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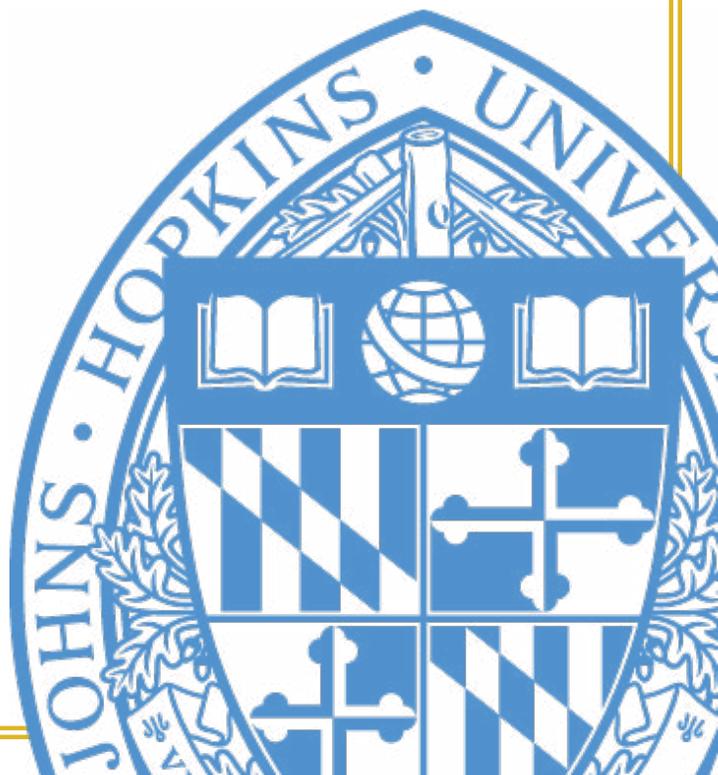
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**NEW UNDERLYING TRENDS IN CHINESE  
CROSS-BORDER INVESTMENTS**

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# **New Underlying Trends in Chinese Cross-Border Investments**

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## **About the Series**

The *Studies in Applied Economics* series is under the general direction of Professor Steve H. Hanke, Founder and Co-Director of the Institute of Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

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## **Abstract**

As global macroeconomic uncertainties influence markets, notable shifts and oscillations in Chinese outbound and cross-border investment flows have become apparent. This study reveals China's key investment characteristics including geographical preferences, investment compositions, and structural changes in industrial and foreign policies, such as Made in China 2025, financial liberalization, and OBOR. While these trends seem contradictory at times, opportunities are available for nimble and creative players who could capitalize on China's increasing demand in the new economy ("*xin jing ji*"), with adequate consideration of regulatory scrutinies.

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**JEL codes:** F21, F68, O53, K23

## Global Economic Uncertainties Dampen Chinese Outbound Investments

Over the past five years, the global investment atmosphere has changed substantially. Although Chinese cross-border investments have mostly shifted according to broader trade trends, they have also exhibited analogous characteristics in response to various stimuli such as numerous domestic policy changes and the evolving relationship between China and other major economic entities.

It would be out of context to discuss Chinese cross-border trends without an examination of the ever-changing global economic landscape. So, before diving into the main drivers of cross-border investments in China and their impact on investments under policy changes, it is worth taking a look at the larger picture first. According to the IMF's World Economic Outlook Report published in October 2018, there has recently been a steady but less balanced expansion of economic growth that has simultaneously increased downside risks and reduced potential for positive surprises for global growth. Meanwhile, the Economic Policy Uncertainty Index has also increased to 907.45 in December 2019 compared with the February 2014 low of 66.53, signaling dropping confidence in the stability of markets.<sup>1</sup>

