

Riding the Silk Road: China sees outbound investment boom

Outlook for China's outward
foreign direct investment

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EY 安永

Building a better
working world

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Albert Ng
Chairman, China
Managing Partner,
Greater China

“Over the past decade, a growing number of sophisticated and confident Chinese investment companies have entered the global market. China becomes a major player in the global investment market - and some even predict that Chinese funds will dominate the global market in the near future. Our experience in working with “Going out” Chinese companies tells us that the keys to successful outbound investments are market knowledge, transaction efficiency, risk control - and a trusted partner. Over the years, EY has been a trusted partner for many Chinese outbound investors. We will continue to enable more Chinese companies to go global and to excel.”

Introduction

China's outward foreign direct investment (FDI) has increased substantially over the past decade. Today, outbound investment flow exceeds USD100 billion making China the world's third-largest overseas investor, strong evidence that Chinese companies are changing their roles from global manufacturers to global investors.

Currently, the focus of China's outward FDI is shifting from natural resources to high technology- and consumption-oriented sectors. This shift, owing to the growth of Chinese companies, accelerated economic transformation and China's evolving overseas investment interests, has far-reaching implications for the sector and the geographic distribution of China's outward FDI. On one hand, Chinese investors are diversifying their portfolios that previously focused mainly on the energy and mining sectors to bring in a new wave of M&As in the technology, agriculture and real estate sectors. And on the other, Chinese investors are now looking beyond resource-rich countries in Asia, Latin America and Africa, as developed economies in Europe and the Americas are emerging as attractive investment destinations.

In line with this growth in China's outward FDI, the number and size of Chinese privately owned enterprises (POEs) is also growing and investment from these POEs currently accounts for half of China's outward FDI and they have become more confident and ambitious. Driven by policy relaxation and public-private partnerships (PPP), a growing number of POEs are also joining hands with state-owned enterprises (SOEs) to expand globally.

2015 will mark another milestone in China's outward FDI. This year, the Chinese government is expected to announce that outbound investment has surpassed inbound investment thus making it an economy with a net capital outflow. This is partly because Chinese companies are being strongly encouraged to go overseas and are receiving more support than ever before. This support includes a simpler administrative system for overseas investment: a change from an approval-based system to a registration and filing system. Driven by the “Silk Road Economic Belt” and “21st Century Maritime Silk Road” policy (known as “One Belt, One Road”), a sharp rise is also expected in infrastructure investment. Therefore, Chinese companies are well poised to continue and expand their world-wide investment journey.

For many years, EY has worked with Chinese companies and has helped them grow their businesses. We understand that the rapidly global market is as changing as the sea, and that it comes complete with hidden reefs to scupper the strongest of vessels. We would like to use our experience in both local and global markets to provide the EY Overseas Investment Growth Navigator to Chinese companies, to help them mitigate risks and challenges on their outbound investment journey and become global market leaders.

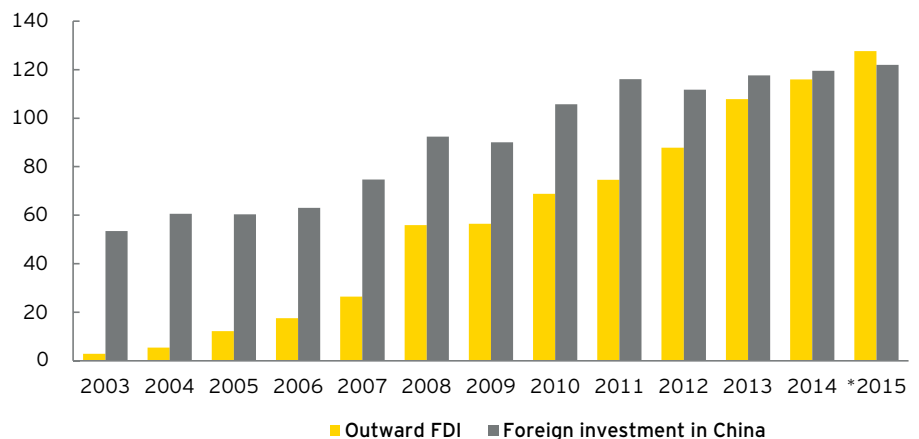
Loletta Chow
EY Global COIN Leader

1

Thriving in the global economy - China sees a boom in outward foreign direct investment

With the ongoing economic development in China and the implementation of the “Going Global” strategy, China’s outward FDI has soared over the past decade from almost nothing to more than USD100 billion . Against the backdrop of total global FDI flow declining at an 8% annual rate from 2011 to 2014, China’s outward FDI increased at a compound annual growth rate (CAGR) of 16%¹. In 2014, Chinese investors invested in 6,128 overseas companies across 156 countries and regions. China’s outward FDI outflow was ranked third in the world for the third consecutive year: a total of USD116 billion, up 15.5% on a year-on-year basis².

Chart 1: China’s outward FDI and foreign investment in China during 2003-2015 (USD billion)



Source: National Bureau of Statistics of China, Ministry of Commerce.

Financial investment is not included in the data for 2006 or before; the data for 2015 is predicted by EY Knowledge.

In 2014, China’s outward FDI and foreign investment in China was almost equal for the first time³. Thanks to the accelerated economic transformation and the stimulation due to reforms, China’s outward FDI is expected to grow more than 10% per year for the next five years. This indicates that China’s outward FDI should continue to surpass the amount of foreign investment in China during the same period, and that Chinese investors will play an increasingly important role in the global market⁴. Chinese investors are clearly beginning to embark on an energetic global investment exploration.

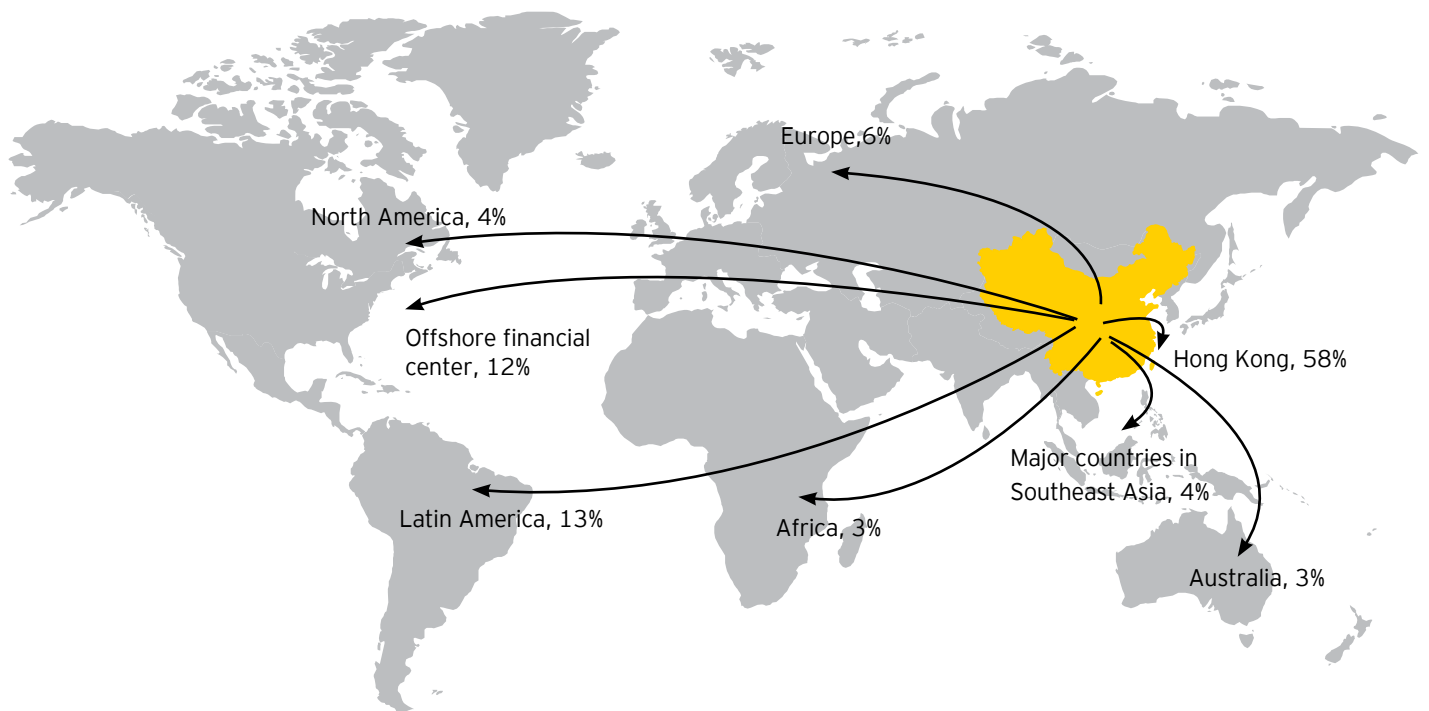
¹ Source: Ministry of Commerce, National Bureau of Statistics, UNCTAD

² Source: “Regular Press Conference of Ministry of Commerce on January 21, 2015”, *Ministry of Commerce*, <http://english.mofcom.gov.cn/article/newsrelease/press/201501/20150100878729.shtml>, 23 January 2015

³ Source: Ibid.

