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China's Expanding Role in Global Mergers and Acquisitions Markets

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Summary

Background and Scope

One of the few propositions on which virtually all China experts agree is that foreign investment *in* China has been a major contributor to the Chinese economy's remarkable growth over the past three decades. In addition to the direct benefits realized from the invested capital itself—which increased more than sixfold between 1992 and 2007—significant additional benefits accrued indirectly from the technology, management, and marketing skills that were associated with foreign investment.

From China's perspective, these large capital inflows were sometimes viewed as entailing risks that were mitigated by imposing restrictions on foreign investment. These measures included limiting foreign equity investment to nonvoting "B" shares, constraining the proportion of ownership that foreign investors could acquire in Chinese companies, and limiting the number and size of foreign firms' financial platforms in China's capital markets.

In the coming decade, foreign investments *by* China may become an important contributor to growth in the rest of the world, as well as a major factor in global mergers-and-acquisitions markets. Besides the direct effects of prospective investments from China, there also will be indirect benefits realized through improved know-how, learning, and market access relating to local procedures and regulations within China's 37 diverse provinces and administrative regions. From the perspectives of recipients of China's foreign investments, there may also be concerns and risks. These risks may entail the broad national inter-

ests, sensitive technologies, and natural resources of countries receiving China's investments. Recipient countries may thus seek to mitigate these risks through various measures discussed in this monograph.

In this monograph, we seek to improve understanding of China's foreign investment patterns and strategy. We explicitly consider whether and how U.S. national interests might be compromised by some of China's investments and how these interests can be safeguarded without interfering with, indeed by encouraging, opportunities for investments that advance the economic interests of the United States, other countries, and China.

Our research focused on China's investments in U.S. companies and, more particularly, investments in U.S. companies whose acquisition by China might affect U.S. national security. This focus entailed paying special attention to prior investments by China that led to reviews by the United States as well as to potential investments that might warrant such assessments in the future. The research also sought to compare China's investments in the United States with those of several top-rated private equity (PE) companies to provide a benchmark for evaluating their respective similarities and differences, as well as their patterns and inferred priorities. A fuller understanding of China's investment strategy also required looking more broadly at China's investments in countries other than the United States and considering how China's investments in the United States fit into this broader pattern. Consequently, the research described in this monograph also provides an initial examination of the pattern of China's investments in Europe, Asia, and the rest of the world, and inferences that may be drawn from this wider view of China's foreign investment strategy.

China, the United States, and the Global Economy

In the evolving global economy, China's large and growing financial resources will strengthen its bargaining power when it looks for companies and resources abroad. The resulting challenge for both target investment countries and China is how to nurture the opportunities for and potential benefits from efficient allocation of Chinese invest-

ments while avoiding or sharply limiting possible risks to national security in the countries of proposed investments. The implied goal of this research is to develop policies and procedures that will promote win-win outcomes while minimizing outcomes that might involve losses for the countries involved.

The drivers of China's remarkable economic growth during the past three decades have included both direct investment from abroad as well as massive domestic investment constituting more than 35 percent of China's gross domestic product (GDP), an unprecedentedly high domestic savings rate of 45 percent of GDP, continued growth of both labor productivity and total factor productivity, and open and expanding markets for China's exports, especially to the United States until mid-2008. These drivers have also included important institutional changes in China: privatization of state-owned enterprises, vigorously competitive domestic product markets, volatile and sometimes highly speculative securities markets, emergent attention to corporate governance, and serious if imperfectly effective efforts to control corruption.

As a consequence of these multiple drivers, China has become the world's second-largest economy. As its economy has grown, China has accumulated the world's largest holdings of foreign exchange reserves—over $2.1 trillion at the start of 2010, one-third larger than those of Japan. These huge holdings enable China to expand its foreign investments and to seek and acquire companies and other assets abroad.

China's increased prominence in the evolving global economy also stems from its bilateral economic relations with the United States; the effects of the global financial crisis on these relations, including the respective fiscal stimulus programs in both China and the United States; and the consequences of these matters for China's recent and prospective investments in U.S. companies, as well as in countries and companies in other parts of the world. China's increasing prominence in the world economy has led to some discussion of possible reforms to the international financial system in which the yuan would become a generally accepted international reserve currency. Such reforms are unlikely in the short to medium term because the yuan's prospects as a reserve currency will be remote as long as it remains incompletely

convertible. China's policymakers have repeatedly stipulated that capital transactions are unlikely to be fully convertible for the indefinite future. In the longer run, the prospects are brighter.

China's Recent and Prospective Foreign Investments

China's broad foreign investment strategy appears to be distinctive, selective, and flexible—characteristics that we discuss in Chapter Three.

