



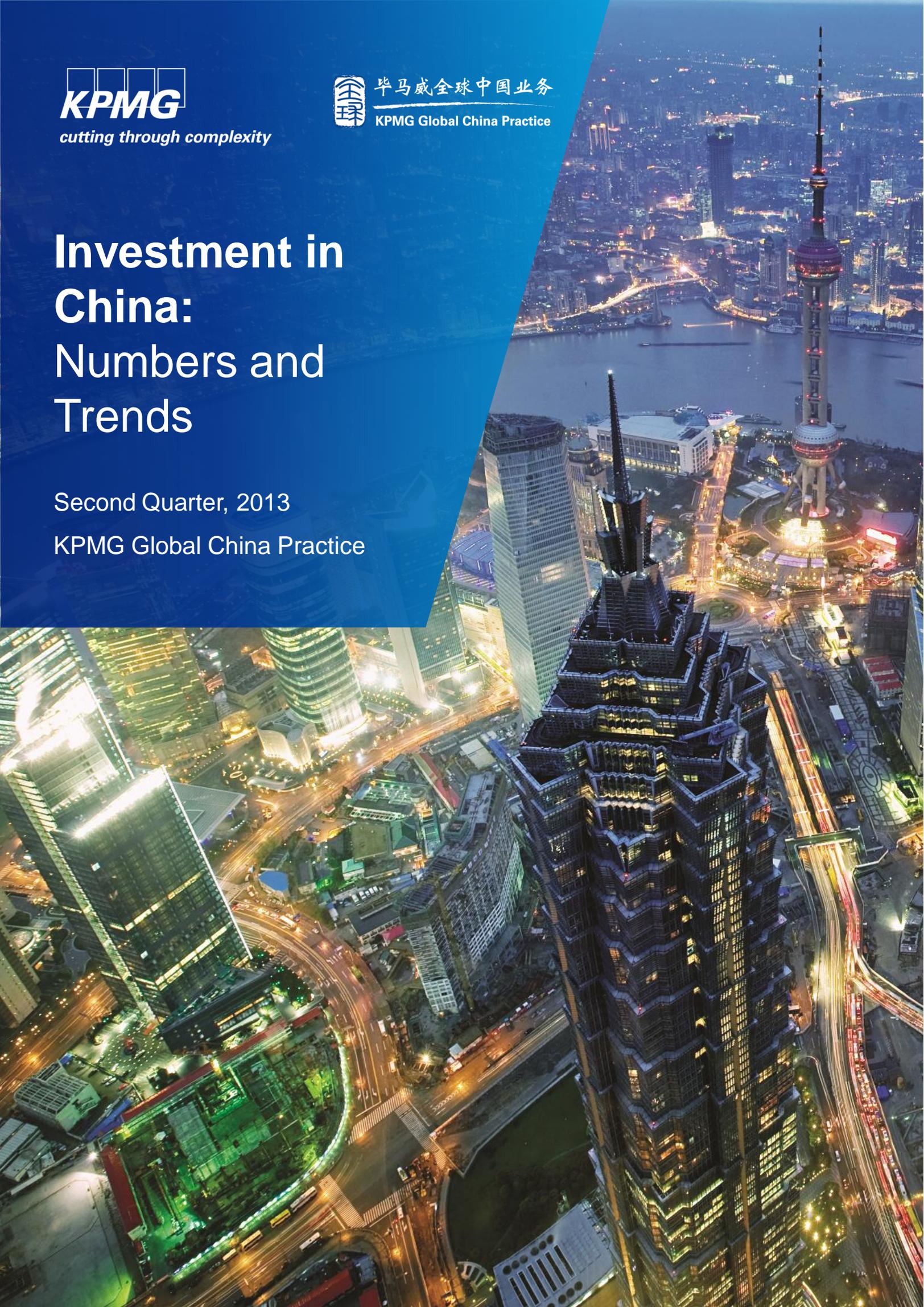
毕马威全球中国业务

KPMG Global China Practice

# Investment in China: Numbers and Trends

Second Quarter, 2013

KPMG Global China Practice



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# Executive Summary

In the second quarter of 2013, the Chinese economy continued to maintain its growth, but at a slower rate. China's second quarter GDP was 7.5 percent, in line with market expectations,<sup>1</sup> while the GDP growth rate for the first half of 2013 was 7.6 percent. Industrial output increased 9.3 percent year-on-year in the first half of 2013, while the growth of fixed-asset investment, a measure of government and private spending on infrastructure, grew by 20.1 percent through the first half of 2013. Other key takeaways from China's second quarter macroeconomic situation include:

- China faces diminishing marginal returns from past stimulus packages, higher rates of total social financing, as well as an increased exposure to credit risk.
- June consumption rose, as total retail sales of consumer goods increased 13.3 percent year-on-year, outpacing May and April by 0.4 and 0.5 percent respectively.
- China's manufacturing PMI and the HSBC PMI both declined, signifying a slight deterioration of the business environment.
- The M2 money supply grew by 14 percent in June, slightly slower than the 15.8 percent growth in May and 16.1 percent increase in April.
- Renminbi-denominated transactions continue to expand outside China's borders, as demand for the currency strengthens.

China's foreign direct investment (FDI) saw an increase of 4.9 percent year-on-year. FDI into China was USD60.98 billion in the first half of 2013, versus USD59.08 billion in the first half of 2012. Manufacturing sector FDI decreased by 2.14 percent year-on-year, while service sector FDI increased by 12.4 percent year-on-year. Since January 2013, FDI has now posted five consecutive months of growth. Other FDI highlights include:

- Service sector FDI growth was supported by substantial investments in consumer goods and services, high-technology, real estate and healthcare industries. Manufacturing industry FDI growth saw support from European countries directed towards automobile manufacturing.
- FDI from the European Union (EU) gained by 14.68 percent year-on-year through the first half of 2013, while FDI from the US increased by 12.29 percent year-on-year.
- In the month of June, FDI recorded a 20.12 percent year-on-year increase, the single largest monthly increase in the last two years.
- FDI investment into the western region of China grew by 32.54 percent year-on-year; the central region also posted significant growth of 15.75 percent, while the eastern region grew by 1.69 percent year-on-year.

Source : (1) 'China's Q2 GDP growth slows to 7.5%'. China.org.cn, July 15, 2013  
[http://china.org.cn/business/2013-07/15/content\\_29422005.htm](http://china.org.cn/business/2013-07/15/content_29422005.htm)

# Part I: Macroeconomic Analysis<sup>2</sup>

## China's short-term economic transition

China's GDP (economic output) grew by 7.5 percent in the second quarter of 2013, down 0.2 percent from the first quarter, averaging 7.6 percent economic growth through the first half of 2013. China's economic growth continues to move marginally lower in the short-term, however these results are not unexpected. In the [KPMG Quarterly Review of China's Economic Globalization: Q1 2013](#), our views on the Chinese economy stated: "there is increased downside risk to China's full-year economic growth", and "the key issue with the Chinese economy is not the slower growth in the short-term, but the potential growth slowdown over the long-term". This potential growth slowdown in the long-term may be foretold by examining what economic factors influence China's future GDP growth rate.

## The potential decline in the GDP growth rate

From a supply-side economic perspective, the future growth rate of China's GDP is determined by three factors: labor, capital, and total factor productivity (TFP).<sup>3</sup> These factors helped support China's rapid economic growth over the past 30 plus years. China has benefited from the growth of its working-age population (15 to 60 years old), as well as higher labor productivity, which was a product of China's ability to transfer a vast number of migrant workers from agriculture to manufacturing/industrial industry; China has also benefited from a production-centric growth model defined by large-scale capital accumulation, as well as an increase in TFP. Total factor productivity has increased in the last 30 years as a result of the ongoing transition from a government-controlled, State-owned economy, to a more market-driven economy. Although these three factors all contributed to China's historically high rates of growth, the economic and demographic landscape in China is changing and may soon experience growth rates that are consistently lower than previous periods.

Source: (2) Wind Database

Note: (3) Total factor productivity refers to the portion of the economic growth which cannot be accounted for by labor and capital, or in other words, the advancement of technology to create economic efficiencies.

The first factor that may affect future economic growth is China's labor situation. China's ongoing transition from a relatively young workforce to a more elderly population is affecting China's demographic dividend. The working-age population growth rate has shrunk from 2.5 percent in 1979, to less than 1 percent in 2011. According to the UN,<sup>4</sup> statistics show that in 2015, the number of workers in China will begin to flatten out, and by 2025 China's labor supply is forecasted to decrease. In addition, the proportion of the employed population in agriculture has fallen from 70 percent in 1978 to about 35 percent in 2011. Considering the industrial sector is already contributing to over half of China's GDP, far higher than most countries, the potential for further agricultural workforce migration is becoming more narrow, and labor productivity levels are also shrinking.