⁴ Source: “The annual growth rate of China’s outward FDI is expected to reach 10% over the next five years”, *Ministry of Commerce*, <http://www.mofcom.gov.cn/article/i/yjll/m/201410/20141000771228.shtml>, 24 October 2014

China's outward FDI footprint



Source: National Bureau of Statistics⁵

⁵ The data for China's outward FDI outflows is updated as of 2013. The total percentage exceeds 100% as the percentages have been rounded off.



2

“Driven by domestic and overseas factors” - A new wave of outbound investment released by favorable policies

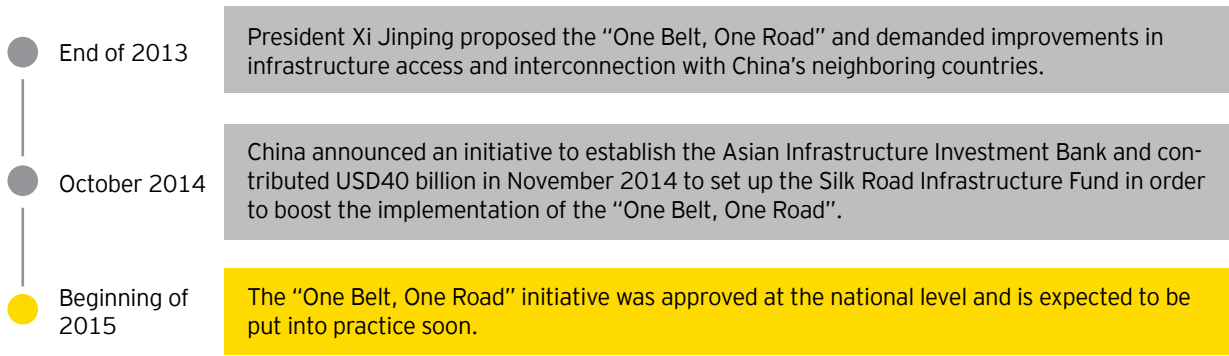
The accelerated economic transformation in China and the enhanced strength of Chinese companies amid the global economic recovery is helping these companies expand their presence overseas. Recently, a new range of new government policies have been providing even stronger support to Chinese companies as the government encourages them to go global. For example, under the newly revised Measures for Foreign Investment Management, the approval-based system has been replaced with a registration and filing system and the administrative procedures for overseas investment have been simplified. Furthermore, the accelerated implementation of the “One Belt, One Road” strategy and increasing flow-on from the policy reforms will bring a new wave of outbound investment.



Recent policies on promoting outward FDI		
Time	Contents	Expected effect
December 2014	At the State Council executive meeting, it was defined that financial support would be provided to invest overseas, including simplifying procedures for the administration of foreign exchange, encouraging banks to provide financial support to the production chain, from design to manufacturing of major equipment, to promote the diversified use of foreign exchange reserves.	A simplified approval system, broadened access to capital and an improved service system will help facilitate overseas investment for Chinese companies and encourage the manufacturing and financial sectors to move to a new level.
November 2014	China announced that it will contribute USD40 billion to set up the Silk Road Infrastructure Fund and work with the newly founded Asian Infrastructure Investment Bank to promote the implementation of “One Belt, One Road”.	China will provide support to countries along the “One Belt, One Road” for infrastructure improvement, resource development, and industrial and financial cooperation to promote China’s outward FDI.
October 2014	The newly revised Measures for Foreign Investment Management from the Ministry of Commerce took effect. Under these regulations, the approval system for investment projects worth over a specified amount has been eliminated and a registration and filing system has been established for all overseas investment projects - except for some sensitive projects - and the timing for approval has been shortened.	To improve efficiency, the scope of approval has been minimized, while the time needed to close outbound investment projects has been shortened.

Source: Notice from government departments, compiled by EY Knowledge.

With the “One Belt, One Road” strategy in place, there will be new opportunities for China’s outbound investment.



Source: Xinhua news agency

The implementation of the “One Belt, One Road” strategy will help improve infrastructure access and interconnection with neighboring countries as well as with those along the routes. This will bring in new development opportunities for outbound investment in infrastructure, energy cooperation and advanced manufacturing sectors.

► **Infrastructure**

The Asian Development Bank predicts there will be a funding gap of USD8,300 billion in infrastructure in Asia during 2010-2020⁶. China is expected to expand its overseas investment and to export technology to developing countries in Asia.

► **Energy cooperation**

Asian countries are rich in energy resources. As many developing countries are facing funding and technology challenges, there will be more opportunities for joint exploration and development, the construction of energy pipelines and electricity facilities.

► **Advanced manufacturing**

China has advantages over some neighboring countries in IT, new material and advanced manufacturing sectors (e.g., high-speed railway and nuclear power, etc.). Those countries are expected to benefit from China’s manufacturing technology.

⁶ Source: “China’s investment under the global transformation”, *Xinhuanet.com*, http://news.xinhuanet.com/fortune/2014-10/30/c_1113046148.htm, 30 October 2014

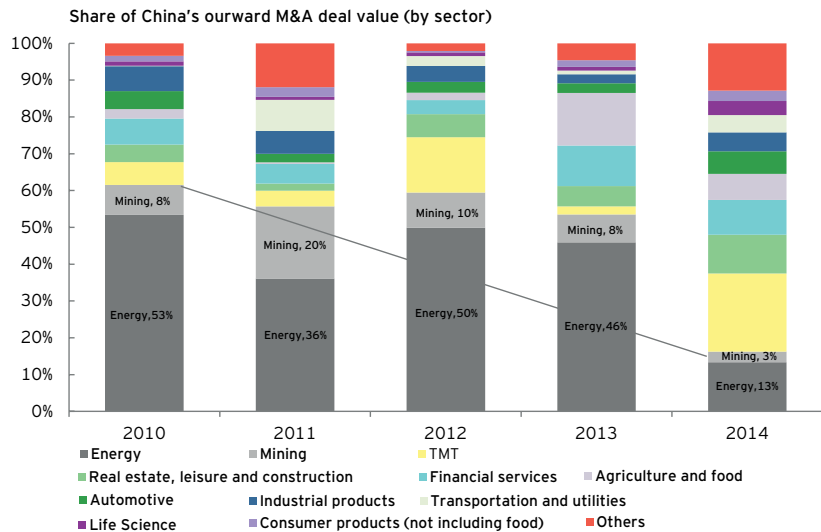
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Optimization and diversification - From “Made in China” to “Made for China”

Optimized structure: Consumer-driven and high-end manufacturing industries will boost robust momentum

China’s outward investment has become more sophisticated as companies shift their focus from seeking natural resources toward creating a global strategic presence. Earlier, investment activities were concentrated in the energy and mining sectors. However, they have more recently expanded into the technology, real estate, finance, agribusiness and health care sectors. The existing M&A market also shows clear diversification: In 2010, energy and mining accounted for 61% of the total value of Chinese companies’ M&A deals but this had dropped to 16% in 2014. Conversely, the share of the technology, media and telecommunication (TMT) sector increased from 6% in 2010 to 21% in 2014; agriculture and real estate are also exciting M&A sectors.

Chart 2: Chinese companies’ outward investment is moving from energy and mining toward diversification



Source: MergerMarket, EY Knowledge analysis

As China undergoes economic transformation, the following two major investment strategies have been particularly prominent:

- ▶ Booming investment in consumer-driven industry: China is becoming more of a consumer economy as its development emphasis shifts from “Made in China” to “Made for China”. In the meantime, the ever-increasing consumption level and the expanding middle-class mean that there is considerable potential for high-quality agricultural products, high-tech products, and high-end consumer products. Chinese companies are investing overseas not only for foreign resources and markets, but also to bring in products and services to meet the growing domestic demand.

“Going out, bringing in”: The escalating consumption level is prompting companies to go overseas.

In 2013, Shuanghui International acquired Smithfield Foods, the world’s largest pork producer, for USD7.1 billion. The main aim of this acquisition was to import American pork products to meet the increasing demand for prime pork in China. Likewise, in November 2014, Yili invested RMB3 billion to launch the second phase of its Oceania production base in New Zealand. Meeting the soaring domestic need for dairy products was undoubtedly an important driver for Yili’s investment.

- Advanced manufacturing industry's bigger role: The "One Belt, One Road" strategy will encourage China's advanced industries and their overcapacity to move into countries along the routes. China has strong capabilities in the high-speed railway, nuclear power, aviation, telecommunications and other advanced manufacturing sectors. The saturated domestic China market is prompting the export of these leading production capacities. In particular, with the implementation of the "One Belt, One Road" strategy, focusing on infrastructure and interconnection, China is expected to accelerate the transfer of these leading industries to Asian neighbors, which face huge gaps in terms of financing and technology. In addition, as China transforms its economy, Chinese companies will move up the industry chain and their needs for advanced technologies will drive them to actively pursue investment opportunities in developed markets.