It is distinctive in that it reflects both the central government and ruling party's broad national priorities that prominently include the salient need of the Chinese economy to sustain high rates of economic growth. This distinctive role of the central government results from the fact that China's major foreign capital transactions require approval of the State Assets Board (SAB) and the State Administration for Foreign Exchange (SAFE), which are accountable to the State Council. When competing claims arise for using China's foreign investments to help meet the demands of the economy, the military, or the economy's technological advancement, these claims are resolved by the institutions at the top of the institutional pyramid. The distinctiveness of China's investment strategy is also reflected in the contrast between Chinese investments in recent years and investments made in the same period by several prominent global PE firms: Blackstone, Kohlberg-Kravis-Roberts, Carlyle, Cerberus, and Berkshire Hathaway.

That China's investment strategy is selective is evident from the conspicuous differences between China's investments in the United States and its investments in Europe, Asia, and the rest of the world during the 2007–2009 period. Selectivity is also reflected by the fact that China's foreign investments sometimes focus on realizing stable returns or realizing higher if more volatile returns; whereas in other instances, the focus is on acquiring companies with large oil, gas, and other mineral resource holdings or companies with advanced technology, laboratories, and testing capabilities; and in still other instances, the companies China has acquired are ones with evident financial experience, connections, and know-how.

That the strategy is flexible is suggested by recent policy pronouncements by top Chinese leaders expressing encouragement for expanded Chinese investment abroad, especially by China's most "capable" companies, including state-owned enterprises, while adopting a more restrictive stance toward ones judged less capable.

Notwithstanding frequent Chinese criticism of mounting U.S. budget deficits and the jeopardy this creates for the stability of the U.S. dollar, China's investments in the United States continue to be predominantly in U.S. Treasury notes and bills and other government obligations. China's accumulation of these government assets by the middle of 2009 reached $1.5 trillion, of which nearly one-third was accumulated from 2007 through the middle of 2009. Apart from these investments, China's investments in U.S. companies in the same period were small, amounting to $25.8 billion, and were concentrated in the financial and business services fields. The reasons for this concentration include China's (plausible but mistaken) expectation of high rates of return on investments in these sectors, as well as the reasonable expectation by China's policymakers that such acquisitions would provide an opportunity to learn about and to access information on the broadest spectrum of companies throughout the U.S. economy.

We expect the scale of China's investments in U.S. companies to rise in the next few years and the pattern to shift from finance and business services. The reasons for this forecast include China's continued accumulation of large current account surpluses, emergent opportunities for acquiring a wider range of U.S companies as a result of their depressed valuations, the expanding needs of the Chinese economy for high technology, and a growing belief that receptivity in the United States to acquisitions by financially well-endowed Chinese investors may be somewhat higher than in prior years.

Our comparison of China's investments in U.S. companies with investments made by the selected PE firms highlights the sharp differences in their respective investment patterns. For example, the five PE firms as a group invested most heavily in hotels and motels, real estate, construction materials, motor vehicles, and packaged frozen foods during the 2007–2009 period of the great recession. In sharp contrast, Chinese investments in the same period were concentrated in financial

and business services, with smaller stakes in electronics, telecommunications, and medical equipment. In turn, the differing investment patterns reflect the differing business models and differing objectives attributed to each: for China, seeking to meet the expanding needs associated with its aggressive growth and geostrategic interests; for the PE firms, seeking to acquire, enhance, and resell companies at high rates of return in the short to medium term.

Turning to China's investments in Europe in the 2007–2009 period, we have only made an initial, cursory effort to collect and analyze the data. We find that China's investments in Europe concentrated in two sectors during that period: namely, minority acquisitions in multinational oil and gas companies and in financial and banking services. The focus on oil and gas reflects the priority accorded to "resource security" by China's policymakers—a theme that is also dominant in China's investments in Asia and the rest of the world. However, in the European context, the oil and gas priority takes the form of acquiring minority shares in some of the large global multinational producers, whereas in Asia and the rest of the world, the same priority leads to investments aimed at acquiring either full ownership stakes or major stakes in production companies.

We also expect China's investments in Europe to expand as a consequence of China's continuing large current account surpluses. The broadened scope of China's European investments may be affected as well by China's anticipation that acquisitions of high-technology companies may encounter less sensitivity and resistance than similarly targeted acquisitions might encounter in the United States.

China's investments in Asia and the rest of the world show a markedly different pattern from its investments in the United States and Europe. In Asia and the rest of the world, China's investments have concentrated on resource industries, such as oil, gas, copper, iron, lead, and zinc. Moreover, the small $18 billion of China's investments in Asia and the rest of the world in the 2007–2009 period tracked in our study excludes substantial additional lending (i.e., $35 billion) by Chinese financial institutions to resource industries in Brazil and Singapore, as well as additional long-term procurement contracts in Iran and

Libya for oil and gas and other resources. These financial commitments may, in some instances, lead to investment acquisitions in the future.

The increasing emphasis on resource investments in these areas is likely to continue in the coming years, as well as grow in scale.

It is not clear whether this policy is wise or optimal, for reasons on both sides of this issue that are discussed more fully in the body of the monograph.