The second factor that may affect future economic growth is China's capital spending. Although some support the view that China still needs to undertake large-scale capital accumulation to increase output, the mainstream view is that China has over-extended itself with regards to capital investment. As of 2010, capital investment as a percentage of GDP reached 46 percent, far exceeding other developed or Asian economies. According to the history of other industrialized countries, once a country has become more affluent or has accumulated a substantial amount of capital, its return on capital investment will fall. One example of this trend is China's steel industry from 2000 to 2012. During this period, capital investment rates continued to increase year-on-year. From 2000 to 2005, the return on total assets (net income as a percentage of total assets) in China's ferrous metals smelting industry also steadily climbed, peaking at 7.8 percent in 2005. However, after 2005 the return on total assets began to fall, subsequently dropping to 1.2 percent in 2012. This shows that the net income of China's ferrous metals smelting industry incurred decreasing marginal returns on cumulative assets invested. Given a continued increase in capital investment over a long-term time horizon, return (net income) was not sustainable.

The third factor that may affect future economic growth is China's total factor productivity. China's TFP consists of two parts: the agriculture population migration and the reform dividend.<sup>5</sup> The agriculture population migration entails moving workers from the relatively low productive agricultural sector to the more efficient industrial and service sectors, while the reform dividend refers to the economic benefits achieved through progressive economic reforms since 1978. Benefits of the reform dividend include, but are not limited to: the rural household contract responsibility system, State-owned enterprise reform, establishment of the Deng Xiaoping market economy system, and China's ascension to the World Trade Organization. Studies on China's TFP over the past 30 years have yielded different conclusions, but basically hold the view that China's historically significant growth rates are unlikely to be sustained.

Sources: (4) United Nations, <http://data.un.org/Search.aspx?q=China%u2019s+working-age+population+from+1950-2050>  
(5) Dorrucci, Ettore, Gabor Pula and Daniel Santabárbara. 'China's Economic Growth and Rebalancing'. European Central Bank, February 2013. <http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp142.pdf>

### Diminishing effect of economic stimulus

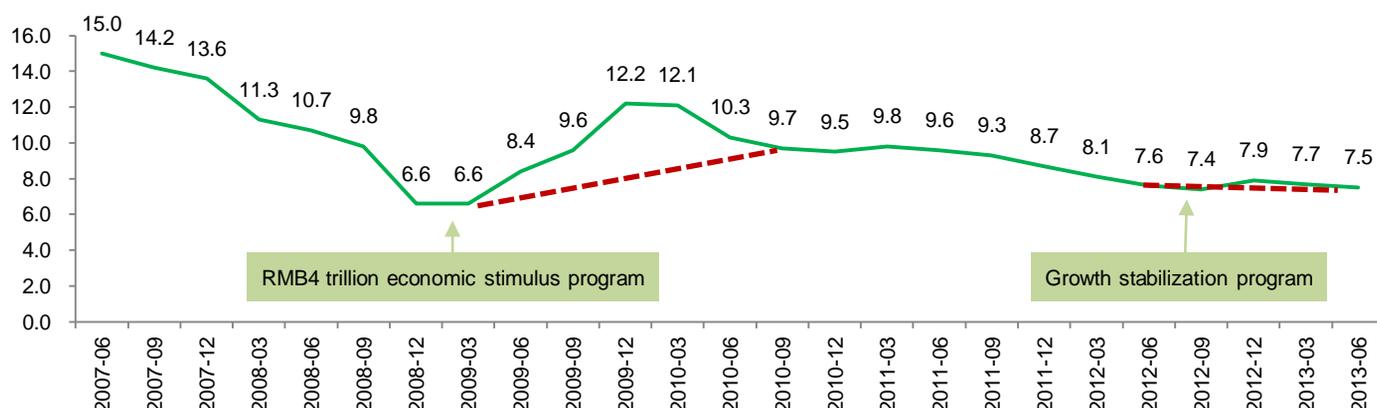
Over the past 18 years or so, China's GDP has continued to grow, reaching as high as 15 percent growth in the second quarter of 2007 (see Figure 1.1). Then, in 2008, the financial crisis affected the global economy. Due to the global slowdown, China's GDP growth fell sharply from its highs in 2007, to a low of 6.6 percent in the fourth quarter of 2008, which prompted the Chinese government to respond with its own RMB4 trillion stimulus package. The stimulus helped stabilize the Chinese economy, and China became one of the first countries to lead the global economic recovery. Most of the investments in the stimulus package were focused on the construction of major infrastructure facilities such as: railway, highway, light rail, airport, water conservancy projects, and urban power grid reconstruction.

Although China was able to temporarily stabilize its economy, its investment decisions may have exacerbated the imbalance amongst the aforementioned three drivers of the economy, as

the effect of the economic stimulus program contributed only to short-term economic growth. After the stimulus, China's downward economic growth trend returned, and GDP fell to 7.4 percent in the third quarter of 2012. This time, various local governments introduced programs to stabilize growth in the second half of 2012. As a result of another round of stimulus, China's GDP growth climbed to 7.9 percent in the fourth quarter of 2012, again temporarily reversing a downward trend. At that time, some analysts speculated that China's economy was in the midst of a recovery, but this 'recovery' lasted only one quarter as well, and China's GDP growth continued to descend to 7.7 percent in the first quarter of 2013, dipping further to 7.5 percent in the current quarter.

It seems the growth stabilization program has not significantly changed the fundamentals of the Chinese economy. Figure 1.1 depicts the growth trend of the Chinese economy from Q2 2007 to Q2 2013, and the impact of the investment-led economic stimulus has had on economic growth momentum.

Figure 1.1 China's quarterly GDP growth rate (%)



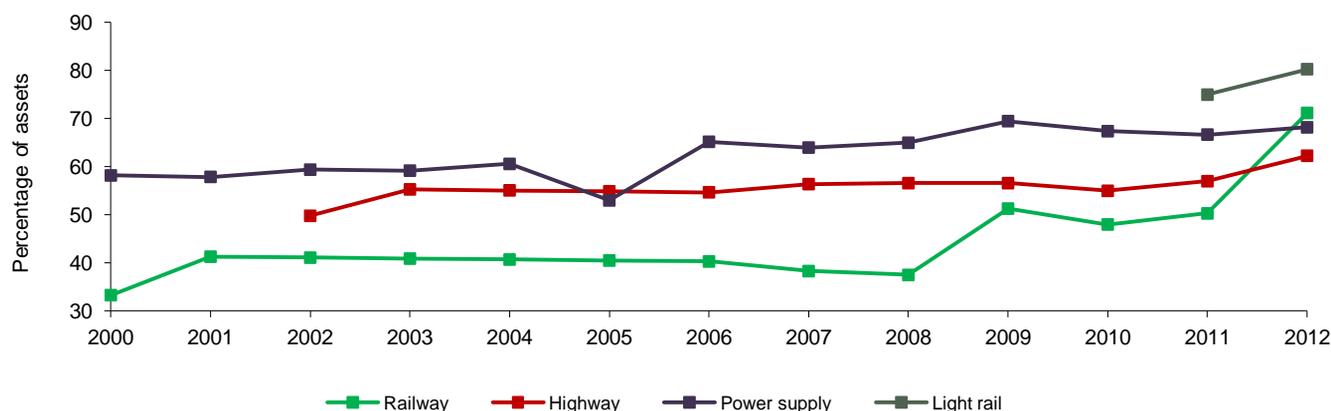
Sources: Wind Database; KPMG analysis

The graphical illustration shows that any temporary boost from an investment-led economic stimulus on economic growth gradually diminished over time. Figure 1.1, indicated by the red dotted line, illustrates the possible trajectory of the economy without the economic stimulus. Hence, the economic stimulus has not only inflated growth on a temporary basis, but also increased China's economic volatility.

### Rising credit risk

The post-financial crisis economic stimulus program invested primarily in infrastructure, using debt investments as the major source of funding (bank loans, trusts, etc). The debt ratio (displayed in Figure 1.2) is a financial ratio that indicates the percentage of a company's assets that are funded by debt. Figure 1.2's debt ratio shows the recent rise in the infrastructure sector's assets (railway, highway, light rail, and power) funded by debt.

