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New underlying trends in China cross-border investments

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Abstract. As global macroeconomic uncertainties there is notable shifts and oscillations in Chinese outbound investment and cross-border investment flows. This study shows 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 time, more 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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1. Introduction

The global investment atmosphere has changed substantially over the past five years. While China cross-border investments have moved with similar movements along with the broader trade trends, it has also exhibited characteristics all of its own in response to various stimuli including numerous domestic policy changes, the evolving relationship between China and other major economic entities, among others.

A discussion of Chinese cross-border trends in the past few years without an examination of the ever-changing global economic landscape would be out of context. Before diving into the main drivers of cross-border investments in China and its impact on investments under policy changes, it is worth first having a look at the larger picture. According to IMF's World Economic Outlook Reports published in October 2018, there is a steady but less balanced expansion of economic growth that increases downside risks to global growth, with receding potentiality for upside surprises. Meanwhile, the Economic Policy Uncertainty Index has also increased to 907.45 in December 2019 compared with the February 2014 low of 66.53.[2]

Over the last five years, we've witnessed significant geopolitical changes and economic upheavals. The historical significance of Brexit and its influence over not only the European Union but the world economy is still an unresolved question mark. Tensions from the US-China trade disputes add even more risks to the global market, exhibiting ever-increasing characteristics of protectionism that can threaten the stability of world trade and GDP growth.

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[2] Economic Policy Uncertainty Index, [Retrieved from].

The volatility and expansion of oil prices is a major concern as it's an important input for economies especially after a prolonged period of general downward trending pricing in the last five years after reaching and sustaining highs. A current pullback after recent localized highs is a positive sign for economies especially after the price drop after December 2018.[3] These are other risks that remain for the M&A 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.[4] The slowdown of global capital flow is shown to be in tandem with the poorer performance of the Chinese market representing one of the major contributors. PwC estimates that ever since the 2016 "mega-year", China outbound 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 the overseas deal-making."

One of the major themes of the Chinese cross-border trade in the last five years has been the explosive growth of Chinese outbound deals over the past decade which saw outbound M&A volume rise from $68.8bn in 2010 to $196.2bn in 2016 and at the same rise from fifth globally to second by country rank.[5] Since the record 2016 highs, China's outbound M&A has plummeted to a 10-year low on trade tension and economic slowdown, standing at $41 billion, less than a fifth of the 2016 peak. While this growth has been more publicized, some other important details have not been as emphasized. While Chinese companies were involved in ten of the largest deals worldwide in 2016, most deals were in the middle market with the median ~$30m deal size and the top mega deals (>US$1 bn). While the absolute dollar values have increased, there is arguably further room for growth as this volume as a percent of GDP is smaller for Chinese companies (0.9%) than its counterparts in Europe (>2.0%) and US (1.3%) in 2015.

With increasing global economic uncertainties, the total number of mega-deals has remained flat in recent years, with significantly fewer larger outbound transactions offset by a surge in the number of domestic mega-deals. 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 PE 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.[6] As investors will deploy more cash to the PE investment as valuations recede and this should be a temporary trend. Meanwhile, businesses renewed their focus in the domestic market, as global economic uncertainties limited 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.

North America and Europe see further declines in Chinese FDI in the first half of 2019 as trade tension and Brexit uncertainty bite in, with just US$12.3 billion, down 18% on the same period last year and the lowest activity since 2014, estimated by Rhodium Group. Asia and Oceania emerged as the most

[3] FRED Economic Research.

[4] World Investment Report 2019, UNCTAD.

[5] EY, MOFCOM, National Bureau of Statistics China, China SAFE.

[6] PwC. "PwC M&A 2019 Mid-Year Review and Outlook" August 2019.

popular outbound M&A destinations for Chinese enterprises, with nearly 60% of the total, according to a report by EY. In H1 2019, both continents record double-digital 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).