Assessing Proposed or Potential Chinese Investments in Other Countries

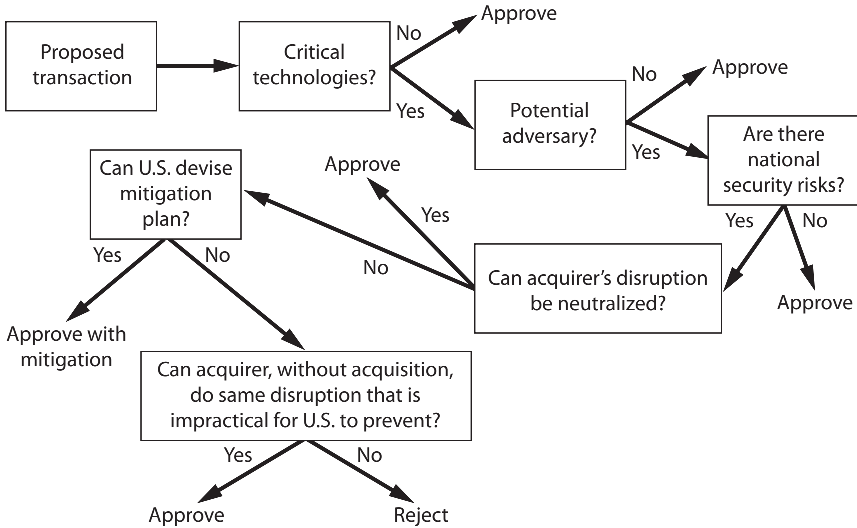
In considering the effects of foreign investments in the United States, we employ a broad definition of these terms, to include those technologies and services pertinent to economic security and economic growth, not limiting these definitions to the traditional and narrower meanings related to national defense. To develop the methodology, we reviewed 20 proposed Chinese investments from 2000 to 2008 and then refined the design by considering four additional cases to illustrate the framework. We then turned to the development of a way to assess the broader national security implications of possible future Chinese investments in financial and business services and in energy.[1]

The analytic methodology, schematized in Figure S.1, consists of a modified decision-tree analysis involving a series of steps sometimes considered simultaneously, at other times considered sequentially.

As the schematic suggests, the methodology describes a process whose successive stops enable the criticality of technology acquisitions to be judged and also shows the status of the potential acquirer to be assessed, whether a national security risk is thereby entailed, whether a mitigation plan can abate such risk, and whether the potential acquirer would have ready access to alternatives to accomplish the same purposes as sought from the acquisition under review.

[1] Other sectors can be examined using the same analytic framework.

Figure S.1
Steps for Assessing National Security Risks and Benefits from Foreign Investments



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This process also results in certain guidelines for assessing possible future bids and proposals by China. In developing these guidelines, we invoke the principle of reciprocity between China's treatment of foreign investments in China and potential treatment by other countries of China's investments in them. We suggest that reciprocity can be invoked without compromising a general preference for open and competitive capital markets. Furthermore, the assessment of risks should be accompanied by a separate assessment of potential benefits from any such acquisition, examining the associated benefits in light of the broadened definition of critical technologies referred to above.

Conclusions, Implications, and Guidelines for Further Research

In the evolving world economy, China's large and growing financial resources are propelled by the world's largest trade balances and the largest current account balances—trends that may diminish somewhat but are likely to continue during the next half-dozen years or more. The result will increase China's influence in the global economy and strengthen its bargaining power as it seeks companies and resources abroad, including those in the United States.

As both a consequence of and contributor to these trends, China's attempts and success in making additional investments in U.S. companies are likely to grow substantially in the coming years. Most of its acquisitions are likely to be mutually beneficial to the United States and to China. Where they may not be beneficial, the analytic methodology we have developed can help to improve understanding and to provide guidelines for further investigation and analysis of such acquisitions.

From discussions within the United States and with China, we concluded that it is important to recall and to invoke the principle of reciprocity in devising mitigation plans to arrive at win-win outcomes, while avoiding losses to either party. During the past two decades, China has acquired considerable experience in both encouraging and circumscribing foreign, including U.S., investments in China. Reciprocity would require cooperative and compliant response by China to creative mitigation plans by the United States or other countries for any proposed acquisitions of companies that may entail potential security risks.

Finally, a "wider-angle lens" would be valuable in tracking China's foreign investments. China's investments in European companies should be viewed with a lens that is no less acute than the one applied to viewing China's acquisition of U.S. companies. This also applies to China's investments in Asia and in the rest of the world. In recent years, these investments have mainly been in resource industries, including oil, gas, copper, iron, lead, and zinc. In turn, China's focus on "resource security" is viewed within China as deriving from the high priority that China accords to economic growth and its presumed requirement

for secure supplies of critical materials. The wisdom of this policy is open to serious questions which we address in this monograph. Also open to question is whether China's efforts to expand such investments in Asia and the rest of the world may be as likely to benefit, as to harm, the United States as another principal importer of oil, gas, copper, iron, lead, and zinc. The wider-angle lens for viewing China's investment acquisitions in resource fields can also help to anticipate whether and when a series of Chinese investments might lead to acquisition of quasi-monopoly power over valuable ores and other resources, which, in turn, might create vulnerabilities for the economy and national security in the United States and other countries.