Figure 1.2 Debt ratio of infrastructure sectors



The debt ratio of the power supply (electricity) sector climbed 10 percentage points over the past 13 years, while the debt ratio of the highway sector was up 12.5 percentage points. The light rail sector saw its debt ratio increase from 75 percent in 2011, to 80.3 percent in 2012, while the railway sector debt levels rose the fastest, from only 33.3 percent in 2000, to 71.2 percent in 2012. In addition, the proportion of interest-bearing liabilities in the infrastructure sub-sectors also slightly increased. Due to the limited cash flow generated by the infrastructure sectors, these sectors may find it increasingly difficult to repay debt upon maturity.

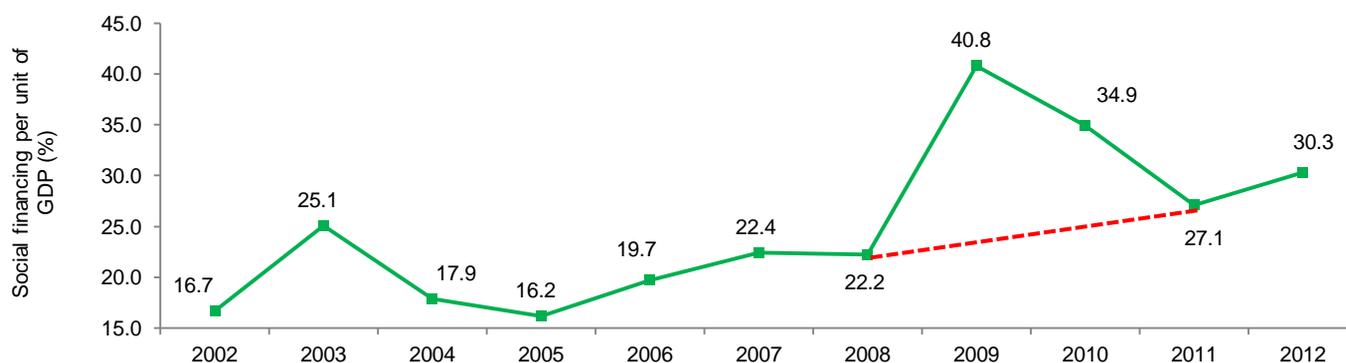
Similar conclusions can be drawn from analysis based on overall economic conditions. Accompanying the rapid growth in the Chinese economy was the rapid rise in the amount of money in circulation (M2 – the broad measure of money supply – grew by an average annual rate of 16.4 percent in China during 2001-2012), and the massive monetization of assets (listing State-owned enterprises on the stock market, and real estate becoming a widespread investment asset class). The general reason behind the rise in China's money supply is due to international trade. As China's international trade relationships have expanded, foreign currency has flowed into China's market. Local Chinese enterprises would then convert the foreign currency to local currency using commercial bank foreign exchange channels. The commercial banks turn to the central bank to facilitate a local currency exchange, swapping the foreign currency for Renminbi (RMB). To facilitate this supply-demand relationship, the central bank then prints Renminbi to purchase surplus inflows of foreign exchange. Once the newly printed Renminbi is received by the commercial banks, the banks will extend credit and provide other financing needs, supplying more liquidity to the market. Thus, the rapid money supply growth is also correlated with the demand for additional financing.

Figure 1.3 depicts 'new additional total social financing (TSF)'<sup>6</sup> required per unit of GDP, over the past 11 years. TSF mainly refers to: Renminbi loans, foreign currency loans, entrusted loans,<sup>7</sup> trust loans,<sup>8</sup> and enterprise bond financing and other forms of debt financing. Indirect financing makes up most of the TSF. In the past 11 years, with the exception of 2007, the proportion of equity financing in TSF has not exceeded 5 percent; in 2012, debt financing made up 98.4 percent of social financing.

It is evident from Figure 1.3 that the new additional TSF required per unit of economic output has been increasing gradually since 2005. In 2005, the new social financing needed per unit of GDP was 16 percent, which means that for every additional RMB of economic output, RMB0.16 of additional capital investment (equity or debt capital) must be initiated. This figure rose to almost 20 percent in 2006 and the trend continued until 2012, where new additional social financing required per unit of GDP reached RMB0.3 (or 30 percent of economic output). The figures for 2009 and 2010 deviated from the trend, but this deviation was attributable to the RMB4 trillion economic stimulus package in 2009. Without this stimulus, there would not be a significant shift in new additional social financing required per unit of GDP, as indicated by the red dotted line in Figure 1.3.

The higher social financing required per unit of economic output implies that the income generated per unit of capital invested is decreasing. This infers that a higher interest cost has to be paid per unit of income, signifying a decrease in capital efficiency. Decreasing capital efficiency means that some capital has been invested in projects that are unable to generate sufficient income. It is also possible that new credit has become renewable through 'evergreen' credits, whereby new debts are raised to repay interest expenses. Such evergreen loans were very common in Japan before its asset bubble burst, and in Indonesia prior to the Asian financial crisis.

**Figure 1.3 New total social financing required per unit of GDP**



Sources: Wind Database; KPMG analysis

- Notes:
- (6) The scale of social financing refers to the total amount of funds received by enterprises and individuals from the financial system in a specified period of time (e.g. per year), and it is an aggregate indicator which reflects the funding support provided by the financial to the real economy.
  - (7) Entrusted loans refer to loans where an entrusting party such as a government agency, corporate or business unit, or an individual provides the funds, and entrusts a commercial bank to disburse the loan, monitor the usage of the loan, and collect the loan in accordance with the loan conditions determined by the entrusting party.
  - (8) Trust loans refer to loans disbursed by trust institutions to projects and recipients of their own choice, using funds from the trust deposits and some of their own funds, and under the prerequisite of guaranteeing that the beneficiaries will receive the profits, hence these loans have the common characteristics of a bank loan.

Source: (9) Beck, Roland, Petr Jakubik and Anamaria Piloitu. 'Non-performing loans: What matters in addition to the economic cycle?' European Central Bank, February 2013. <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1515.pdf>

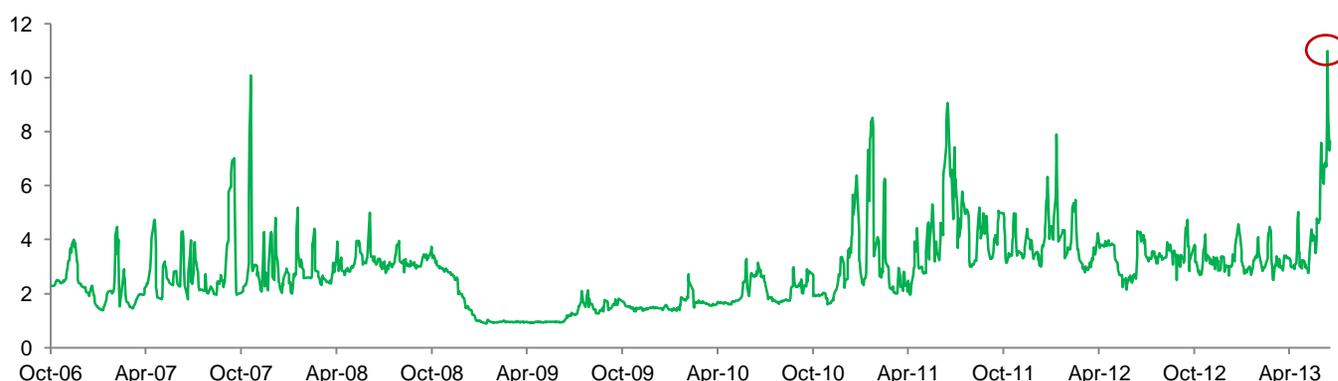
The direct consequence of lower capital efficiency is the deterioration of asset quality at banks. Empirical evidence has studied the relationship between macroeconomic conditions and asset quality, and the basic conclusion is that economic growth is positively correlated with asset quality. For example, the European Central Bank conducted a study in 2013 based on the data for 75 countries over the past 10 years and the results showed that, though economic growth could not account for all non-performing loans (NPL), economic growth indicators were the most important drivers.<sup>9</sup> In general, there is a several quarter time lag between a dip in economic growth and an increasing non-performing loan ratio. As China's economic growth continues to decelerate, NPL in the Chinese banking sector could sharply increase.