Diversified sectors: M&A rush in various industries

China's overseas M&A landscape is seeing a lot of activities in various sectors but mainly in the technology, agribusiness and real estate sectors. The policy support is making infrastructure a new market focus. Enthusiasm for investing in the energy sector is faltering, but it is still one of the investors' focus areas.

- TMT: booming market and active transactions**

China's TMT sector has entered a busy period as large overseas deals are frequently being reported. Lenovo was involved in two significant deals in 2014: the acquisition of Motorola Mobility from Google for USD2.91 billion and of IBM's x86 server business for USD2.1 billion.

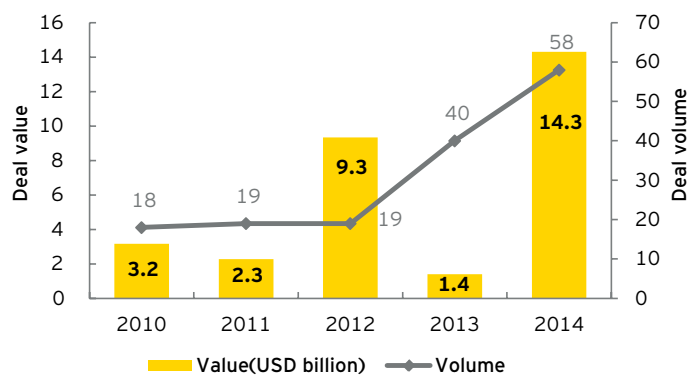
Owing to the booming internet era and accelerated digital transformation, emerging sectors like TMT will continue to prosper in China. As more Chinese companies step into the technology sector offering value-added products, Chinese investors will maintain their active presence in the international TMT market.

- Agribusiness: "Go out" for new breakthroughs**

In early 2014, the "Central No.1 Document" encouraged agribusiness to "go out" and strengthen agricultural cooperation with neighboring countries. The major SOEs, such as COFCO, responded and achieved new breakthroughs in outward FDI: In 2014, COFCO paid USD1.5 billion for a stake in Noble's agribusiness and USD1.29 billion for Nidera of the Netherlands – two of the largest outward FDIs in agriculture to date.

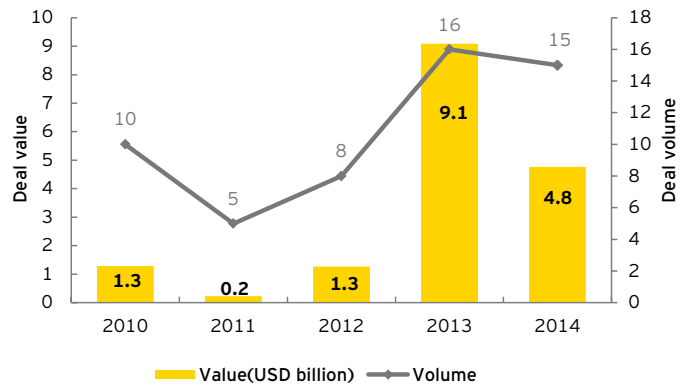
The future is expected to produce huge potential for development in the agriculture and related sectors as demand for high-quality agricultural products by Chinese consumers continues to increase and as domestic logistics and agricultural technologies develop. Considering the large populations of the countries, especially the Middle East countries that are involved by means of the "One Belt, One Road" strategy, implementing this initiative will lead to huge demand for agricultural products and increased opportunities for agricultural cooperation.

Chart 3: China's overseas M&A deals in TMT



Source: MergerMarket, EY Knowledge analysis

Chart 4: China's overseas M&A deals in agribusiness and food



Source: MergerMarket, EY Knowledge analysis

Case analysis

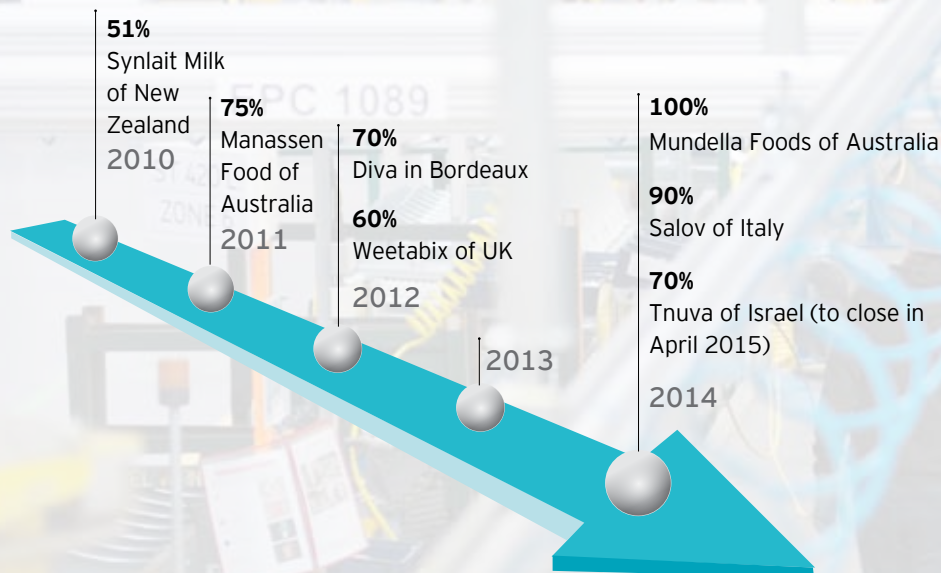
Bright Food's road to internationalization

Bright Food (Group) Co., Ltd. ("Bright Food") was founded on August 8, 2006, as a result of the efforts of the State-owned Assets Supervision and Administration Commission of the Shanghai Municipal Government to restructure and consolidate food industry resources in the city. Bright Food is a large comprehensive food industry group and has a food industry chain that covers modern food production, processing and distribution. It focuses on "big industry, big brand and big market-access," has a "5+1" (marketization,

professionalization, internationalization, securitization, standardization and talent) reform strategy, and an "8+2" primary business structure, including dairy, sugar, meat, vegetable, rice, branded food, modern agriculture, sales channel, real estate and finance.

Bright Food has been engaging in overseas investment since 2010, and it has become a leader in outbound investment within five years.

Chart 5: Timeline of Bright Food's overseas deals



Looking back, Bright Food's overseas M&A journey has not been that smooth. In its early attempts, it missed several opportunities because of a lack of overseas M&A experience. From January to July 2010, Bright Food desired to buy the sugar business of Australia's CSR. If that purchase had succeeded, Bright Food would have acquired 45% of Australia's raw sugar production capacity and become one of the top three global sugar industry players. Bright Food signed the letter of intent first, without a binding exclusivity agreement. And then, because of the participation of Singapore's Wilmar International Limited in the bidding, Bright Food lost the deal. In the same year, Bright Food

attempted to acquire United Biscuits, GNC (the largest health and nutrition product manufacturer in the United States of America (US)) and Yoplait (the second-largest yogurt producer in France), but these attempts also failed because of high purchase prices, M&A risks or other factors.

These early failures did not change the international strategy or vision of Bright Food. Learning from these early difficulties, Bright Food has become increasingly sophisticated and experienced. Initially, it did not have enough knowledge of the foreign investment environment. To gain insight, Bright Food has started keeping a close eye on investment activity. Furthermore, by improving their

public relations, offering reasonable prices and seeking government support and M&A partners, Bright Food has grown gradually in their ability to close significant overseas deals.

In July 2010, Bright Dairy & Food Co., Ltd., a subsidiary of Bright Food, announced an RMB382 million deal to acquire a 51% stake in New Zealand's Synlait Milk. This deal brought prime dairy resources and manufacturing technology to Bright Dairy & Food while circumventing obstacles in acquiring pasture. Synlait Milk was successfully listed in New Zealand in July 2013. In August 2011, Bright Food acquired a 75% stake in Manassen Foods. This deal allowed Bright Food and Manassen Foods to collaborate on brand and production, the introduction of medium- and high-end products, international sourcing, provision of raw materials and replication of business model, and they have achieved positive results together. Manassen Foods started its listing campaign at the end of 2013. In May 2012, Bright Food announced a £1.2 billion deal for a 60% stake in Weetabix – at that time, the largest overseas deal for China's food industry.

Other deals include the following: In June 2012, Bright Food subsidiary Shanghai Tangjiu (Group) Co., Ltd. acquired a 70% stake in Diva, the largest wine trader in Bordeaux. In January 2014, Manassen Foods acquired Mundella Foods, Western Australia's premier dairy company. In December 2014, Shanghai Yimin No. 1 Foods (Group) Co., Ltd., another Bright Food subsidiary, acquired a 90% stake in Italian olive oil producer Salov, signaling Bright Food's official debut in the olive oil market. It was also the first time for Bright Food to use the Shanghai Free-Trade Zone as a platform to complete an overseas deal. Since May 2014, Bright Food has been in talks with Apax to acquire a 70% stake in Tnuva, the largest food producer in Israel.

