

## Juggernaut China

The world is slowly beginning to feel the impact of Beijing's mighty financial steamroller

By RAMKISHEN RAJAN

WITH the strong backing and support of Chinese political leaders, many Chinese companies have been on a hectic buying spree over the last few years.

Chinese companies have been involved in around 120 new outbound mergers and acquisitions (M&As) worth US\$7.7 billion thus far in 2005. This compares with 83 deals valued at US\$4.4 billion in the same period in 2004.

In terms of destination countries, China has predominantly invested in the US, Canada and Australia, but by region, Asia (including Hong Kong and Macao), with North America close behind received the most investment. China has also been ratcheting up its investments in developing countries in Africa, Latin America and Eastern Europe. Of course, such acquisitions are a subset of China's overall foreign direct investment (FDI).

China is also actively investing in greenfield projects in a number of countries, particularly developing ones.

The stock of China's investment abroad in 1991 stood at US\$3 billion, rising to US\$15 billion in 1995, and US\$35 billion in 2004.

Beyond the obvious desire to build global champions, what are the motivations behind this spurt in overseas activity by Chinese businesses and the keenness shown by Chinese policymakers in such an internationalisation thrust?

First, and most commonly recognised, is China's strategic goal of ensuring that it has sufficient supplies of key resources, such as oil, gas and steel, needed to fuel domestic growth. This was the reason behind the highly public bid for Unocal by China National Offshore Oil Corporation (CNOOC) which was eventually aborted.

However, China has successfully bid for a number of other overseas oil and gas investments and companies in other countries without much drama or publicity. For instance, CNOOC has bought stakes in a number of oil companies in Indonesia and elsewhere.

Similarly, in what would be China's largest foreign takeover to date, state-owned Chinese oil company China National Petroleum Corporation (CNPC) has recently agreed to purchase PetroKazakhstan for US\$4.18 billion despite tough competition from India's ONGC and Mittal Energy (OME).

Chinese firms are also investing in or acquiring mining and other resource companies worldwide (nickel, copper, iron, aluminum etc). The desire for energy security is key to China's policy and it appears willing to pay a hefty premium to fulfill this objective.

### Cutting out middlemen

Second is the aspiration by Chinese companies to buy brand names, technology, processes, management know-how and marketing and distribution networks. This was the motivation behind

Lenovo's purchase of IBM's personal computer, thus propelling Lenovo to become the world's third-largest computer maker, after Dell and Hewlett-Packard (HP).

Other prominent examples include the initial attempt by China's largest home-appliance maker electric appliance maker Haier to buy Maytag, and the purchase of the French television manufacturer Thomson by Chinese company TCL, making it the world's biggest television set maker.

In addition to purchasing advanced technology and brand names, the desire to cut out middlemen and thus increase profit margins will inevitably imply that more cash-rich Chinese companies will be looking to enter the Western markets, particularly the US.

Thus, one would not be surprised if, at some stage, mega American retailers, like Home Depot, become targets of cash-rich Chinese companies.

Third is the desire by Chinese companies to solidify existing markets or seek new ones. This has been the motivation behind overseas acquisitions by Haier, TCL and Hisense Group in both developed and developing countries. Such market-seeking investments will grow in importance as Chinese companies are beginning to face intense foreign competition at home and are looking to expand overseas market shares.

Fourth, building an external wing ought to have positive effects on the domestic economy. For instance, once Chinese companies acquire overseas companies, they may decide to more aggressively shift some labour-intensive activities to China, hence enhancing China's GDP. The point here is that if the company were not China-owned, it may not necessarily decide to set up base in China, possibly preferring other viable bases in India or Vietnam, for instance. In addition, such overseas investments could also increase China's current account balance by fuelling greater investment income inflows in the future.

Fifth, Chinese authorities want to increase China's geopolitical influence. This has been part of the motivation behind the recent Chinese investments in countries in Africa as well as in South-east Asia, particularly Indonesia and Myanmar. Such acquisitions are complementary to the provision of substantial aid and soft loans to these countries by the Chinese government to develop infrastructure projects such as dams, bridges and roads.

Finally, a rather tangential rationale for - or rather, result of - overseas acquisitions and concomitant capital outflows will be an easing of exchange rate pressures on the yuan, thus reducing the need for reserve buildup and having to manage the inflationary consequences.

There may be other motivations as well for China's external thrust. For instance, possible Chinese investments in significant pieces of real estate in the US and elsewhere could be seen as a means of raising profile and gaining via asset speculation. However, while purchases of hotel resorts and signature office properties were the preferred options of Japanese investors in the 1980s, China has thus far limited such foreign purchases, especially in the US. The ongoing process of yuan revaluation ought to facilitate the process of internationalisation of China Inc by making overseas assets cheaper.

Conversely, however, investment income from overseas Chinese subsidiaries may decline with continual revaluation (as conversion of foreign income into yuan is less attractive).

While China has liberalised its rules governing capital account outflows and use of foreign

exchange, there has been, until recently, a restriction on banks being able to act as guarantors for Chinese companies making overseas acquisitions. Such guarantees could hitherto only be offered by a few major banks such as the Bank of China and the Industrial and Commercial Bank of China.

This in turn has created a myriad of potential problems. One, because guarantors were limited to these two banks, there have been a number of instances where some Chinese companies have failed to get the necessary financial backing, as they may have been deemed to be 'less important' (ie those not directly controlled by the state or by provincial governments and with limited political interests or government links).

Two, it is highly unlikely that the risks of being a guarantor have been appropriately priced in (being heavily subsidised by the government and state banks). This availability of cheap leverage (close to zero cost of capital) may be one of the reasons behind the ability and willingness of Chinese companies to overpay for some overseas assets.

Take-off stage

Three, the guarantor risks have been concentrated in these two Chinese financial institutions, thus potentially creating significant off-balance sheet risks.

In this light, the recent ruling by China's foreign exchange regulator, the State Administration of Foreign Exchange (SAFE) that - as of Sept 1, 2005 - all China-based banks already licensed to undertake foreign exchange business (including foreign bank branches) will be able to act as guarantors for foreign investment by overseas units of Chinese companies, is significant. This will allow all Chinese companies with overseas units to apply for financial backing from mainland banks, consequently making it relatively easy for China to outbid rivals for overseas assets.

The policy ought also to help spread the off-balance sheet risks to other banks in China, including foreign ones willing to act as guarantors.

In relation to this, it would be reasonable to expect that the foreign and domestic private banks in China will pay closer attention to the price offered on overseas assets by Chinese companies before they decide to act as guarantors. This, in turn, ought to help ensure that Chinese companies do not offer unrealistic bids for their overseas acquisitions and exercise selectivity in the choice of targets.

In fact, anecdotal evidence suggests that some of the overseas investments by Chinese firms have thus far rendered rather poor rates of return. Chinese companies would do well to learn lessons from the not-altogether-successful experiences of some Japanese companies that made several high-profile acquisitions in the US at high prices in the 1980s and 1990s.

China's overseas investments are still at the take-off stage. While somewhat less noticed, many Indian firms have been venturing overseas to secure market access and real assets. While China Inc's internationalisation thrust has hitherto been more top-down, India Inc's approach has been more decentralised and calibrated, a reflection of the differing political systems in and overall development strategies of the two countries. Many Indian companies have been involved in outward ventures for longer than their Chinese counterparts and have developed knowledge and acumen to deal with the complex issues relating to management of cross-border alliances. However, annual Indian overseas purchases are not yet at a scale of their Chinese counterparts.

Going forward, while China and India continue to attract large-scale FDI, it is inevitable that their own companies will continue to flex their muscles on the world stage.

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