Credit risk is also rising from China's shadow banking industry. Shadow banking mainly refers to businesses providing alternative financing functions to meet consumer and business demand, outside of the conventional bank lending business. A large portion of the market cannot secure loans from traditional sources, thus a majority share of new debt origination is occurring in the shadow banking industry. According to estimates by various institutions, at the end of 2012, the size of China's shadow banking industry was between RMB23-28 trillion.<sup>10</sup> Some of the shadow banking risks include: lack of transparency, high leverage, and liquidity risk. For example, in wealth and trust management, 'fund sources' are mainly acquired using short-term capital (interbank lending); however 'fund uses' or assets that are invested generally have longer-term maturities. Thus, financial institutions may not be able to

raise sufficient cash to meet the maturity or duration requirements of the portfolio, resulting in portfolio liquidity and portfolio duration risk.

As China's economic growth continues to decelerate, the probability of a debt crisis may increase. The challenge confronting regulatory authorities in China lies in the supervision of the extensive credit expansion in the Chinese banking sector. The foremost task is to suppress the increase in new debts, or at least raise the quality of these debts. One of the measures adopted by the People's Bank of China (PBOC) is to manage the interbank offered rate.<sup>12</sup> On June 20, 2013, and in response to the PBOC's stance on liquidity management, the Shanghai Interbank Offered Rate hit a historical high of 11 percent (see Figure 1.4).

**Figure 1.4 Shanghai Interbank Offered Rate (SHIBOR): Weekly**



Sources: WindDatabase; KPMG analysis

According to data from Moody's, at the end of 2012, State-owned banks and medium-sized banks sourced 9 percent and 23 percent of their funding from the interbank market respectively.<sup>11</sup> Banks are able to borrow from the interbank market at a lower interest rate, and then lend the funds to other institutions at a higher rate. These funds will ultimately channel into various projects including local government financing vehicles. The June 20, 2013 event conveyed the PBOC's stance on liquidity management to the banks and constrained the rapid credit growth in the interbank market. The result of this stance will weaken the banks' ability to exploit interest rate arbitrage opportunities and restrict the flow of incremental debts into real estate and local government financing vehicles. Thus, the June volatility in the money market does not represent a 'new normal'. It served to convey the PBOC's stance on liquidity management to the markets, which was to improve capital allocation efficiency with the prerequisite of meeting the needs of the economy.

### A round of necessary adjustment

Under the principles of a market economy, factors of production (capital, labor, and land, etc.) will adjust according to market principles. When a particular enterprise/sector faces financial difficulty, the market will decide whether or not the company can continue operations. One of the bigger problems with the Chinese economy is that resources are misallocated over the long-term. In other words, allocation of resources to inefficient enterprises leads to low return/low efficiency ratios. In China, not only do a large number of poor-performing enterprises still exist, but they continue to survive and rely on capital injections and policy subsidies. Sometimes, industry-specific policies may affect the entire sector and lead to the emergence of a large number of poor-performing enterprises, or even inefficient sectors.

As such, China's economic growth has slowed over the past few years because the economic growth model has been negatively affected by the misuse or misallocation of resources. However, policies from the new Chinese government and regulatory authorities have also indicated that they are starting to resolve some structural issues that have plagued the Chinese economy. The government is also becoming more tolerant to a slower economic growth rate (readers may refer to earlier reports by the KPMG Global China Practice, including [How to interpret China's current slowdown](#) and [The 7.5 percent target - What's behind the change?](#)).

Sources: (10) BBVA; China International Capital Corporation; Gao Hua Securities; HSBC; Standard & Poor's

(11) QQ.com, June 24, 2013. <http://finance.qq.com/a/20130624/019608.htm>

Note: (12) Interbank offered rate refers to the interest rate used in the interbank borrowing and lending market.

## Q2 2013 economic data

Table 1.1 examines specific quarter-end and cumulative economic data, up to the end of June 2013. In terms of cumulative demand, January to June fixed asset investment grew by 20.1 percent, down 0.3 percentage point from January to May, while real estate investment growth also fell. Foreign trade slowed sharply; both exports and imports declined in June, dipping 3.1 percent and 0.1 percent respectively. In May, exports edged up only 1 percent year-on-year (significantly slower than 14.7 percent growth in April) and imports slid 0.3 percent (versus 16.8 percent growth in April).

Consumer spending trended in a positive direction: June total retail sales of consumer goods rose 13.3 percent year-on-year, outpacing 12.9 percent and 12.8 percent growth in May and April respectively. Other economic indicators were not as optimistic: China Manufacturing PMI (Purchasing Managers Index) fell from 50.8 in May, to 50.1 in June. Although higher than the watershed line of 50.0, the index still trails the March reading of 50.9 reflecting relative pessimism in the business community towards China's economic outlook. The HSBC Flash PMI, which is focused on manufacturing small- and medium-sized enterprises (SMEs), stood at 48.3 for June, down 0.9 from 49.2 in May. This was the lowest level since October 2012, signifying the constant deterioration of the business climate for SMEs.

June's Consumer Price Index (CPI) rose 2.7 percent. The material increase was mainly due to the relatively low base last year. CPI came in at 2.1 percent in May and April. The Producer Price Index (PPI) fell 2.7 percent in June, recording negative growth for 16 consecutive months and reflecting relatively soft domestic demand.

In terms of the monetary agenda, regulators are moving towards a less expansionary policy: M2 only grew by 14 percent in June, slower than the 15.8 percent growth in May and 16.1 percent increase in April. Total social financing also fell significantly by 41.6 percent in June, compared with the slight increase of 3.7 percent in May and 82.8 percent rise in April; the total volume has been down for three straight months. Despite regulators' effort to monitor and stabilize foreign capital inflows, as well as the progressive unwinding of quantitative easing by the Federal Reserve, Premier Li Keqiang has mentioned "revitalizing the existing stock of money" to convey a new policy signal.<sup>13</sup> This implies that the Chinese government thinks that relying solely on incremental money supply to stimulate demand will not be sustainable, and future monetary policies will need to place more emphasis on utilizing the existing money supply.

Based on current economic developments, and the policies of the Chinese government and regulatory authorities, China's economic growth may continue its downward trend in the third and fourth quarters of 2013. This includes a further slowdown of capital investment growth, combined with stable consumption growth and moderate growth in foreign demand. If defaults and restructuring arise in some of the wealth management products, financial institutions, enterprises or even local governments, it will be an opportunity for the market to clear out any enterprises that would otherwise fail in a normal or efficient market economy. This clearing may also

lead to more efficient allocation of resources in the future. In a research study conducted in 2008, Hsieh and Klenow of the National Bureau of Economy Research said that "if capital and labor are allocated to sectors that can generate higher output, the TFP of China's manufacturing sector could increase by 30-50 percent".<sup>14</sup>

Along with the upcoming economic transitions, the Chinese government is expected to promulgate a series of reform measures including, but not limited to: financial regime reform, which includes reforming the interest rate and exchange rate setting mechanisms; urbanization reform, which includes reforming the household registration system; reform on the local fiscal regime and land use policy; reform on administrative control, as well as income distribution policy and opening up to private investments. Depending on how the current structural economic issues are addressed and how new reform measures are unveiled, the Chinese economy may return to higher growth trends in the future. Currently, more economic transitions may be needed, as current structural headwinds will continue to prolong organic growth.

**Table 1.1 Economic data for Q2 2013**

Economic data (YoY, %)	Apr	May	Jun
I. Gross domestic product (GDP)	Second Quarter: 7.5		
II. Industrial value-added			
1) Industrial value-added of enterprises with annual operating revenue over RMB20 million	9.3	9.2	8.9
2) Power generation	6.2	4.1	6.0
III. Fixed asset investment (cumulative)	20.6	20.4	20.1
1) Real estate development (cumulative)	21.1	20.6	20.3
IV. Total retail sales of consumer goods	12.8	12.9	13.3
V. Total imports and exports	9.9	0.3	(2.0)
1) Exports	11.7	1.2	(3.1)
2) Imports	7.9	(0.6)	(0.7)
VI. Money supply			
1) Total social financing (RMB trillion)	1.8	1.2	1.0
2) M2 (broad measure of money supply) balance	16.1	15.8	14.0
VII. Consumer prices	2.4	2.1	2.7
1) Food	4.0	3.2	4.9
VIII. Producer price index	(2.6)	(2.9)	(2.7)
IX. Fiscal revenue and expenditure			
1) National public fiscal revenue	6.1	6.2	12.1
2) National public fiscal expenditure	18.0	12.0	3.0
X. Purchasing managers index (PMI)			
1) China manufacturing PMI	50.6	50.8	50.1
2) HSBC manufacturing PMI	50.4	49.2	48.3

Sources: Wind Database; National Bureau of Statistics of China; PBOC; Ministry of Commerce, People's Republic of China; State Administration of Foreign Exchange; General Administration of Customs of the People's Republic of China; Ministry of Finance of the People's Republic of China

Sources: (13) Zhang, Monan. 'Chinese reform goes local'. *Caijing*, August 7, 2013. <http://english.caijing.com.cn/2013-08-07/113142356.html>

(14) Hsieh, Chang-Tai and Peter J. Klenow. 'Misallocation and manufacturing TFP in China and India'. October 2008. [http://faculty.chicagobooth.edu/chang-tai.hsieh/research/MMTFP\\_Klenow\\_101108-1.pdf](http://faculty.chicagobooth.edu/chang-tai.hsieh/research/MMTFP_Klenow_101108-1.pdf)

## Analysis of China's currency: The Renminbi continues its rapid development and internationalization<sup>15</sup>

The Renminbi (RMB) is now the world's 13<sup>th</sup> largest payment currency. As of April 2013, 47 countries and regions have used the Renminbi to settle at least 10 percent of their total trade with China (including Hong Kong), up from 31 countries in July 2012. As the Renminbi becomes more international, banks and enterprises that have RMB-denominated business may stand to gain from greater business opportunities.