By the end of 2014, Bright Food had emerged as a truly international player. The company has endeavored to establish an international presence but with a focus on Europe, Australia and Southeast Asia. According to Forbes, Bright Food is one of the "10 Chinese Companies Going Global in 2015"⁷. Successful overseas M&A enables companies to attain growth, access premium resources, achieve brand recognition, broaden channels, acquire advanced technologies and expand into overseas markets in

a relatively short period of time. Bright Food has matured and now it cautiously considers investment targets and focus areas in terms of markets, resources and channels, and is achieving internationalization on a gradual basis.

For overseas investment, there are opportunities as well as challenges. Being an SOE with abundant funds and sound credit, Bright Food is undoubtedly a competitive player, and it has sophisticated brands, products and sales channels. Given the active support from the Chinese government in terms of "going abroad" and the weakening of certain European and Western economies, it is a good time for Bright Food to expand further into foreign markets. On the other hand, the state-owned background of Bright Food raises red flags in the overseas government approval process for its deals. Western countries have certain restrictions against Chinese SOEs and many consider Chinese SOEs' business interests are aligned with the governmental ones. Also, the limited public relations skills of Chinese SOEs lead to insufficient communication with overseas stakeholders. As a result, it becomes challenging for SOEs to secure support from foreign media and governments. There could also be interventions from local governments and resistance among farmers. For Bright Food, there is still a long way to go internationally.

In a recent interview, Lv Yongjie, Chairman of Bright Food, said that the international presence of Bright Food has begun to take shape, and by 2018, it would achieve 25% in its Internationalization Index⁸. By then, Bright Food will be importing its products from all around the world. With this vision in mind, Bright Food will continue to implement its international expansion strategy, conducting M&A deals and the consolidation of its primary businesses, namely wine, sugar, dairy, their distribution and comprehensive food production.

It will be a bumpy road to internationalization. However, with its newfound experience, Bright Food continues to move forward in this process.

⁷ Joel Backaler, "10 Chinese Companies Going Global in 2015", Forbes, <http://www.forbes.com/sites/joelbackaler/2015/01/14/10-chinese-companies-going-global-in-2015/>, 15 January 2015.

⁸ Wang Yongjuan, "Bright Food's international 'ambition': future Bright food will produce around the globe", *Eastday.com*, <http://sh.eastday.com/m/20141114/u1ai8444063.html>, 14 November 2014.

► **Infrastructure: Favorable policies make this sector ready to be explored**

China has performed admirably in the overseas infrastructure and public facilities sectors. In the infrastructure sector, China carries comparative advantages in funding and technologies. The improvements in PPP have established a sound foundation for attracting Chinese investment. “High-speed rail diplomacy” is a prominent illustration of China’s aggressive expansion into

the overseas infrastructure sector.

At the end of 2014, China announced plans to establish the Silk Road Fund and the Asian Infrastructure Investment Bank to implement its “One Belt, One Road” strategy. The aim of this strategy is to connect and link the infrastructures of Asian countries, which will provide an important platform for Chinese infrastructure companies to go out and boost Chinese investments in countries on these routes.

Recent outward mega infrastructure contracts or projects under discussion			
Time	Value	Country	Description
Jan 2015	RMB1.5 trillion	Russia, Kazakhstan	China proposed building a 7,000km high-speed rail link from Beijing to Moscow, passing through Kazakhstan. Source: Chinadaily.com http://caijing.chinadaily.com.cn/2015-01/23/content_19389602.htm
Dec 2014	USD18 billion	Kazakhstan	China and Kazakhstan reached preliminary consensus on a capacity cooperation framework agreement covering infrastructure, highway and housing construction. Source: Xinhuanet.com http://news.xinhuanet.com/world/2014-12/16/c_127309209.htm
Dec 2014	RMB67.8 billion	Singapore, Malaysia	A conglomerate led by the China Railway Construction Corporation is expected to win the construction contract for the Kuala Lumpur-Singapore high-speed rail, which will be the first high-speed rail in Southeast Asia. Source: Chinadaily.com http://caijing.chinadaily.com.cn/2014-12/16/content_19095612.htm
Dec 2014	USD10.6 billion	Thailand	China and Thailand signed a memorandum of understanding on railway cooperation, resulting in the planned collaboration on building rail lines over 800km. Source: State Council Information Office http://www.scio.gov.cn/ztk/wh/slx/htws/Document/1388923/1388923.htm
Nov 2014	USD11.97 billion	Nigeria	It was announced that the China Railway Construction Corporation will build the coastal railway line in Nigeria. The railway line will be 1,402km long with 22 stations and a designed speed of 120km/h. Source: People.com http://scitech.people.com.cn/n/2014/1121/c1057-26064468.html
Nov 2014	USD60 billion	Brazil, Peru	A China-Brazil-Peru working group was announced to be established soon to discuss the details of a proposed transcontinental railroad in South America. The rail would run between coastal cities in Peru and Brazil, extending about 5,000km, including 3,000km of new railway construction. Source: People.com http://www.chinadaily.com.cn/kindle/2015-02/16/content_19609137.htm

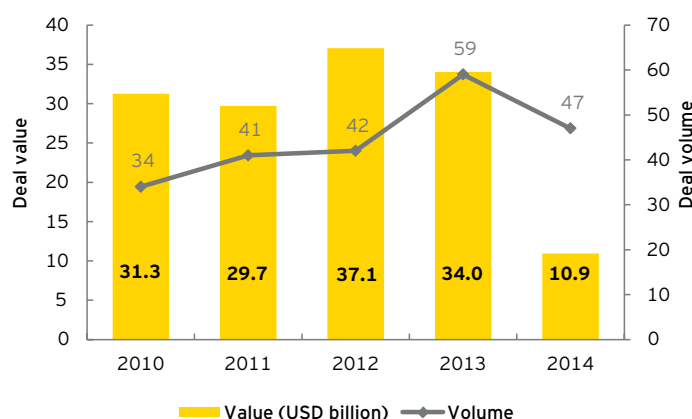
Source: EY Knowledge

► **Energy and mining: The pillars of investment**

The sluggish energy and commodities market has not stopped Chinese companies from going overseas. Although this sector witnessed a significant decline in M&A deal value by Chinese companies, the deal volume is quite stable. Notable deals include a China Minmetals-led consortium buying the Las Bambas copper project in Peru for USD5.85 billion, State Grid Corporation of China acquiring a 35% stake in CDP Reti for USD2.54 billion and a consortium led by Baosteel acquiring Aquila Resources.

The Ministry of Commerce recently said that compared to developed countries, the share of Chinese investment in energy and mining is still low⁹. To meet the increasing demand for resources and energy during industrialization, China still has a large need to invest in the energy and mining sectors. In addition, the recently falling prices of oil and metals provide great opportunities for Chinese companies to “buy low”.

Chart 6: China’s overseas M&A deals in energy and mining



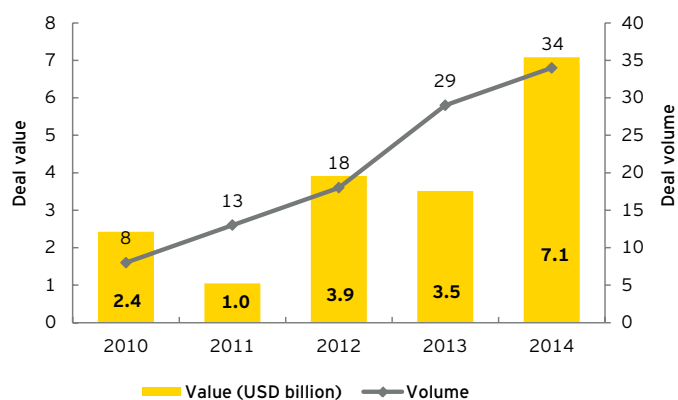
Source: MergerMarket, EY Knowledge analysis

⁹ Source: “MOFCOM: Measures for Foreign Investment Management employs negative listing concept”, Ministry of Commerce, <http://www.mofcom.gov.cn/article/difang/henan/201410/20141000769013.shtml>, 22 October 2014

► **Real estate: Financial capital enters and the pace of going out accelerates**

Chinese capital continued its aggressive interest in the overseas real estate sector in 2014. Overseas real estate investment has increasingly become the new normal. And with looser restrictions on the investment channels of insurance funds, the financial capital represented by insurers will be an important source of capital allocation, which will be another significant highlight in the market. 2014 saw active deals in real estate and hotels. Many megadeals were conducted by financial capital, including Anbang Insurance buying the Waldorf Astoria New York for USD1.95 billion and Sunshine Insurance acquiring the Sheraton on the Park in Sydney for AUD460 million.