Causing this volatility, the world has witnessed significant geopolitical changes and economic upheavals in recent years. The historical significance of Brexit and its influence over not only the European Union but the entire world economy is still an important question mark. Further exhibiting ever-increasing characteristics of protectionism, tensions from the US-China trade disputes have added even more risk to the global market and threaten the stability of world trade and GDP growth. Additionally, the recent volatility and expansion of oil prices is a major concern, especially after the prolonged period of general downward trending pricing in the last five years. Although a current pullback after recent localized highs is a positive sign for economies, especially after the price drop after December 2018.<sup>2</sup> Yet, there are still other risks that remain for the mergers and acquisitions market. According to UNCTAD's World Investment Report 2019, global foreign direct investment (FDI) flows slid by 13% in 2018, which was the third consecutive annual decline.<sup>3</sup> This slowdown of global capital flow is occurring in tandem with the recent poorer performance of the Chinese market, as they are one of the major contributors. PricewaterhouseCoopers estimates that ever since the 2016 "mega-year", Chinese outbound investment has fallen for three straight years, partly due to the "greater scrutiny of larger cross-border M&A in many jurisdictions and a generally uncertain environment for overseas deal-making."

One of the major themes of Chinese cross-border trade has been the explosive growth of Chinese outbound deals over the first half of the past decade. In this period, Chinese

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<sup>1</sup> Economic Policy Uncertainty Index, <http://www.policyuncertainty.com>.

<sup>2</sup> FRED Economic Research.

<sup>3</sup> World Investment Report 2019, UNCTAD.

outbound M&A volume rose from \$68.8bn in 2010 to \$196.2bn in 2016 which moved China's ranking from fifth to second globally.<sup>4</sup> While this growth has been highly publicized, some other important details have not been as emphasized. Although Chinese companies were involved in ten of the largest deals worldwide in 2016 (> \$1 bn), most deals were in the middle market with the median deal size (\$30m). Even as absolute dollar values increase, there is arguably further room for growth as M&A volume as a percent of GDP was smaller for Chinese companies (0.9%) than its counterparts in Europe (>2.0%) and the US (1.3%) in 2015. Astonishingly, since the record 2016 highs, China's outbound M&A has plummeted to a 10-year low due to trade tensions and economic slowdown, currently standing at \$41 billion, less than a fifth of the 2016 peak.

Even though the past few years have been littered with global economic uncertainties, the total number of mega-deals has remained flat because significantly fewer large outbound transactions have been offset by a surge in the number of domestic mega-deals. Yet, the latest figures suggest that the value of China's overall M&A fell by 18% in the first half of 2019, the largest single-period decline over the last decade. Although Private Equity deals fell sharply by 46%, volumes of both inbound and outbound transactions in most sectors have increased, indicating an opportunity for smaller cross-border transactions.<sup>5</sup> As investors will deploy more cash to the PE investment as valuations recede, this should be a temporary trend. Meanwhile, businesses have renewed their focus in the domestic market, as global economic uncertainties limit outbound opportunities. China's domestic strategic M&A has picked up by 8% in value and 12% in deal volume, while foreign inbound investments rose by 64% in volume but declined by 29% in value.

Furthermore, it is also noted that small, overseas, Chinese acquisitions, worth \$100 million or less, have fallen significantly in 2019. Even though fewer smaller and mid-sized deals are being announced, the overall value is boosted by a few large transactions. In 2019, the number of Chinese outbound mega-deals was significantly lower, but these lows are offset by the rising number of mega-deals from private equity and domestic strategic players. It is estimated that Chinese outbound transactions alone have dropped 60% from 48 in 2016 to 20 in 2019, a 29% drop from the 24-deal year of 2018.<sup>6</sup>

Due to the effects of global uncertainties within China, other regions have seen significant changes. North America and Europe have seen declines in Chinese FDI in the first half of 2019, with estimates by the Rhodium Group showing just \$12.3 billion, down 18% from the same period last year and the lowest activity since 2014. On the other hand, Asia and Oceania have emerged as the most popular outbound M&A destinations for Chinese enterprises, comprising nearly 60% of the total, according to a report by Ernst and Young. In H1 2019,

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<sup>4</sup> EY, MOFCOM, National Bureau of Statistics China, China SAFE.