From October 2010 to June 2012, the institutional payment business helped spur Renminbi payment volume to grow by 17.4 times. In contrast, the total payment volume in all other currencies grew by only 1.1 times, reflecting the rapid growth in RMB-denominated payments and demand for the RMB. The only other currency that posted relatively large growth was the Russian Ruble, which grew by only 3.2 times over the same period. In December 2012, the RMB climbed three places in the payment currency ranking to surpass the Danish Krone, South African Rand and New Zealand Dollar. In February 2013, Renminbi payments rose 24 percent for the month, while payments in the Russian Ruble fell 5.4 percent, allowing the RMB to officially overtake the Ruble and move up one place, to take 13<sup>th</sup> place in the 'world's payment currency' ranking.

In addition to its rise in payment volume, the Renminbi is now the world's third largest currency for letters of credit (LOC) issuance, trailing only the US Dollar and the Euro. As of May 2012, the Renminbi accounted for 4 percent of the LOC issuance currency market, behind only the US Dollar (84.4 percent) and the Euro (7.0 percent), but has overtaken the Japanese Yen (1.9 percent). The Asia-Pacific region represents the most concentrated RMB-denominated LOC market. In terms of transaction value, over 50 percent of the LOCs are issued by onshore Chinese banks to Hong Kong, and almost 20 percent of the LOCs are issued from China to Singapore.

### Offshore Renminbi continues to develop, as demand continues to expand

Hong Kong remains the largest offshore Renminbi center in the world, processing 70 percent of Renminbi payments, while London is the second largest offshore Renminbi center.<sup>16</sup> The primary reason for London's prominence may be the agreement in 2011 between the British Chancellor of the Exchequer George Osborne and the then Vice-Premier of the State Council Wang Qishan to 'develop an offshore Renminbi market in London'.<sup>17</sup> In January 2012, Osborne visited Hong Kong and met with the Chief Executive of the Hong Kong Monetary Authority Norman Chan, leading to an agreement to further strengthen the cooperation between London and Hong Kong in the offshore Renminbi market. On June 22, 2013, the People's Bank of China (PBOC) signed a RMB200 billion/GBP20 billion bilateral local currency swap agreement with the Bank of England, which was China's first currency swap agreement with a member of the G7. To date, RMB deposits in London have reached tens of billions of Renminbi (RMB).

Singapore is another major offshore RMB center. According to data from January 2013, the value of Renminbi payments was up 123 percent year-on-year and 33 percent month-on-month. The Industrial & Commercial Bank of China (ICBC) was selected to be the Renminbi clearing bank in Singapore in February 2013, and the Renminbi clearing business officially started on May 27, 2013.<sup>18</sup> Succeeding Hong Kong and Taiwan, Singapore is one of the first overseas Renminbi clearing centers set up by the PBOC.

Taiwan is another offshore Renminbi center. The usage of Renminbi in Taiwan has increased significantly since July 2011. In August 2012, the PBOC signed a currency clearing memorandum with the Central Bank of Taiwan, whereby a Renminbi clearing bank would be appointed to handle the business in Taiwan. In February 2013, Bank of China's Taipei Branch was appointed the local Renminbi clearing bank. Meanwhile, the Taiwan Stock Exchange also expressed an interest to issue offshore Renminbi products, and these positive development factors are driving further growth in Renminbi payments. In July 2011, Taiwan was ranked 57<sup>th</sup> globally in terms of the value of Renminbi payments, but has since risen to seventh in August 2012, and broken into the top five in March 2013. Given the historical links between mainland China and Taiwan, and the steadily increasing direct economic activities across the straits, the rapid and widespread acceptance of Renminbi in Taiwan should continue to be expected.

Among the Euro zone countries from March 2012 to April 2013, France has been the leader for using Renminbi payments, and the value of Renminbi payments has shot up by 2.5 times. In terms of Renminbi payment value, France trails only Hong Kong, the UK, Singapore and Taiwan in the global ranking. In March 2013, 21.4 percent of payments between France and China/Hong Kong were denominated in Renminbi, compared with only 6.5 percent in the previous year. This may be a sign that France has stepped up the pace of Renminbi payments following the three-year currency swap agreement between the Bank of England and China in March 2013, and that it intends to compete with the UK to be an offshore Renminbi center. Australia, Italy and Russia are also making great strides towards the development of an offshore RMB market, and are rapidly increasing the use of the Renminbi.

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## Part II: Industry Analysis, Foreign Direct Investment into China<sup>19</sup>



### Tourism and hotels

#### International hotels may face short-term oversupply in China

International hotel groups operate more than 1,000 hotels in China, and have experienced double-digit profit growth for several years. Because of this growth, leading global hotel groups continue to expand their presence in China to capture the increasing travel traffic in the country and build brand recognition amongst the local Chinese business people and government officials. Their current expansion strategy focuses on entering various third- and fourth-tier cities, bringing high-end upscale brands into the smaller, but growth-oriented regions of China.

However, with an increasing number of international hotels opening in China, the industry may be over-extending itself. Statistical sources claim that a hotel should hold occupancy rates greater than 70 percent to maintain consistent profits, yet the average occupancy at international hotels in China is just above 50 percent. This is because current demand for international hotels is slack in China:

China's top percentage of wealthy individuals have been favoring foreign travel versus domestic, and government spending at luxury hotels has also been less active since new leadership positions have been installed in March. This has translated to far less business revenue at the five-star international hotels, particularly in smaller cities where five-star hotels are normally preferred as event venues for the local government.

In the short- and medium-term, international high-end hotel groups may face challenges in China. However, as third- and fourth-tier cities develop and local governments continue to add special economic and technology zones, these smaller cities should continue to generate robust international business interest and foreign direct investment flows. Going forward, one could reasonably assume that the international hotels will continue to strengthen brand name and quality recognition, despite the recent tightening of market demand.

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## Machinery and industrial equipment

### Global machine tool manufacturers enhancing presence in China; seeking market share advantages

China has not only been the largest market and production site for machine tools in the world, but also stands to upgrade key manufacturing sectors in China to stay in front of the technological trends. The key sectors for machine tools that stand to benefit from increased demand include: aerospace, automotive, railway construction, energy, electronics, and defense. Chinese domestic manufacturers have strengthened technology bases through acquisitions, joint ventures and partnerships with global machine tool leaders. However, in the upper price segment they still lack the capability to produce reliable and accurate high-precision machines, which may represent big opportunities for global manufacturers.

In April, Japanese manufacturer Mitsubishi Heavy Industries (MHI) announced that it has expanded local production at its machine tool plant in Jiangsu Province to enhance their ability to accommodate the more diverse machinery needs of local customers. German-based EMAG Group's first Chinese production facility is also being built in Jiangsu and will be completed by the end of this year, which will give EMAG a stronger edge in China. International companies offer efficient integration, higher speed, more intelligence, greater accuracy and more environmentally-friendly features, which has created a steep competitive advantage for them in China's market.

However, competition from local Chinese manufacturers is on the rise, as they become more familiar with the aspects of quality and consumer demand. Thus, to sustain a long-term edge in this market, international manufacturers should do more to become more localized; they could partner with Chinese local companies to obtain deeper penetration into the local market. In addition, they could expand production facilities, re-design or tailor products to meet demands from local customers, and improve after-sales services in local market by setting up technology centers to provide first-hand technical support to local customers.