Chart 7: China's overseas M&A deals in real estate, hospitality and construction



Source: MergerMarket, EY Knowledge analysis

The real estate market in China faces a degree of downward pressure; however, overseas real estate markets are promising good returns so Chinese investors are currently active buying buildings overseas. At the beginning of 2015, Wanda and Fosun both announced new investments in overseas real estate. The pace of “going out” for overseas real estate is expected to further accelerate.

Recent deals buying overseas properties and hotels by Chinese companies				
Time of announcement	Country	Value	Target	Buyer
Feb 2015	US	USD230 million	Baccarat Hotel, New York	Sunshine Insurance
Jan 2015	Australia	AUD117 million	73 Miller Street, Sydney	Fosun
Jan 2015	Australia	AUD415 million	Gold Fields House, Sydney	Wanda
Nov 2014	US	USD1.95 billion	Waldorf Astoria Hotel, New York	Anbang Insurance
Nov 2014	Australia	AUD463 million	Sheraton On the Park Hotel, Sydney	Sunshine Insurance

Source: EY Knowledge, company announcements and www.people.com.cn

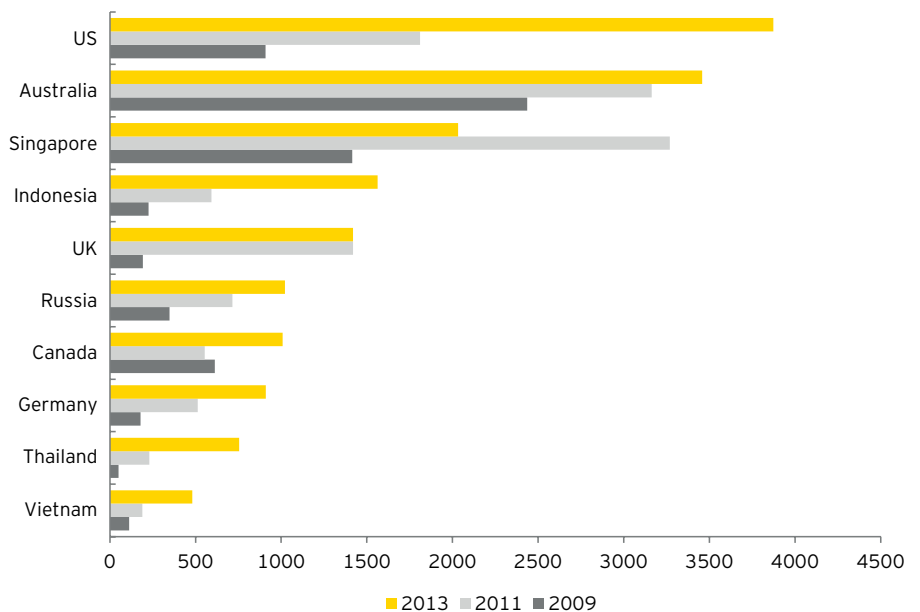
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Diversified geographies - Developed countries becoming a new focus

The world saw the Chinese investment footprint expanding to 156 countries and regions in 2014. The main destinations for Chinese investment were the US, ASEAN, the European Union (EU), Australia and Russia (but excluding destinations designated as Hong Kong, the Cayman Islands and the Virgin Islands). With the transformation and strengthening of the Chinese economy and the development of Chinese enterprises, the objective of investment has shifted from acquiring production factors such as resources to acquiring advanced technology and brands. This shift in focus is aimed at increasing the international competitiveness of Chinese companies and meeting the changing domestic consumption behavior. Driven by this shift, the investment destinations for China are becoming increasingly diversified, as Chinese companies are expanding into the developed countries in Europe and America rather than the resource-based economies in Asia, Africa and Latin America.

Furthermore, the slow economic recovery of developed countries after the 2008 financial crisis has also provided a good opportunity for Chinese companies to “buy on the dips”. In recent years, the growth of Chinese investment in developed countries was significantly outpaced that in the developing countries. China’s investment in the US increased 23.9% in 2014 and investment in the EU increased 1.7 times, much higher than the 14.1% overall FDI growth in the same period¹⁰.

Chart 8: Top 10 destinations of China’s outward FDI (USD million)



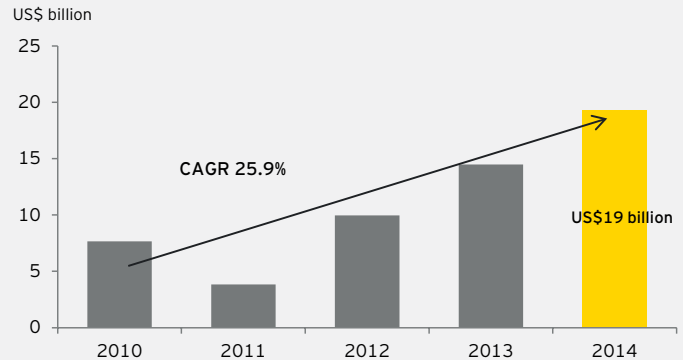
Source: Ministry of Commerce, data excludes Hong Kong, the Cayman Islands and the Virgin Islands

¹⁰ Source: “China will become a capital exporting country”, *Ministry of Commerce*, <http://www.mofcom.gov.cn/article/difang/jilin/201501/20150100875265.shtml>, 22 January 2015

The US market remains attractive for diversified investments

As the largest developed country in the world, the US has stable political and social environments, sound legal and regulatory systems, a successful market system, and leading competence in science and technology and education, which are main attractions for China's outward FDI. According to data from the Ministry of Commerce, until 2013, the US was the second-largest destination for China's outward FDI, after Hong Kong. For 2010 to 2014, the CAGR of China's outward FDI to the US was 25.9%¹¹. Although large SOEs have encountered some barriers to investing in the US, with the growing power of the POEs and the increasing needs of investment, more POEs are focusing on the US for their investment opportunities.

Chart 9: China's FDI to the US, 2010-2014



Source: MergerMarket, EY Knowledge analysis

Since China joined the World Trade Organization, China and the US have increased their cooperation in energy security, high tech, environmental protection, health care and intellectual property protection. China and the US reached consensus on the Information Technology Agreement expansion in November 2014, which will cut tariffs on high-tech products such as semiconductors, medical equipment, and GPS devices¹²; China and the US co-issued the US-China Joint Announcement on Climate Change in December 2014, with the promise of reductions in carbon emissions¹³. The Bilateral Investment Agreement between the two countries has experienced many rounds of negotiation with significant progress in text negotiation, although the wording is not finalized. The focus of negotiations will be the prohibited investment list in 2015¹⁴.

In the past five years, China's FDI into the US has gradually increased. The investment has been more diversified and the M&A transactions are more vigorous than those in other regions. Data from MergerMarket shows that China's FDI into the US increased from USD7.7 billion in 2010 to USD19 billion in 2014. Energy has traditionally formed a large proportion of China's outward FDI, but recently, especially in M&A transactions, Chinese companies have targeted new sectors with an increasing focus on technology, agriculture and consumer products. M&A transactions in the technology sector comprised 44% of China's total M&A in the US in 2014. Of these transactions, Lenovo's acquisition of IBM's x86 server business and Motorola's mobility business totaled USD2.1 billion and USD2.91 billion, respectively. In September 2014, Alibaba Group listed on the NYSE and set the record as the largest IPO ever in the US stock markets¹⁵. As the needs of Chinese companies for internationalization, industrial transformation and development increase, investment in the high-tech industry is expected to keep rising.

¹¹ Source: MergerMarket, EY Knowledge analysis

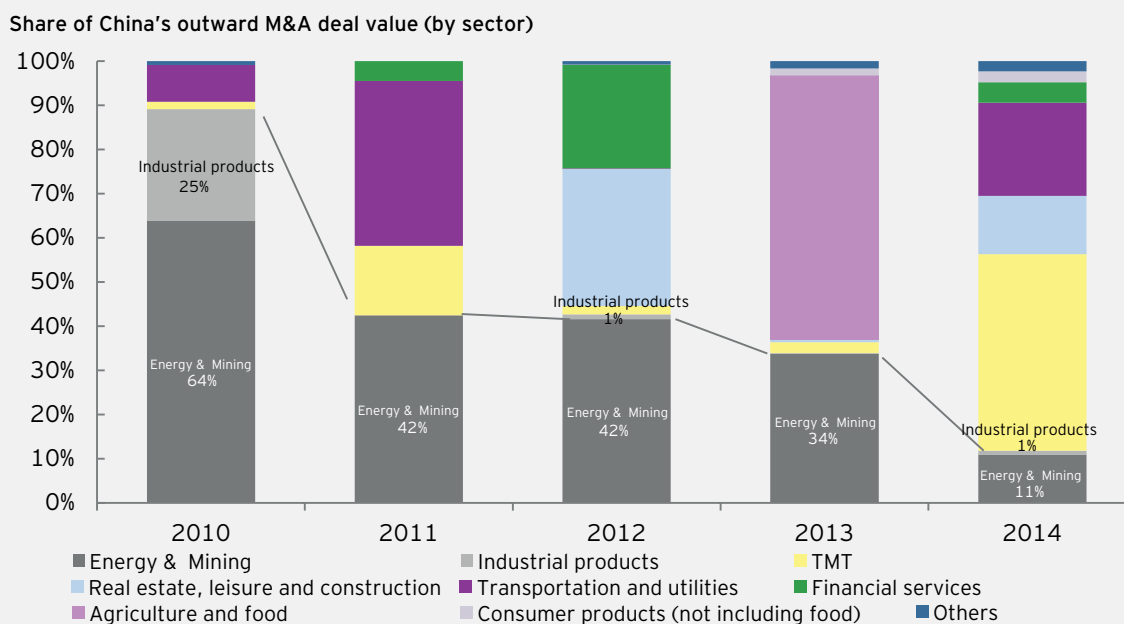
¹² Source: "China and the US reached consensus on Information Technology Agreement expansion", *Ministry of Commerce*, <http://www.mofcom.gov.cn/article/i/jshz/xm/201411/20141100793077.shtml>, 12 November 2014