<sup>5</sup> PwC. "PwC M&A 2019 Mid-Year Review and Outlook" August 2019.

<sup>6</sup> Thomson Reuters, China Venture and PwC.

both continents recorded double-digit growth, despite the overall contracting M&A trend – Asia (US\$7.9 billion, up 21.9% YOY) and Oceania (US\$4.2 billion, up 38.3% YOY).

### **Positive Signs and Structural Optimization in the Chinese M&A Market**

All these ominous signs do not completely dampen the potential for the Chinese M&A market to thrive. Regional GDP in Europe, North America and especially the Asia Pacific (including China) have been constantly growing. When comparing the now to pre-2008 financial crisis figures, there is significantly more liquidity and lower costs of funding as interest rates are still near historic lows. Though we have observed an increasing 3-month LIBOR rate which will increase the hurdles needed to jump over to close deals, all else being equal. This period of low US dollar interest rates has encouraged the development of the global M&A market and has brought Chinese business enthusiasm to new cross-border investment and strategic opportunities. Although PwC data showed that Chinese outbound M&A fell in the first half of 2019, the announced total deal volumes actually increased in most sectors, including outbound deals, with the exception for PE transactions, which fell by 46%. To simply look at dropping deal volumes and values would be misleading if one overlooks the trend of steady and high-quality development behind Chinese overseas investment.

EY's Chinese Overseas Investment Report H1 2019 points out that the structure of cross-border deals is gradually being optimized and diversified with a focus on the new economy ("*xin jing ji*"), with sectors such as manufacturing and information transmission/software and IT services experiencing the highest growth rates at 7.3% and 31.7% YOY growth respectively. The high-end value chain continued to dominate China's overseas M&As. By deal value, tech, media and telecom (TMT) (US\$5.1 billion), consumer products (US\$3.2 billion) and health & life science (US\$2.1 billion) sectors accounted for more than 50% of the total. By deal volume, TMT (67), consumer products (40) and advanced manufacturing & mobility (33) claimed over half of the deal flows.<sup>7</sup>

There are many broad and sub-themes behinds these intuitively contrary figures. One of the major Chinese policy drivers is President Xi Jinping's One Belt One Road (OBOR) initiative which aims to link countries across land and sea along the old silk road through investment in infrastructure and increased trade. While this concept was first announced in 2013, the real traction kicked off in earnest in 2015 and was developed alongside the founding and backing of the Asian Infrastructure Investment Bank in 2013 and the Silk Road Fund in 2014. This focus on trade has driven much of the cross-border and outbound investment to countries along the route. From 2014 to 2018, China committed to invest over US\$1 trillion in about 1,700 projects across 130 nations around the world, according to the data released by the American Enterprise Institute.<sup>8</sup> More specifically, investment grew rapidly in the 66

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<sup>7</sup> EY. "Overview of China outbound investment in H1 2019" August 2019.

<sup>8</sup> China Global Investment Tracker, AEI.

OBOR countries from \$1.9 billion in 2016 to \$14 billion in 2018, an increase in M&A volume of over 627% from 22 to 160, according to Thomson Reuters.<sup>9</sup> This new flow has seen a remarkable surge of investment in the aviation space, seen in investments in airports, airlines, tourism activities, and in aircraft leasing. While not necessarily required by China as it is open to any country, Italy became the first member of the EU to sign on to OBOR with big expectations of usage in infrastructure.

Another major theme and driver of the M&A market is the series of supply-side reforms that China has been implementing since 2015. Through changes in the operating environment for potential outbound companies, cross border investments have seen sweeping effects. The main sub-category initiatives include cutting excess industrial capacity, deflating the real estate inventory and bubble, corporate deleveraging, lowering corporate costs (taxes, fees, etc.) and Made in China 2025.