## Natural resources

### China Guanghui Energy joins with Shell, seeking to restructure China's energy industry

On May 31, 2013, Guanghui Energy announced that the company's holding subsidiary, Qidong, intends to sign a 'letter of intent' joint venture with the Royal Dutch Shell (Shell) for a LNG (liquefied natural gas) distribution and a transshipment station project in Qidong. LNG is a process that involves transporting natural gas to other areas where it is re-gasified and distributed as pipeline natural gas. The construction is planned to start during the second half of 2013.

In addition to its global leadership position in energy, Shell is one of China's largest LNG suppliers. This partnership seeks to jointly raise China's proportion of clean, low-carbon fossil energy, promote the efficient and clean utilization of coal, develop substitute energy resources, and speed up the optimization of energy production. The importance of this joint venture between Guanghui Energy and Shell points to the fact that Guanghui Energy will not only be at the forefront of the world's largest LNG market, but they will also be seeking out new, innovative and technologically efficient ways to provide energy to Chinese consumers. The world's two largest natural gas producing countries – the US and Russia – are gradually loosening restrictions for LNG export, while Asian countries, namely China and India, represent the main consumer markets.

Most industry experts point to 2015 as a key transitional year for LNG, as they project China will become the world's second largest natural gas consuming country. Therefore it is reasonable to suggest that energy deals, specific to clean energy and low-carbon emissions, will experience greater activity in the future as China shifts from standard energy to more efficient methods of environmentally-friendly energy production. Partnering with Chinese companies to expand China's energy industry could provide first-mover advantages for Shell, or other multinationals looking to tap into a developing market.

## Financial services

### AXA Group of France invests in Tianping Insurance Company

According to reports, AXA Group of France reached an agreement with China's Tianping Auto Insurance Co., Ltd. (Tianping Insurance), stating AXA will acquire 50 percent of the shares of Tianping Insurance. According to the terms of the agreement, the deal considerations stipulate that RMB2 billion (EUR270 million) will be injected into Tianping Insurance, and AXA will acquire 24 percent of the shares from existing shareholders of Tianping Insurance.

AXA Group is headquartered in Paris, France, and is a global investment management and insurance group. Its business regions include: West Europe, North America, Asia-Pacific, and the Middle East. According to the latest annual financial report, its total revenue in 2012 was EUR90.1 billion, and the net profit was EUR4.15 billion. Tianping Insurance was established in December 2004, and it was the first specialized auto insurance company to enter China. The company is headquartered in Pudong, Shanghai, with a registered capital of RMB630 million. It mainly operates businesses such as compulsory insurance for motor vehicle traffic accident liabilities, and commercial insurance for motor vehicles.

In April 2012, China's regulatory department allowed foreign insurance companies to enter the compulsory insurance business for motor vehicle traffic accident liabilities. AXA hopes that after becoming a shareholder of Tianping Insurance, it will have a deeper reach into Chinese markets, specifically the Chinese commercial auto insurance market. This acquisition could provide unique domestic direct sales channels for AXA Group in the rapidly developing Chinese property insurance market, and may strengthen its brand and business capabilities relating to the global property insurance business in an otherwise weak market for international insurance companies.

## Private equity (PE)

### Foreign private equity companies show interest in Qianhai Cooperation Zone

As a new financial zone in China, Qianhai has gathered attention relatively quickly from global investors. This is primarily due to the convenience Qianhai provides, in terms of taxation, as well as domestic and overseas investing and financing. To date, two international PEs have successfully registered in the zone, while many other global PEs have shown their interest in doing so.

Since its establishment, the major functions of Qianhai include creating a Renminbi (RMB) return channel, and serving as a pilot zone to innovate policies and service models related to RMB business. Thanks to its unique location, the zone helps Hong Kong grow as an offshore financial center for RMB, which in turn enables foreign PEs that have registered in Qianhai and raised money overseas to invest in domestic equities. Although many foreign PEs are interested in registering in Qianhai, only few have actually moved into the zone. One important reason is that the zone is still in the process of planning and construction, with many infrastructures to be completed. In addition, Qianhai encourages foreign PEs to register in the zone; however there is no detailed regulation and rules announced to guide the actual implementation.

With the development of the infrastructure and detailed rules for taxation, registration approval, and cross-border investment, Qianhai will become an increasingly important channel for foreign PEs to collect RMB overseas and invest domestically. An equity trading center will also be established in Qianhai for foreign PEs to facilitate secondary equity transfers. As the RMB continues its ongoing processes of liberalization, and the government continues to promote and support Qianhai as a cooperation zone, more and more foreign investment should flow into the region.

## Consumer goods

### Danone and Mengniu agreed on a joint venture

French food group Danone announced an agreement with Mengniu and its major shareholder COFCO to establish joint ventures, whereby Danone will invest approximately EUR325 million (RMB2.6 billion). The two parties aim to combine their respective businesses in China, to create a market leader in the country's yogurt industry. Danone will own 20 percent of the joint venture.

Although Danone is one of the largest yogurt producers in the world, it has made relatively less progress in its China yogurt business model. In China, Danone lacks both a network and a salesforce; in addition, Danone's sales figures have continued to be unimpressive in China. Thus, gaining access to China's market resources was a major reason that triggered the deal. Upon completion of the deal, Danone will be able to leverage Mengniu's assets, to become a leading firm in China's dairy market with a well-developed national distribution network. Alternatively, Mengniu hopes to leverage Danone's strengths in processing technology, management rationale, brand influence, and international processes. They also hope to leverage Danone's reputation for safety and lessen the amount of food incidents in China.

As dairy giants, both Danone and Mengniu want to pursue the interests that best serve their respective management agendas, thus cooperation may be met with ongoing challenges. In 2006, Danone and Mengniu had planned to work together to expand their business in China's yogurt market. The cooperation did not last long, and the two parties encountered internal communication and coordination issues. This time, contingency plans should be in place to manage proper integration and coordination if both companies want to reap the economies of scale from an M&A transaction of this magnitude.

## Solar power

### Solaria expands into China's PV market

In May, the US photovoltaic (PV) maker Solaria Corporation announced its plan to establish an operation center and a

large-scale manufacturing base in China to meet the country's increasing demand. Solaria is currently involved in several solar projects in China, including the megawatt-size power plants located in Qinghai Province and Inner Mongolia.

As the economy rapidly develops, both energy demand and carbon emission in China have increased. With the strong national policy support, PV power has great potential. Solaria's move reflects these policy initiatives from the Chinese government towards PV industry development, and to increase the supply and demand for solar energy in China. PV power is convenient and flexible, which can be installed in a large scale plant or perhaps on building roofs or walls. Yet, compared with hydro power and wind power, PV power occupies only a small part of the nation's entire installed capacity, and is not as developed as hydro and wind power supplies.

Solaria's march into China will help improve the country's PV industry. Solaria owns many exclusively patented techniques, with extensive experience in large PV projects. The company is the solar power industry leader and does not compete on price, or engage in price wars. This may require Chinese enterprises to improve their business model, put more efforts in their R&D, and raise the technological level of their products, which in turn will contribute to the transformation and advancement of the domestic PV industry.

## Manufacturing

### Central and western China now preferential for inbound automobile manufacturers

China's government recently stated it encourages foreign investment in vehicle manufacturing in the western and central regions of China, reversing a prior policy to remove automobile manufacturing from a list of industries qualifying for government incentives. Starting on June 10, 2013, foreign auto investment will be given preferential treatment according to the National Development and Reform Commission and Ministry of Commerce. The policy was among measures taken to encourage labor-intensive projects in the central and western regions, which attracted USD19.2 billion in overseas investment in 2012.

Central and western provinces in China can provide favorable advantages for foreign auto producers. Chengdu, for example, is the capital city of the Sichuan province in southwest China. Chengdu's production of vehicles surged in 2012 to 375,000 units, from 800 farm vehicles just 10 years prior. Chengdu is part of China's 'Go West' strategy that is offering various incentives and support for foreign invested capital in the western areas of China. In addition, western China also offers a favorable investment environment, sound infrastructure, efficient services, lower cost in terms of labor wages and plant and property leases and rent, as well as easier logistic capabilities.

