Administration of State Assets of the PRC, and as the context may require, any of its regional offices in the PRC.

"Bank" means a bank in the PRC designated by the Hotel Owner and the Purchaser for receiving and distributing the Hotel acquisitions costs in accordance with the instructions of the Hotel Owner and the Purchaser.

"COFTEC" means the Commission of Foreign Trade and Economic Co-operation of the PRC, which is an authorized regional office of MOFTEC at any municipal, provincial or autonomous region level of the PRC government.[1]

"FIE" means a limited liability foreign invested entity incorporated under the laws of the PRC. An FIE may be in the form of a wholly foreign-owned enterprise ("WFOE"), a Sino-foreign equity joint venture enterprise ("EJV"), or a Sino-foreign contractual/co-operative joint venture enterprise ("CJV").

"Hotel" means the hotel to be acquired by HIC.

"LRPMB" means the Land and Real Property Management Bureau which has jurisdiction over the Hotel building and the land use right covering the building.

"MANCO" means a hotel management company to be engaged by the Purchaser for the future management of the Hotel.

"MOFTEC" means the Ministry of Foreign Trade and Economic Co-operation of the PRC.

"Planning Commission" means State Planning Commission of the PRC.

"PRC" means the People's Republic of China.

"RMB" means Renminbi, which is the legal currency circulating in the PRC.

"SAFE" means the State Administration of Foreign Exchange of the PRC, and as the context may require, any of its regional offices in the PRC.

"SAIC" means the State Administration of Industry and Commerce of the PRC, and as the context may require, any of its regional offices in the PRC.

"STB" means State Tourism Board, and as the context may require, any of its regional offices in the PRC.

[1] In the PRC, there are four municipalities (*i.e.* Beijing, Shanghai, Chongqing and Tianjin), over thirty provinces (*e.g.* Hunan, Hebei, Guangdong and Jiangsu) and more than four autonomous regions (*e.g.* Inner Mongolia, Ningxia and Guangxi).

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