Furthermore, it is also noted that Chinese acquisitions overseas worth $100 million or less have fallen in 2019. Fewer smaller and mid-sized deals are being announced, while the overall value is boosted by a few large transactions. It may be disappointing to see the number of China outbound mega-deals is significantly lower in 2019. Offsetting some of this is the rising number of mega-deals from private equity and domestic strategic players. It is estimated that China outbound transactions alone have dropped 60% from 48 to 20 compared to 2016, 29% compared to the prior year of 24 deals.[7]

2. Positive signs and structural optimization in Chinese M&A market

All these ominous signs don't 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) are constantly growing. At the same time comparing with pre-2008 financial crisis figures, there is significant liquidity and cost of funding and interest rates are still near its historical lows, though we have observed an increasing 3-month LIBOR rate which will increase the hurdle rates needed to do deals with all else being equal. This period of low US dollar interest rates has encouraged the development of the global M&A market and brings Chinese business enthusiasm towards 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, with the exception for PE transactions, which fell by 46%. To simply look at the dropping number of deal volume and deal value would be misleading if one overlooks the trend of a steadier and high-quality development behind China overseas investment.

EY's China Overseas Investment Report H1 2019 points out that the structure of cross-border deals is gradually being optimized and diversified with a focus on new economy (*"xin jing ji"*), such as manufacturing, information transmission/software, and IT services, with 7.3% and 31.7& YOY growth, respectively, against the backdrop of overall M&A investment. The high-end value chain continued to dominate China's overseas M&As. By deal value, 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.[8]

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 up the countries through 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

[7] Thomson Reuters, China Venture and PwC.

[8] EY. "Overview of China outbound investment in H1 2019" August 2019.

founding and backing of the Asian Infrastructure Investment Bank in 2013 and the Silk Road Fund in 2014. This focus on trade has driven a lot of cross-border and outbound investment to countries along the routes. 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.[9] This has amounted to $14 billion in 66 countries in 2018 compared with $1.9 billion in 2016 according to Thomson Reuters with an increase in M&A volume of over 627% from 22 to 160.[10] In the aviation space, for example, this has seen a surge of investment in airports, airlines, tourism activities and in aircraft leasing. While not necessarily required by China as it's 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 is the series of supply-side reforms that China has been implementing since 2015. All of these different components are the overarching policy directions that have large effects on cross-border investments through changes in the operating environment for potential outbound companies. 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 making the sources of growth more sustainable. This would include cutting excess older industrial capacity and encouraging more clean energy projects. This goes hand in hand with overall 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. This desire 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, and in China SOEs control pillar industries like oil, electronics, automobiles, etc. 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 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, etc. due to the concern for the amount of additional debt burden. These policies, however, do not dampen 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. As China is going to replace the US as the world's largest aviation market in the next five years, 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 airport's capacity to 72 million by 2025, and ultimately 100 million,

[9] China Global Investment Tracker, AEI.
[10] Thomson Reuters, China Venture and PwC.

according to the Centre for Aviation. There is additional large capacity airport currently under construction in Chengdu with capacity for over 90 million passengers.[11] The plan also doesn't include the general aviation airports which currently stand at 310 with the goal of reaching 500 by 2020.[12]

The lowering of corporate costs has not been an as big point of emphasis until recently. It has so far focused on reducing fees and bureaucracy rather than major tax cuts while trying to stimulate the economy through encouragement of "mass entrepreneurship" by Premier Li Keqiang. This has especially been true of the test regions of policies such as the free trade zones such as the Tianjin Dongjiang Free Trade Port zone ("DFTP") and Shanghai FTZ which are the homes of the most active jurisdictions for aircraft leasing in China. These include the newly announced $300bn of tax and fee cuts made at the beginning of 2019 with the recent additional $50bn of cuts in government and operating service fees. This is additional direct stimuli to spur businesses and individuals include cutting electricity, internet, portfolios, airport and railroad charges are examples of levers that are unavailable for other countries to induce more growth. The reduction in airport development fund contributions is 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 its roots in 2013 which focuses on the upgrade of the Chinese industry similar to the "Industry 4.0" initiative by Germany. The plan is the final installment of a series on China's plan to move its industries up the value chain to reduce reliance on foreign technology. In the aviation world, this would be focused on new bio-fuels, clean technologies implemented for airlines, aircraft and airports. This theme is sometimes combined with the OBOR initiative. As China's aviation market is expected to overtake the US as the world's largest in the next five years, the country needs 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.[13] 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 is the Chinese government's resolution in cutting frivolous overseas investment. The appreciation of USD and the corresponding depreciation of the Renminbi in recent years have led to the boom of capital outflows in China due to the increased desire for offshore assets as well as perceived higher regional investment growth and returns. The number of high profile cross-border investments carried out by Anbang and HNA Group has alerted the CBRC and caused a review of the credit exposures for "systematic risk" to these four outbound groups. In addition, the government has stepped up scrutiny of both the convertibility of RMB to other liquid currencies and the transfer of funds to offshore locations.