General Motors (GM) is aiming to increase its market share in China by expanding its luxury vehicle segment through local production of its high-end Cadillac and SUV automobiles. In fact, many of the foreign auto producers will be focusing more on the luxury brands of their automobile line, which may not interfere with local, low-cost automobile producers. The change in policy direction is meant to give a boost towards foreign investment and economic growth. However, preferential treatment to foreign automakers for building plants could allow companies like Volkswagen, Toyota, and General Motors to accelerate expansion in China, which may cause an increase in excess capacity and make it more difficult for local automakers to compete with foreign companies.

# Part III: Overview of Foreign Capital Utilization<sup>20</sup>

## A general overview of China's utilization of foreign capital

Through the first half of 2013, total foreign direct investment (FDI) into China was USD61.98 billion, up 4.9 percent year-on-year. FDI also increased 7.3 percent from the first quarter of 2013. The service sector attracted the majority share of FDI, at 49 percent totaling USD30.37 billion, increasing by 12.4 percent year-on-year. The manufacturing sector attracted USD26.44 billion, or 42 percent of the total, down 2.14 percent from a year earlier. The government has continued to express hitting its FDI goal of USD120 billion in the next three years. Shen Danyang, the Ministry of Commerce spokesperson said that "The aggregate FDI increase through the first six months has verified the ongoing competitiveness of the Chinese economy and also lends proof that international investors continue to recognize the benefits of the investment environment in China. We expect the FDI in the second half to continue its steady growth". In comparison, China's outbound direct investment (ODI) totaled USD45.6 billion, an increase of 29 percent year-on-year. Although total ODI was still less than total FDI, ODI growth continued to outpace FDI.

The eastern region of China once again reigned as the largest regional recipient of FDI, totaling USD25.05 billion, accounting for 83.7 percent of the national total, but only growing by 1.69 percent year-on-year. The central region utilized USD2.5 billion of foreign capital, representing 15.75 percent year-on-year growth, while accounting for 8.4 percent of the national total. The western region of China continued to maintain the most impressive growth, extending its streak through the first half of the year. This region received USD2.36 billion, accounting for 7.9 percent of the national total, growing by 32.54 percent year-on-year. The relatively larger FDI growth rates in the central and western parts of China lend proof that the FDI migration towards the more inner areas of China is creating economic diversity within the regions, which also supports the government objectives to develop the third- and fourth-tier inland cities of China. The western region of China covers six provinces: Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan; one municipality: Chongqing; and three autonomous regions: Ningxia, Tibet, and Xinjiang, according to the definition given by the Chinese government.

## Regional FDI and M&A summary

Breaking down FDI by the three largest global source regions shows a modest increase in year-on-year activity, with continued positive signs from the European Union (EU). The European Union's FDI to China jumped 14.68 percent in the first half of the year to USD4.04 billion, which bucks the trend from the end of 2012. In the fourth quarter of 2012, EU FDI was slack, as lingering sovereign debt issues may have handicapped regional willingness and ability to outwardly invest. Through the first and second quarters of 2013, EU FDI investment seemed to be flowing back into China, and was targeting diverse investments within China's service and manufacturing industries including: industrial manufacturing, financials, and consumer goods/services industry. FDI from the US also rose 12.29 percent in the first half of 2013, while FDI from the top 10 Asian economies, including Hong Kong, Japan, and Singapore increased by 5.3 percent year-on-year through the first six months.

Merger and acquisition (M&A) activity is a significant contributor to FDI, representing slightly over 25 percent of total FDI into China. Aggregate mergers and acquisitions activity through the first half of the year is summarized as follows: there were a total of 233 announced or completed transactions totaling slightly over USD15.5 billion of M&A investment activity. Twenty-seven countries and regions invested in China year-to-date, while a substantial majority of total M&A investments came from Hong Kong (107 total deals worth over USD6.4 billion). The US had the largest average deal size (excluding countries with less than 10 deals), totaling 14 deals worth nearly USD2 billion. Deals originating from Hong Kong were primarily targeting China's real estate industry as well as consumer goods and services industry, while deals from the US were primarily targeting the healthcare/biotech and high-technology industries.

Sources: (20) Thomson One; MergerMarket; Ministry of Commerce, People's Republic of China

The two sectors that received the largest M&A deal flow through the first half of the year were real estate and industrials, with industrials generating a larger number of total transactions than real estate. Amongst the top 10 largest M&A deals, two of the deals were struck in China's real estate sector, while three deals targeted industrials. Another noticeable trend was the total number of deals in the consumer goods/services and materials industries. Both of these industries generated 35 deals or more through the first six months of 2013. M&A transaction size was also quite variable; M&A transactions were grouped according to the following structure: USD500 to 999 million, USD100 to 499 million, USD10 to 99 million, and USD1 to 10 million. Through two

quarters, most individual M&A transactions were in the purchase range of USD10 to 99 million. This evidence suggests that, although there were a few mergers of significant size (six transactions between USD500 and 999 million), the majority of target M&A transactions were smaller or mid-sized companies. Greater economic value may be realized in mergers of smaller size; these types of mergers can create accounting benefits as well as intrinsically-linked, synergistic benefits between the buyer and the target. Smaller acquisition targets seem to be favorable in China, as the integration of personnel and business strategy would be less complex in these deals than on a merger of much larger scale and size.



## 2013 YTD FDI trend analysis

### FDI during the first half of 2013 is trending higher; consistent monthly growth points to possible record breaking numbers in 2013

Going back to January 31, 2013, foreign direct investment into China had declined every month since May 2012, as well as 14 out of the last 15 months. Total FDI for 2012 was down 4 percent from its all time highs in 2011 and the trend looked as if it was going to continue into 2013. However, February and March FDI re-emerged and grew by 6.3 percent and 5.7 percent year-on-year respectively, signaling a possible reversal from the previous trend. Fast-forward to the end of June and FDI has now posted five successive months of positive growth, establishing a new inbound investment trend. This FDI trend analysis examines the possible bullish indicators that have recently emerged, and sets out to explain any possible trends going into the second half of the year.

Total FDI for the first half of the year posted a robust USD61.98 billion, growing by 4.58 percent year-on-year. As pointed out in previous trend summaries, a structural shift continues to develop, whereby greater investment and government focus is being given to China's service industry. Through two quarters, China's service industry continued to post impressive FDI numbers, receiving 30.6 billion in FDI, gaining 12.43 percent versus YTD 2012 FDI. The service industry allocation continued to increase as a percentage of total FDI, to 49 percent, versus 46 percent of total FDI in 1H 2012, and 48 percent in Q1 2013. Within the service industry, a myriad of sectors are posting significant FDI investment growth from diverse countries and regions. The US, for example, continues to pump more investment into China's healthcare, biotech, and high-technology service sectors. The EU has also re-emerged as a strong contributor of foreign direct investment into China, investing into China's financial services, retail, and food and beverage service sectors, while Hong Kong and Singapore continue to show interest in China's real estate (services) sector.

The other significant industry component of FDI is China's manufacturing/industrial industry. And while China's service economy continues to receive burgeoning interest from abroad, China's manufacturing industry slipped a bit in the first half of 2013. Manufacturing inflows for the first half totaled USD26.4 billion, decreasing 2.14 percent from a year ago. The manufacturing industry's market share also declined to 42 percent in the first half, from 45 percent in 1H 2012, and 44 percent in the first quarter of 2013. Despite the small decline, large investments and international interest can still be identified. The EU, for example, is still very much committed to investing in China's manufacturing industry, committing large amounts of FDI into China's auto industrial manufacturing industry throughout the first half of the year.

It would also be useful to examine first half trends by looking at individual monthly results. In the second quarter of 2013, April and May experienced relatively flat periods of FDI growth, increasing by 0.5 percent and 0.29 percent respectively. However, June saw an incredibly strong push in FDI, increasing by 20.12 percent versus June 2012. This was China's largest single month FDI increase in over two years. Despite the relatively flat numbers in April and May, China has now posted five consecutive months of FDI growth, and is up 12.43 percent in the first six months of 2012. Although one month of solid growth alone is not enough data to conclude that China's FDI has rebounded, one can speculate that FDI inflows, combined with a healthier global economy, will continue in the second half of the year (notwithstanding systemic instabilities or significant negative global events).