Some of these sub-themes are aimed at realigning the domestic economy and transforming it from the old to the new, while also making the sources of growth more sustainable. This would include cutting excess outdated industrial capacity and encouraging more clean energy projects. This goes hand in hand with the other themes of deleveraging and control of the growth of the credit exposure in China, as well as deflating the real estate bubble and excess inventory, especially outside of top tier cities. The Chinese desire to reform also includes slowing down credit growth due to normal and shadow banking activities.

There are two main ownership types in China: State-owned Enterprises (SOEs) and Private-owned Enterprises (POEs). SOEs refer to enterprises funded by the State and state-owned holding companies that belong to the State Council and the local people's government on behalf of the State's performance of investors' duties. In China SOEs control pillar industries like oil, electronics, and automobiles. Previously, the overall deleveraging measure focused on larger private companies and smaller banks, but now it has moved on to local municipal and provincial SOEs. Credit growth has intensified since the 2008-2009 global financial crisis and infrastructure spending and borrowing has been a key method to drive economic growth by local governments. But lately, such initiatives have shut down projects, such as new subways in farther out regions, due to the new concern for the amount of additional debt burden.

These deleveraging policies, however, have not dampened the growth of airports and related aviation infrastructure especially in more western and more underdeveloped regions in China which have continued to see steady growth. China is poised to overtake the US as the world's largest aviation market in the next five years, as the government plans to build 74 new airports by 2020 and 136 by 2025. In 2019, Beijing unveiled the Daxing International Airport, with an initial capacity of 45 million passengers, but there are plans to expand the airport's

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<sup>9</sup> Thomson Reuters, China Venture and PwC.

capacity to 72 million by 2025, and ultimately 100 million, according to the Centre for Aviation. More so, there is an additional large capacity airport currently under construction in Chengdu with capacity for over 90 million passengers.<sup>10</sup> The plan does not even include the many general aviation airports whose numbers currently stand at 310, with the goal of reaching 500 by 2020.<sup>11</sup>

Previously, supply-side reforms had focused on reducing fees and bureaucracy while trying to stimulate the economy through encouragement of “mass entrepreneurship” by Premier Li Keqiang, rather than major tax cuts. This has been especially true of the test regions of policies in free trade zones such as the Tianjin Dongjiang Free Trade Port zone (“DFTP”) and Shanghai FTZ, which have the most active jurisdictions for aircraft leasing in China. However, recently, the lowering of corporate costs has been a focal point of supply side reforms. These changes include the newly announced \$300bn of tax and fee cuts made at the beginning of 2019 and the recent additional \$50bn of cuts in government and operating service fees. Additional direct stimuli to spur businesses and individuals like cutting electricity, internet, portfolios, and airport and railroad charges are examples of levers that are unavailable for other countries to induce more growth. The reduction in airport development fund fees has been a huge gift for airlines amid other industry wide cost pressures.

The Made in China 2025 (MIC 2025) industrial plan is also part of the overall supply-side reforms that have their roots in 2013. MIC 2025 focuses on the upgrade of Chinese industry, remarkably similar to the “Industry 4.0” initiative by Germany. The plan is the final installment of a series of China’s plans to move its industries up the value chain to reduce reliance on foreign technology. In the aviation sector, this would entail a new focus on biofuels and clean technologies implemented for airlines, aircraft and airports. The MIC 2025 plan has also sometimes been combined with the OBOR initiative. As China’s aviation market is expected to expand vastly over the next five years, the country will need more than 7,000 planes in the next 20 years. Under MIC 2025, China expects home-made commercial aircraft, like COMAC C919 and ARJ21, to supply more than 10% of the domestic market, and its jetliners to account for nearly 20% of the global market by 2025.<sup>12</sup> This will give the aviation industry and its supply chain a renewed push in the structural optimization of the M&A market.