¹³ Source: "US-China Joint Announcement on Climate Change released", *Ministry of Land and Resources*, http://www.mlr.gov.cn/xwdt/jrxw/201411/t20141115_1335187.htm, 15 November 2014

¹⁴ Source: "Historic progress was made in Bilateral Investment Treaty negotiations", *Ministry of Commerce*, <http://tjtb.mofcom.gov.cn/article/y/aa/201407/20140700662482.shtml>, 15 July 2014

¹⁵ Source: "Alibaba's listing proves the success of Chinese internet development model", *Xinhuanet.com*, http://news.xinhuanet.com/fortune/2014-09/19/c_1112555941.htm, 19 September 2014

Chart 10: Chinese M&A transactions in the US moving toward diversification, from energy and mining and industrial products



Source: MergerMarket, EY Knowledge analysis

Through their attempts to acquire US technology in recent years, Chinese acquirers have made good progress in developing their M&A capabilities and are generally competent in assessing the technologies in question. However, they have yet to adopt the more holistic approach to technology deals that the leading international companies use. Chinese acquirers have continued to view a technology M&A transaction purely as an asset acquisition (a technology with intellectual property), but the core value of any technology corporation is actually in its workforce – from management and R&D to production and sales. Understanding culture is a two-way street, but

many Chinese investors assume their culture as the acquirer is always the “right way”, thus they lack the ability to retain talent. Having a sensible human resource strategy is important for Chinese acquirers to maintain their attractiveness when competing with other buyers for a limited pool of target.

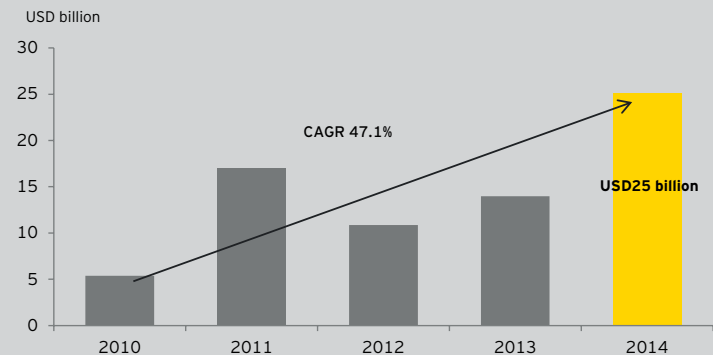
The overseas M&A teams of Chinese companies are often staffed by junior or middle-level managers with limited international experience. However, in such a rapidly changing and complicated investment environment, Chinese business leaders need to improve their sensitivity to the cultural environment of the US.

Five tips for investing in the US	
Be willing to invest for the long term	The purchase price of the target corporation is a one-time cost. However, it is necessary to consider the ongoing costs, including integration expenses and especially the fees of external advisors to help smooth the path to a successful integration.
Send in a small, smart and agile team, including external advisors if necessary	We have seen many cases where a Chinese acquirer sends in a large team, with far too many nonessential “observers,” which intimidates the target.
Thoroughly research the costs of operating in the targeted region	This would include quantifying the fully loaded costs to acquire and retain talent (e.g., compensation, benefits and equity incentives), so as to avoid any surprises. It is important to determine before closing if the total costs are affordable.
Determine the integration approach up-front	For targets that have a higher and more complex compensation structure, the Chinese acquirer must have a fully developed plan for integration, or in some cases not integration, to ensure compensation parity across the new organization. It is necessary to develop a contingency plan for situations in which it might benefit the acquirer not to integrate the entire target. Some of the best acquirers have a detailed integration plan that has been designed and approved before the acquisition agreement is signed.
Determine a strategy that can facilitate future deals	M&A is a continuous process as technology will never cease to evolve. A business leader with long-term vision must determine how the terms and conditions of a current deal may lay the foundation for future deals of the same type.

Advanced technology: The aim in the European market

European countries, especially the developed ones, are increasingly sought after by Chinese investors for their advanced technology and expertise, well-accepted and recognized brands and mature marketing networks. For 2010 to 2014, China's FDI into Europe increased at a CAGR of 47.1%; from 2013 to 2014, Chinese investment into Europe increased by 80%¹⁶, showing both their strong desire for investment and their capabilities.

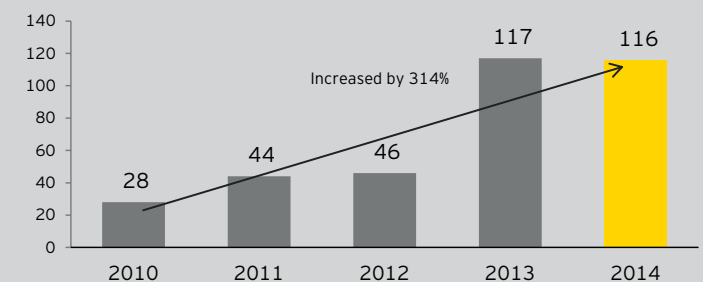
Chart 11: China's FDI to Europe 2010-2014



Source: MergerMarket, EY Knowledge analysis

Despite being affected by the 2008 financial crisis, the European debt and economic crises, European countries, especially Germany, have succeeded in attracting investment from Chinese companies. Germany, the strongest economically among the EU members, props up half of the European economy. China is Germany's third-largest trading partner, while Germany has been China's largest trading partner in Europe for 10 years. Sino-German economic and trade relations have reached an unprecedented depth and breadth. The bilateral trade and economic cooperation structure is more efficient. The proportion of high value-added products such as in the automotive, aerospace and communications sectors has increased. Processing, design, financial services and other fields has also been strengthened¹⁷. In 2005, there were only 12 Chinese M&A transactions in Europe, of which 5 were of German targets. In 2007, before the financial crisis, there were 15 Chinese M&A transactions in the European region (of which 2 were of German companies). Since then, the volume of Chinese M&A deals in Europe has increased more than three times: In 2014, Chinese companies or their overseas subsidiaries completed 116 M&A projects in Europe¹⁸, increased by 314% comparing with 2010.

Chart 12: Volume of Chinese M&A deals in Europe



Source: MergerMarket

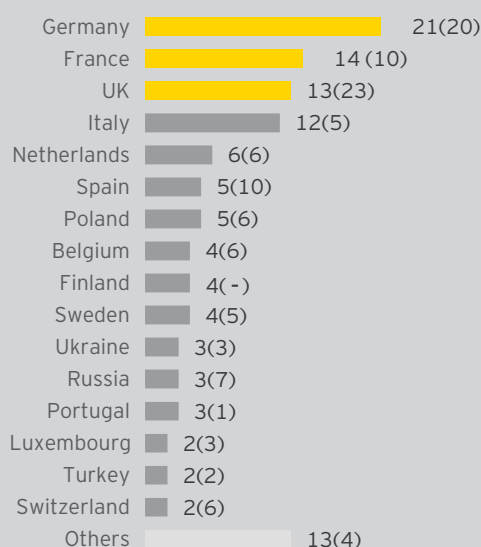
¹⁶ Source: MergerMarket, EY Knowledge analysis

¹⁷ "Counsellor's Keynote", Guidance for FDI cooperation by countries/regions-Germany (2014), Ministry of Commerce, September 2014

¹⁸ Source: MergerMarket. The acquirer was a company headquartered in the Chinese mainland and its subsidiaries, while the target was limited to Europe. New deals not completed as on 31 December 2014 are also included.

For Chinese investors, Germany is the most attractive country in Europe. In 2014, the number of Chinese M&A transactions in Germany rose to 21, making China the sixth-largest investor in Germany and the second-largest investor outside Europe, only after the US¹⁹. The industrial, TMT and automotive sectors are favorites for Chinese investors.