In 2017, the Chinese State-Owned Assets Supervision and Administration Commission issued several documents to regulate the investment of SOEs. It is required that outbound investments should be within the competencies of

[11] China National Development and Reform Commission and Civil Aviation Administration of China, Centre for Aviation.
[12] Civil Aviation Administration of China.
[13] US Chamber of Commerce. "Made in China 2025" 2017.

the business and core policy of the government to be supported. The aim has been to slow down and dampen the more frivolous offshore investments that are outside the scope of the main business competencies and refocus on more core policy has driven investments who still have government backing. The corresponding response in the market is the witness of a significant drop in overseas deal volume and value from the SOEs.

The hurdle for overseas M&A has increased for Chinese enterprises. China has become much more selective about M&A deals struck by state-owned enterprises, driven by the caution in drawing down foreign exchange reserves as well as the effort of curtailing domestic debts. In 2018, SOEs only conducted 64 outbound deals—a 37% decrease compared with the number in 2017 and a 50% decreased compared with the number in 2016, with PwC commenting that SOEs have spent less money doing outbound deals than at any time since 2014. SOEs are more focused on the internal restructuring under the supply-side reforms and have slowed down in their overseas acquisitions. At the same time, a large number of private enterprises take up the lead and consist of nearly 50% of the total deal volume and value. Although private enterprises' outbound investment has also dropped almost half compared to 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 more capable of providing capital for overseas deals as well. They have hit a new high of a deal volume of 253 deals in 2018, a 6% increase from 2017 and a 30% increase from 2016. The 2018 break down from SOEs to POEs is higher compared with 2017 based on the announced deals.

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 from the 1980s to its all-time high of $4.0 trillion reached in June 2014, though it has since receded to its recent low of $3.0 trillion in January 2017. Despite a slowing economy and an escalating trade war, China's foreign exchange reserves have been gradually rising since late last year, standing at $3.1 trillion in December 2019, helped by tight capital control and rising inflow from foreign investors with the renewed optimism towards the US-China negotiations, especially after the Phase 1 trade deal.[14]

The Chinese foreign exchange reserves have hit a low in October 2018 after the announcement of a 10% tariff on $200 billion worth of Chinese goods by the US, but are gradually recovering for the last four months with a growing optimism towards the US-China negotiations.

3. China outbound M&A destination shift amid US-China trade tensions

Intensifying trade tensions and tightened regulatory scrutiny have been critical factors affecting the Chinese cross-border trend. In 2018, the total value of Chinese M&A deals in the US has dropped 38% to $13.2 billion. The drop accelerated in the first six months of 2019, as China's M&A fell by 18%, marked the largest single-period decline over the last decade, as estimated by PwC. Closer scrutiny illuminates a 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

[14] People's Bank of China. [Retrieved from].

deals. Notably, China's investment in the US technology sector plunged 79% to its lowest level in seven years.

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

In the attempt to axe the largest transaction, CFIUS blocked the proposed US$1.2 bn merger between MoneyGram, a US money transfer business, and the 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 a gay dating APP Grindr to give up their 60% share of the company. Beijing Kunlun Tech, who completed the buyout of Grindr early last year, is now under the charge of possible threats to the US national security under the CFIUS decision due to data privacy issues. The announced deals of Chinese M&A are expected to continue decreasing if the hostility of the US-China trade is not eased as Chinese companies are cautious with future M&A deals in the US considering the rising costs and difficulties of such investments. Moreover, 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 the future threats on small value Chinese tech acquisition and the already completed suspicious deals.