Along with the supply-side reforms, the Chinese government has resolved to cut frivolous overseas investment. The appreciation of the U.S. Dollar and the corresponding depreciation of the Renminbi in recent years combined with the increased desire for offshore assets and the perceived higher regional investment growth opportunities have all led to the boom of capital outflows from China. As a result, the number of high-profile cross-border investments

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<sup>10</sup> China National Development and Reform Commission and Civil Aviation Administration of China, Centre for Aviation.

<sup>11</sup> Civil Aviation Administration of China.

<sup>12</sup> US Chamber of Commerce. “Made in China 2025” 2017.

carried out by Anbang and HNA Group have alerted the China Banking Regulatory Commission and caused a review of the credit exposures for “systematic risk” to these outbound groups. To cut down impractical investment, the government has stepped up scrutiny of both the convertibility of RMB to other liquid currencies and the transfer of funds to offshore locations.

Specifically, to reduce unnecessary investment, the Chinese State-Owned Assets Supervision and Administration Commission issued several documents to regulate the investment of SOEs in 2017. It is now required that outbound investments must be within the competencies of the business and core policy of the government to be supported. The aim has been to slow down and dampen the more flippant offshore investments that are outside the scope of the main business competencies and refocus on more core policy driven investments which still have government backing. The corresponding response in the market has been a significant drop in overseas deal volume and value from SOEs.

The hurdles for overseas M&A have increased for Chinese enterprises. China has become much more selective about M&A deals struck by state-owned enterprises, driven by caution in drawing down foreign exchange reserves as well as the effort directed at curtailing domestic debts. In 2018, SOEs only conducted 64 outbound deals—a 37% decrease compared with 2017 and a 50% decrease compared with 2016, with PwC commenting that SOEs have spent the least money on outbound deals since 2014. SOEs have been more focused on the internal restructuring under the supply-side reforms and have subsequently reduced their overseas acquisitions. Seeing opportunity, a large number of private enterprises have picked up the slack, and now consist of nearly 50% of the total deal volume and value. Although private enterprises’ outbound investment has also dropped almost half since its peak in 2016, in the most recent year, the group has announced 310 deals (5 times more than its state-owned counterparts). Financial buyers are increasingly more capable of providing capital for overseas deals as well. They have hit a new high, with 253 deals in 2018, a 6% increase from 2017 and a 30% increase from 2016. Overall, SOE’s have seen their share of outbound deals decrease while private enterprises and financial buyers have grown.

The reforms of SOEs and industry structures in China not only help support the RMB exchange rate, but also total foreign reserves, which have steadily grown since the 1980s to their all-time high of \$4.0 trillion in June 2014. Although since then, foreign reserves receded to a low in October 2018 after the announcement of a 10% tariff on \$200 billion worth of Chinese goods. Then, despite a slowing economy and an escalating trade war, China’s foreign exchange reserves have been gradually rising since October, standing at \$3.1 trillion in December 2019. Foreign reserves have been recently assisted by tight capital control and a rising inflow from foreign investors due to renewed optimism from US-China negotiations, especially after the Phase 1 trade deal.<sup>13</sup>

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<sup>13</sup> People’s Bank of China. <https://tradingeconomics.com/china/foreign-exchange-reserves>.

## China Outbound M&A Destination Shift Amid US-China Trade Tensions

Intensifying trade tensions and heightened regulatory scrutiny have been critical factors affecting the Chinese cross-border investment trend. In 2018, the total value of Chinese M&A deals in the US dropped 38% to \$13.2 billion. The decline accelerated in the first six months of 2019 as China's M&A fell by 18%, marking the largest single-period decline over the last decade, as estimated by PwC. Closer scrutiny illuminates an even more sullen outlook. Chinese spending on acquiring US companies fell from its peak of US\$55.3bn in 2016 to just US\$3bn last year, a 95% drop, with American authorities rejecting several high-profile deals. Notably, in 2019, China's investment in the US technology sector plunged 79% to its lowest level in seven years.