Chart 13: Volume of Chinese M&A transactions in Europe in 2014 (2013)

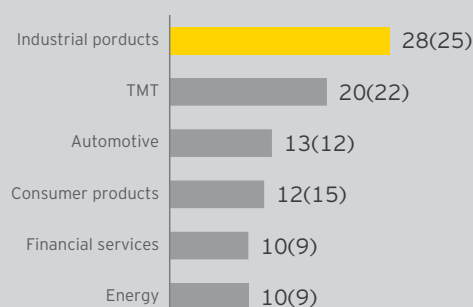


Source: MergerMarket, EY analysis

As China has a large market for high-end equipment and auto parts, with the need for industrial upgrading, Chinese investors have a keen interest in German technology and products. In August 2012, Weichai acquired the German Kion Group, and in the same year, Sany completed the acquisition of the global concrete machinery giant, German Putzmeister. Later in October 2014, AVIC Electromechanical successfully acquired Hilite, the internationally renowned automotive parts manufacturer. Auto parts suppliers in China can access certain top German auto clients by merging with or acquiring German auto parts suppliers.

Chinese companies invest in Germany not only to obtain technology, but also to speed up their transformation into world-class competitors in the automotive and machinery industries. Acquisitions in Germany have also helped realize China's international strategy. Due to the overcapacity of some Chinese industries, certain Chinese companies, especially SOEs, have decided to expand their industrial chain. There are many mid-sized companies in Germany offering attractive opportunities to build new businesses for Chinese companies.

Chart 14: Volume of Chinese M&A transactions in Europe (by sector) in 2014 (2013)



Most investors hope to explore new clients in Germany and learn from German companies. The "brain drain" that many German companies were worried about has not happened. As Chinese companies know too well, in global competition, the quality of products is the core, and "Made in Germany" represents high quality. Chinese companies have made concessions such as providing job guarantees in many deals. Some have also acquired German companies that were in financial distress. In these circumstances, Chinese investors provided timely help to these German companies.

In recent years, the Chinese automotive OEM and parts supplier market has been in an integration phase because the Chinese government has made considerable effort to increase competitiveness with European and American companies. While expanding their scale, Chinese companies have also enhanced their acquisition ability. Some Chinese companies are also showcasing their successful acquisitions in Europe in order to improve their chances of a successful IPO.

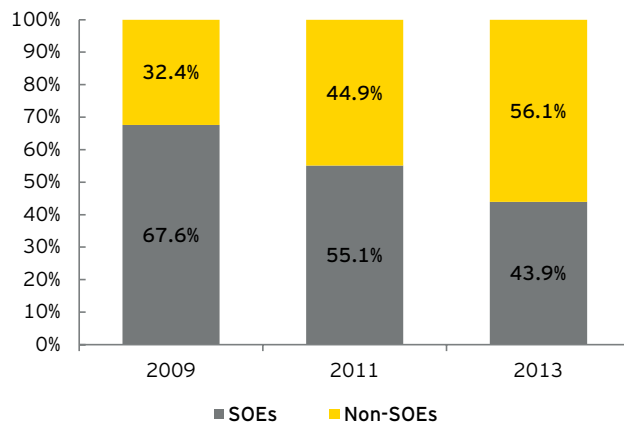
¹⁹ EY internal research report

5

Rise of privately owned enterprises - China's new force

With the growing strength of Chinese POEs and the government's support for "going out", a smaller proportion of China's increasing outward FDI is coming from SOEs. By the end of 2013, China's outward FDI of non-SOEs accounted for 44.8% of China's total accumulated outward FDI value, and their outflow comprised 56.1% of the total outflow of 2013²⁰.

Chart 15: FDI outflow of Chinese non-SOEs outruns that of SOEs, taking up half of the total



Source: Ministry of Commerce

Chinese POEs are more flexible, faster-growing, more diversified in terms of investment, and less affected by possible stringent political censorship in the host countries. Therefore, they are more likely to gain better investment results and benefits.

But at the same time, POEs experience more difficulties in being able to "go out", especially for financing as POEs are rarely supported by China's policy banks, and commercial banks prefer large SOEs. Many POEs are smaller and lack a good credit basis for overseas financing and cross-border payments.

POEs also have problems in strategy and management. For example, many lack long-term strategy development and risk awareness, an understanding of the investment environment and cultures of host countries, and experience of overseas investment. Insufficient strategic coordination can easily lead to vicious competition.

To address these challenges, efforts must be made internally as well as externally: Companies need to increase their core competitiveness, while the government may assist with the following measures.

- ▶ **Decentralization:** The recent announcement of the reform of the administration and approval of foreign exchange is undoubtedly a major positive. But the execution of local regulatory agencies and the government remains to be seen. Regulatory fragmentation, insufficient of existing legislation and other issues also need to be resolved.
- ▶ **Financing support:** Further financial market reform needs to be achieved: This is namely increased experience setting up specialized agencies or funds, the provision of diversified financing channels, and the encouragement of banks to provide full support for POEs, such as overseas loans, equity financing, and offshore financial services.
- ▶ **Guidance and coordination:** Cooperation between companies needs to be promoted, and the complementary advantages of the POEs and SOEs need to be encouraged, and companies with mixed ownership encouraged to "go out". Other measures include the development of an information network of overseas markets, the provision of training and guidance for POEs, and the promotion of risk awareness.