EU was once the alternative destination of Chinese outbound investment, as it has contributed to 34% of the total China M&A announced deal value in 2017, and in 2018 this number jumped to 59% as the deal value in the US has further decreased.[15] The "Big Three" economies (UK, Germany, France) still attract the most capital, but northern Europe and the Benelux (Belgium, Netherlands, and Luxembourg) also caught up in 2018. The most preferred destination in northern Europe is Sweden, who has received in 2018 with EUR3.4bn of total investment driven by Zhejiang Geely's EUR3bn investment in Volvo AB.[16] EU is and is likely to continue to be the most favorable foreign investment destinations for Chinese businesses in a foreseeable future due to the deteriorating US-China relation.

With Boris Johnson's emphatic election victory accelerating the Brexit process as well as the European Union framework for the screening FDIs, the announced value of China's overseas M&As in Europe was US$3.6 billion in H1 2019, down 86.6% YOY, representing the largest decline in years. Similar 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,

[15] PwC. "PwC M&A 2018 Review and 2019 Outlook." Feburary 2019.

[16] Hanemann, T., Huotari, M., and Kratz, A. "Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies.", *MERICS Papers on China*, Mar. 2019.

the proposal has been adopted and related legislation is approved by the European Parliament on February 14, 2019, which is to come into effect in 18 months. Although this new EU investment screening framework is not as aggressive as many OECD screening frameworks, it's a significant landmark that will influence future Chinese investors' decisions.

The Rhodium Group 2019 report especially points out some of its provisions "overlap with core characteristics of Chinese investment in Europe to date." While most of the Chinese investments in the EU are targeted at European technology and innovation assets, many of these preferred sectors are 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-control entities, will further create troubles for Chinese outbound investment in EU. The new rules are built on a friendly "coordination and cooperation" framework with a generally friendly gesture, but Chinese firms may no longer enjoy the same level of convenience as before in the coming years.

As scrutiny intensified in Europe and the US, emerging economies in Asia and Oceania have become the most popular overseas M&A destinations for Chinese enterprises. Driven by the improved Sino-Australia relations and the BRI, 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 & life science, real estate, and hospitality & construction.[17] According to the Ministry of Commerce, China's non-financial outbound direct investment (ODI) was US$53.8 billion in H1 2019, dropped by 5.9% YOY.[18] Despite overall downward trend, the main investment sectors were leasing and commercial services. The data indicate that the structure of China's ODI remained healthy and optimized in 2019.

4. New trends in domestic economy opening up

Moving forward, China's internal policy reforms and external pressures from the trade negotiation will dictate the country's economic liberalization. With the size of the financial sector at US$44 tn, China has 1.1 bn potential retail banking customers, who have a US$14 tn asset pool under management by 2022. However, options to participate in China's financial markets have been limited due to the regulatory barriers since its accession to WTO in 2001.

Recently, there have been more policies relating to the opening up of the domestic economy by foreign capital including publications of a national unified negative list of industries for inbound investments which was previously more locally administered policies as well as a pledge for the opening up of investments in the financial institution space along with asset management companies. The strongest indication of China's willingness to change is President Xi's commitment to implement the country's "Opening-up Initiatives," marked by the unification of its banking and insurance regulators to form the China Banking and Insurance Regulatory Commission (CBIRC) in 2018. Against such background, China's Financial Stability and

[17] EY. "Overview of China outbound investment in H1 2019" August 2019.
[18] Ministry of Commerce, [Retrieved from].

Development Committee under the State Council announced a further 11 measures to ease foreign ownership limits on financial services firms in July 2019. They encouraged global asset managers to accelerate the entry of foreign capitals into China's securities industry.

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

China's retrenchment from outbound investment echoes its renewed focus on financial liberalization catalyzed by the domestic economic reforms and trade deal with the US. The new measures, characterized by "faster rather than slower, sooner rather than later", which is 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 can seem a bit contradictory at time, what is certain is the encouragement of technologies and growth platforms that enhance the sources of GDP growth and composition, especially as China continues to liberalize its economy as a driving force in technological innovation. There will be continued challenges as these policies and drivers evolve to changing the global economy and industry which bodes well for more opportunities 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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