As a part of trade tensions, the US Committee on Foreign Investment (CFIUS) tightened their reviews of announced deals after the US Congress finalized the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018, the first reform of national security review in the last decade. The law expands the array of deals CFIUS can now review by including non-controlling foreign investments in the technology industry, and also prolongs the timing of the review, incurring a higher cost for firms waiting for the review results. Though the provision may not take full effect for about another 18 months because of to the reallocation of resources necessary for more intensified reviews. The act's effects are already starting to show in the market, and even those deals that have been already completed are facing new threats.

In the attempt to axe one of the largest transactions of 2018, CFIUS blocked the proposed US\$1.2 bn merger between MoneyGram, a US money transfer business, and Ant Financial, a Chinese online payment company owned by Alibaba, citing national security concerns over data aggregation. In late March 2019, the US also required the Chinese owners of dating APP Grindr to give up their 60% share of the company. Beijing Kunlun Tech, who had already completed the buyout of Grindr early last year, is now under the charge of possible threats to US national security under the CFIUS decision due to data privacy issues. Announced M&A deals of Chinese companies are expected to continue decreasing if the hostility of trade between the US and China is not eased. Chinese companies are cautious over future M&A deals in the US, having considered the rising costs and difficulties of such investments. Interestingly, in recent years, Chinese companies have been pursuing smaller M&A deals to avoid the CFIUS scrutiny. The CFIUS demand on Grindr after its transaction, which is a relatively small sum of \$245 million, signals future threats on small value Chinese tech acquisition and already completed suspicious deals.

The European Union was once the alternative destination of Chinese outbound investment, as it had contributed to 34% of the total Chinese M&A announced deal value in 2017, and

grew to 59% in 2018 as the deal value in the US decreased further.<sup>14</sup> The “Big Three” economies (UK, Germany, France) attract the most capital, but northern Europe and the Benelux (Belgium, Netherlands, and Luxembourg) showed signs of catching up in 2018. The most preferred destination in northern Europe is Sweden, who received EUR3.4bn in total investment in 2018, primarily driven by Zhejiang Geely’s EUR3bn investment in Volvo AB.<sup>15</sup> At the time, one would have thought that the EU is likely to continue to be one of the most favorable foreign investment destinations for Chinese businesses in the foreseeable future due to problematic US-China trade relations.

However, With Boris Johnson's emphatic election victory accelerating the Brexit process as well as the European Union framework for the screening of FDI, the announced value of China’s overseas M&As in Europe was just US\$3.6 billion in H1 2019, down 86.6% YOY, the largest decline in years. Similarly to CFIUS, the EU framework reinforced the screening mechanism by asking members states to review investments not only directly from non-EU countries, but also intra-EU investments involving non-EU ultimate owners. The proposal has been adopted and related legislation will be voted on by the European Parliament on February 14, 2019, coming into full effect in 18 months. Although this new EU investment screening framework is not as aggressive as many of the Organization for Economic Cooperation and Development’s screening frameworks, it is still a significant landmark that will influence future Chinese investors’ decisions.

The 2019 Rhodium Group report especially points out how some of the proposal’s provisions “overlap with core characteristics of Chinese investment in Europe to date.” Most Chinese investments in the EU are targeted at European technology and innovation assets, and many of these preferred sectors are now demanded by the new screening rules to undergo special scrutiny. Also, since 60% of Chinese FDI in the EU is directed by state-owned or sovereign entities in China, the new rules’ requirement to review deals with funding backed by the state, not simply deals owned by state-controlled entities, will further create troubles for Chinese outbound investment in the EU. The new rules are built on a friendly “coordination and cooperation” framework, but Chinese firms may no longer enjoy the same level of convenience they did in previous years.