²⁰ Source: Ministry of Commerce

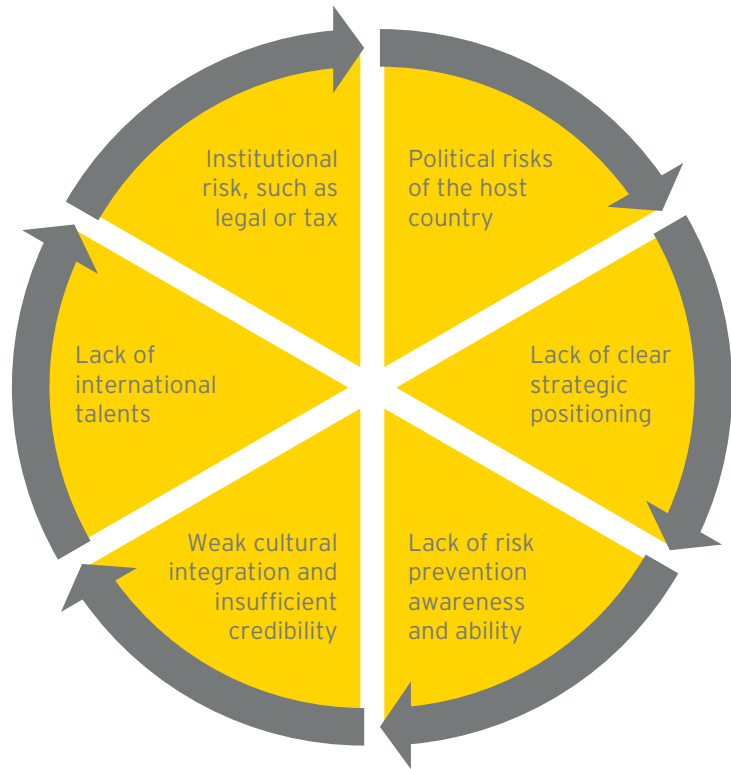


6

Undercurrents of risks - Making the right decisions

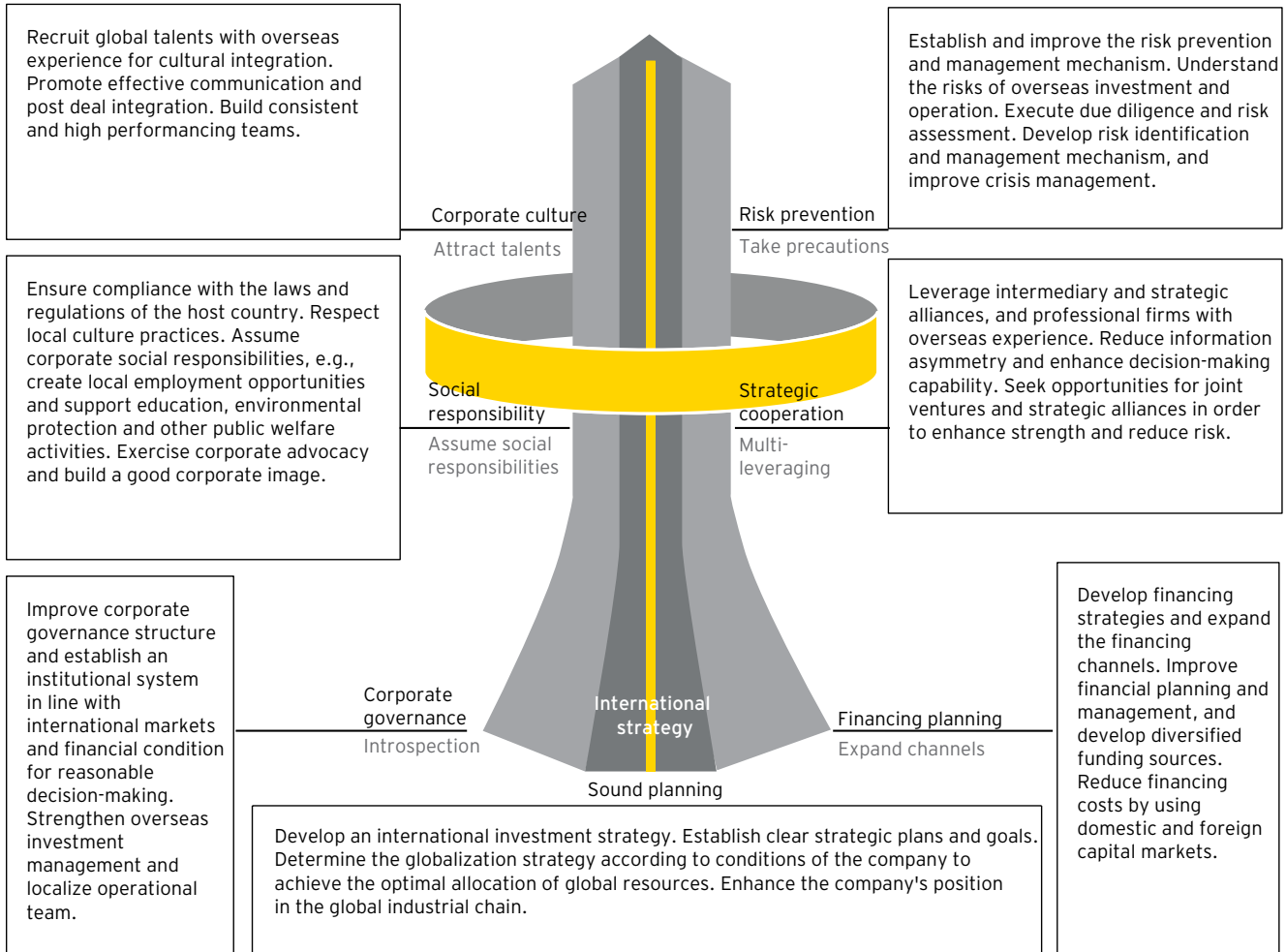
While the vast global market seems close at hand, Chinese companies must realize the difficulties of “going out”, namely increasing geopolitical risks, “neocolonialism”, turbulent global markets and fierce competition. Learning how to control and navigate through risk is vital for a successful overseas investment.

Chart 16: Overview of main risks faced by Chinese companies “going out”



“EY Overseas Investment Growth Navigator” helps Chinese companies mitigate risks and challenges on their outbound investment journey and become global market leaders.

EY Overseas Investment Growth Navigator



7

Looking forward - Silk Road expects a new wave of overseas investment

The accelerated economic transformation and increasing policy bonus are driving a new wave of overseas investment. We will see the following trends in China's outward FDI in the coming years.



A new wave of internationalization will be unveiled and China's outward FDI will reshape the global economic landscape.

- ▶ Over the next five years, China's outward FDI will grow more than 10%²¹ and continue to surpass the amount of foreign investment into China, and China will become a capital-exporting country.
- ▶ Chinese capital will continue to seek global investment opportunities and play an increasingly important role in the development of the global economic, financial and industrial landscape.



Structural transformation will dominate the shaping of the industrial landscape and Chinese investors will become increasingly involved in upstream industries.

- ▶ China's economic transformation will help drive investment into upstream services and industries, making Chinese investors move toward "Made for China" from "Made in China" to boost M&As in the high-tech and agri-business industries.
- ▶ This process will accompany a shift of industries with traditional advantages and overcapacity. With the release of the bonus from the "One Belt, One Road" policy, investment in infrastructure and advanced manufacturing industries is poised to take off.



The land and maritime Silk Roads are helping connection between Europe and Asia; Europe and America have become attractive destinations for Chinese investors.

- ▶ As the "One Belt, One Road" strategy has been put on the agenda, the spotlight will fall on investment cooperation between China and the neighboring countries on infrastructure construction.
- ▶ Chinese investment destinations are being diversified – from Asian, African and Latin American countries to developed economies in Europe and America – and are achieving optimal asset allocation across the globe.



POEs have emerged as the mainstay of investment and PPPs are achieving win-win outcomes.

- ▶ The rapid rise of overseas investment by POEs has enabled them to be the mainstay of China's outward FDI. Encouraged by favorable government policies, more Chinese POEs are embarking on a new investment journey.
- ▶ SOEs have advantages in the infrastructure and energy sectors, and POEs are adaptable and in favor of diversified investment. With the PPPs evolving and their complementary advantages in place, there is great potential for joint overseas investment by SOEs and POEs.

As Chinese capital continues to seek overseas investment, more leading Chinese companies will go global. However, besides the opportunities, there are significant risks as well. Chinese companies should not make a move without sufficient planning. Well-planned "going abroad" strategy, risk management and post merger integration are critical for Chinese companies to overcome obstacles, navigate the growth and expand their presence across the globe.

²¹ Source: "China will become a capital exporting country, while the quality of the investment need to be improved", *Ministry of Commerce*, <http://www.mofcom.gov.cn/article/i/dxfw/gzdd/201410/20141000773145.shtml>, 27 October 2014

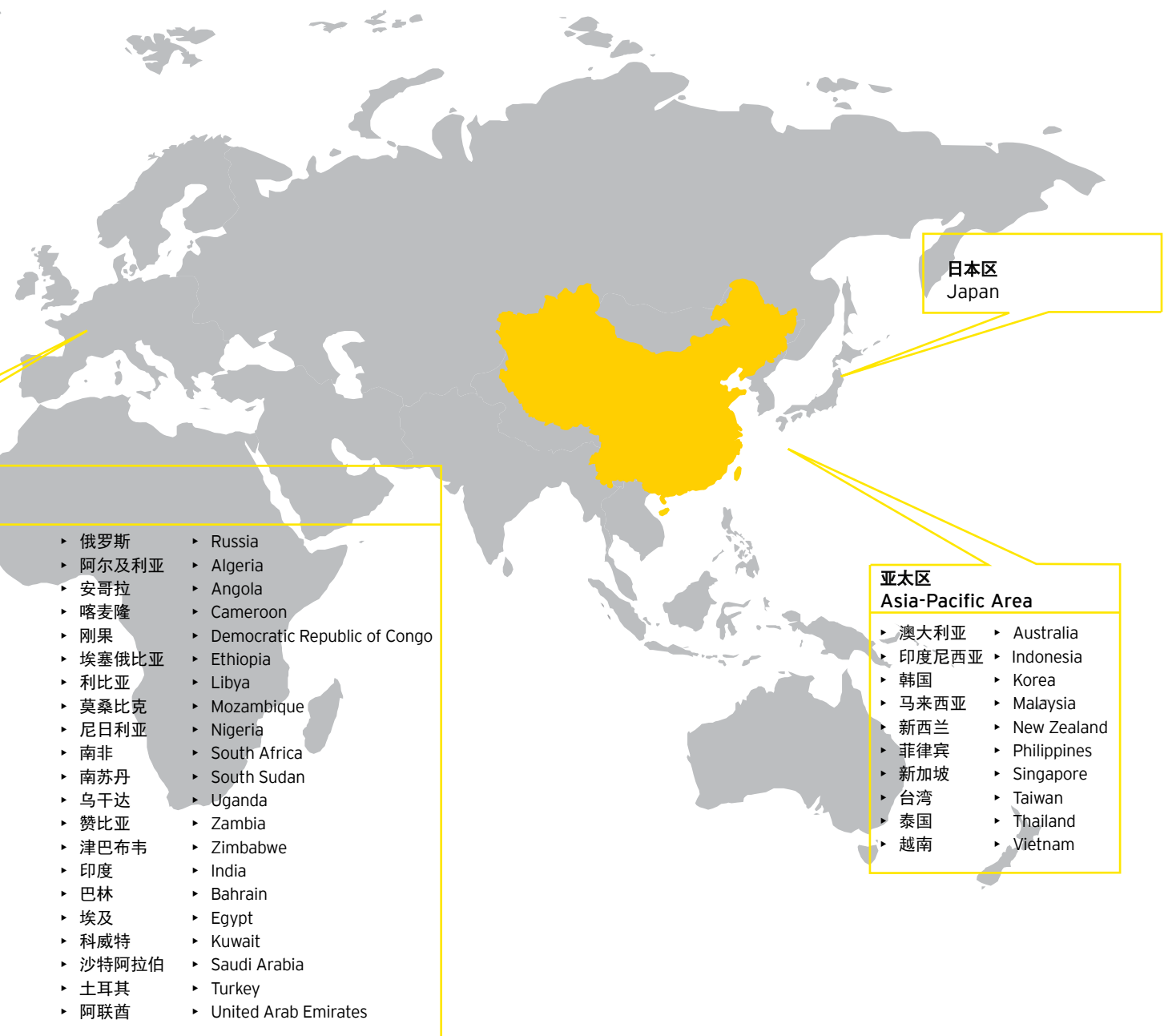


China Overseas Investment Network helps Chinese businesses navigate through global markets

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