As scrutiny intensifies in Europe and the US, emerging economies in Asia and Oceania have become the most popular overseas destinations for Chinese enterprises. Driven by improved Sino-Australia relations and the OBOR, the announced M&A value by Chinese enterprises increased significantly in Oceania (US\$4.2 billion, up 38.3% YOY), and Asia (US\$7.9 billion, up 21.9% YOY), accounting for nearly 60% of the total. The main sectors of China’s M&As in Asia are TMT, consumer products and financial services, while in Oceania, key sectors are health

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<sup>14</sup> PwC. “PwC M&A 2018 Review and 2019 Outlook.” February 2019.

<sup>15</sup> Hanemann, T., Huotari, M., and Kratz, A. “Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies.”, *MERICIS Papers on China*, Mar. 2019.

& life science, real estate, and hospitality & construction.<sup>16</sup> According to the Ministry of Commerce, China's non-financial outbound direct investment (ODI) was US\$53.8 billion in H1 2019, a drop of by 5.9% YOY.<sup>17</sup> Despite the overall downward trend, the main investment sectors were leasing and commercial services and data indicates that the structure of China's ODI remained healthy and optimized in 2019.

### **New Trends in the Domestic Economy Opening Up**

Moving forward, China's internal policy reforms and external pressures from trade negotiations will dictate the country's economic liberalization. With the size of the financial sector at US\$44tn, China has 1.1 billion potential retail banking customers, who will have a US\$14tn asset pool under management by 2022. However, regulatory barriers have minimized methods to participate in China's financial markets since its accession to the World Trade Organization in 2001.

Recently, there have been more and more policies helping to open up of the domestic economy to foreign capital. Publications of a national unified negative list of industries for inbound investments which was previously locally administered, as well as a pledge for the opening up of investments in the financial and asset management sector have all been implemented over the past few years. The strongest indication of China's willingness to change is President Xi's commitment to implement the country's "Opening-up Initiatives," notably marked by the unification of its banking and insurance regulators to form the China Banking and Insurance Regulatory Commission (CBIRC) in 2018. Against this backdrop, China's Financial Stability and Development Committee under the State Council announced 11 further measures to ease foreign ownership limits on financial services firms in July 2019.<sup>18</sup> These encouraged global asset managers to accelerate the entry of foreign capital into China's securities industry.

The Phase 1 Trade Deal with the United States has also ensured the removal of barriers to help US banking, insurance, and other financial services companies to continue to expand into China. Under the agreement, China has agreed to set up a clear deadline of April 2020 for removing foreign ownership caps on securities firms, including investment banking, underwriting, and brokerage operations. China's commitment provides more stability for foreign investors especially in airlines and aircraft leasing and also prevents retroactive unraveling of deals due to unanticipated policies. This development has seen more foreign lessors establish local onshore subsidiaries in China to attract more local customers.

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<sup>16</sup> EY. "Overview of China outbound investment in H1 2019" August 2019.

<sup>17</sup> Ministry of Commerce, <http://english.mofcom.gov.cn/article/statistic/>.

<sup>18</sup> EY. "Financial Liberalization in China" 2019.

China's retrenchment from outbound investment echoes its renewed focus on financial liberalization catalyzed by domestic economic reforms and the trade deal with the US. The new measures are characterized by "faster rather than slower, sooner rather than later" rhetoric in response to encouraging market feedback on China's commitment towards deeper institutional reforms and economic openness.

While some of these macroeconomic drivers and domestic policies may seem a bit contradictory, what is certain is that the encouragement of technologies and growth platforms will enhance the sources of GDP growth and diversify its composition, especially as China continues to liberalize its economy and remains a driving force in technological innovation. There will inevitably be challenges as these evolving policies and drivers change the global economy and industry. But this creates more opportunities and bodes well for nimble and creative players who could capitalize on China's increasing demand in the new economy (*"xin jing ji"*), with adequate consideration of regulatory scrutinies.