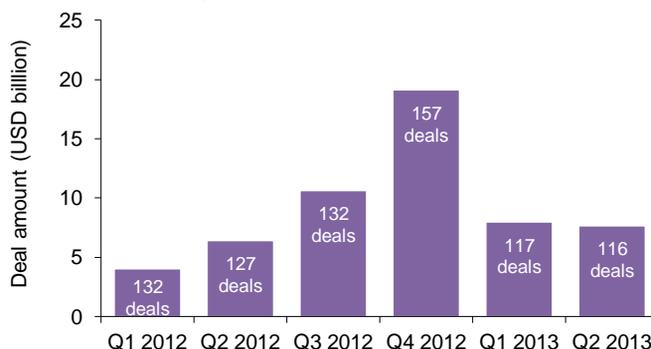
FDI is not only a measure of foreign investors attraction to China, it is also a measure of the global market's ability to invest in operations outside of their own local markets. As the global market continues to progress economically, one could reasonably expect that FDI investments will continue to flow into various industries in China. In the first quarter of 2013, FDI into China ended its 15-month streak of either flat or negative growth, with two months of substantial growth. This quarter, FDI continues along its positive trend. Thus, as the global market continues to grow, and China's service industry continues to develop, one may expect China's FDI to continue to grow at a measured pace. If the second half of the year maintains equivalent or greater growth than the first half of the year, China will hit its goal of attracting USD120 billion, and yet again break its record of FDI set at USD116 billion in 2011.

### M&A deals overview

Year-to-date overview: There were a total of 233 'announced' or 'completed' inbound M&A deals through 1H 2013, versus 260 deals in 1H 2012. Total FDI M&A deal flow into China for the first half of the year was USD15.57 billion. This compares favorably to USD10.38 billion received through the first half of 2012. Although the total number of deals was down year-on-year, the total investment amount of inbound M&A deals increased by approximately 50 percent year-on-year. There were 220 announced or completed outbound direct investment deals through the first half of 2013, versus 117 through the first half of 2012. In addition, outbound M&A deal values also greatly expanded, totaling USD37.15 billion in the first half of 2013, versus USD21.65 billion in the first half of 2012, for an increase of approximately 72 percent year-on-year.

Quarterly overview: There were a total of 116 deals in the second quarter of 2013, versus 127 deals in the second quarter of 2012. Despite the number of deals decreasing year-on-year, the actual deal amount increased. In the second quarter of 2013, total M&A deal activity was USD7.6 billion. This was a 19 percent increase versus the second quarter of 2012 (USD6.39 billion). Adjusting for extraordinary deals,<sup>21</sup> the last six quarters produced a deal average of approximately USD7.9 billion. M&A deal flow for the first and second quarter was USD7.97 and USD7.6 billion respectively, hovering very close the six quarter average. If past is any indicator of future deal flow, then deal flow would be expected to increase in the second half of the year.

Figure 3.1 Quarterly deal summary

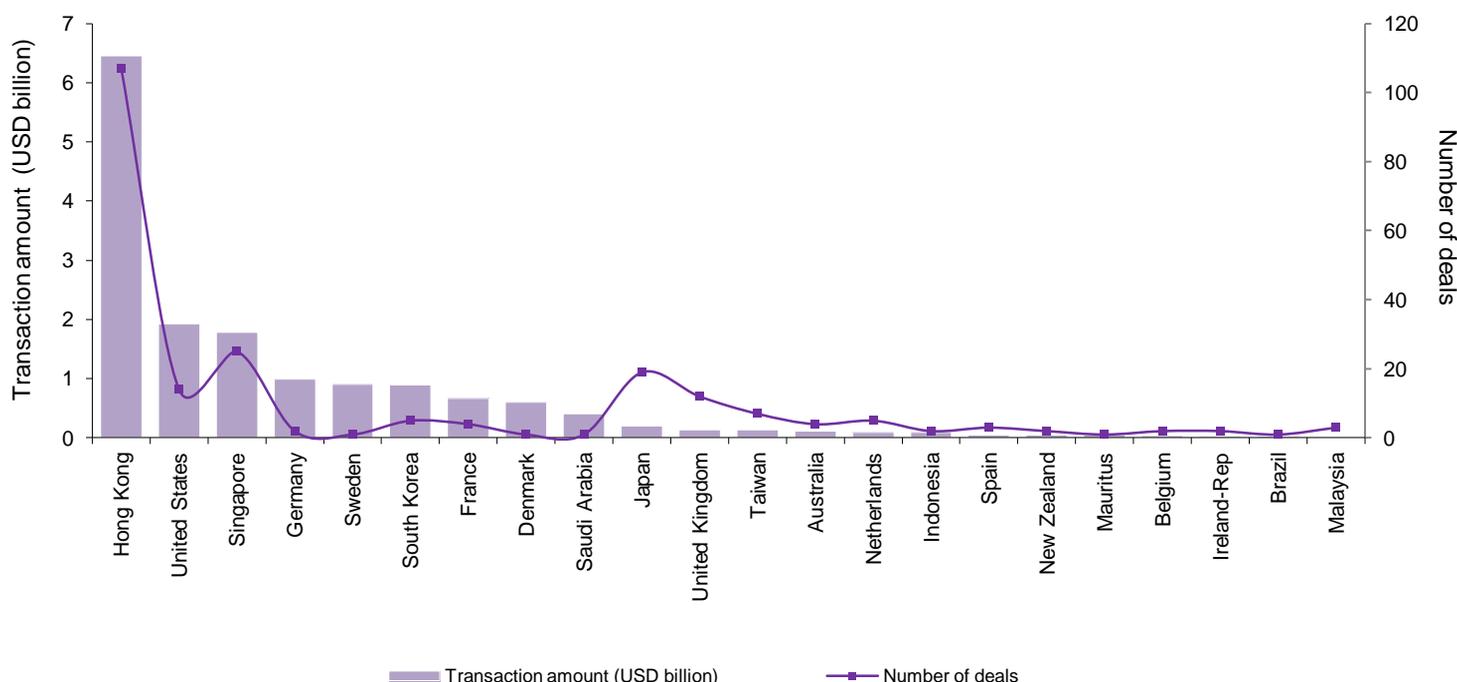


Sources: Thomson One; MergerMarket; KPMG analysis

### M&A regional analysis

Through the second quarter of 2013, a total of 27 countries and regions (22 listed in Figure 3.2 below) invested in Chinese companies via inbound M&A. These M&A transactions primarily originated from Hong Kong, the US, and a select few EU countries. As shown in Figure 3.2, Hong Kong engaged in more deals than any other country – 107 deals in the first two quarters, totaling over USD6.4 billion – for an average deal amount of USD60 million. The US engaged in 14 deals during the first and second quarter, totaling over USD1.9 billion, for an average deal amount of USD135 million. This average was far greater than any other region with 10 deals or more. Singapore was second only to Hong Kong in total number of deals, engaging in 25 transactions, while investing 1.78 billion into China through June 30, 2013. Comparatively there were a total of 53 countries and regions that were recipients of outbound M&A investment from China. The largest region was the US, receiving USD12.8 billion.

Figure 3.2 YTD China inbound M&A, by country deal size and number of deals



Sources: Thomson One; MergerMarket; KPMG analysis

Note: (21) A single, extraordinary deal of USD9 billion was removed due to abnormal size in Q4 2012

Table 3.1 lists the value and number of foreign acquisitions in China, sorted by region, for the first quarter of 2013. The Asia-Pacific region was the main source of M&A into China, as it accounted for approximately 64 percent of YTD M&A activity (USD9.96 billion) and 73 percent of the total number of deals (170 deals). Hong Kong, Macau, and Taiwan accounted for the lion's share of YTD Asian M&A investment (USD6.57 billion and 115 deals).

The Europe Union accounted for the second largest amount of M&A activity (USD3.5 billion). Key countries included: Sweden and its investment of USD900 million in Dongfeng Commercial Vehicles; France and its investment of USD631 million in Tianping Auto Insurance; Germany and its investment of USD873 million in BAIC Motors; Denmark and its investment of USD600 million in Chongqing Brewery Company. These four deals accounted for over 85 percent of all deals originating from the EU. North America was third: deals originating from the US nearly contributed the entire investment amount (USD1.94 billion); Canada participated in a few M&A deals, but the deal sizes were insignificant or not disclosed.

**Table 3.1 2013 Geographical distribution and transaction amount of foreign investment in China M&A**

Region	Transaction amount (USD million)	Number of transactions
<b>Global</b>	<b>15,620</b>	<b>233</b>
<b>Asia</b>	<b>9,959</b>	<b>170</b>
HK, Macau, Taiwan	6,583	115
Southeast Asia	1,885	30
Japan & South Korea	1,091	24
South Asia & Middle East	400	1
<b>America</b>	<b>1,942</b>	<b>16</b>
North America	1,920	15
Central, South America	22	1
<b>Europe</b>	<b>3,504</b>	<b>39</b>
EU member countries	3,504	39
Non-EU member		
<b>Oceania</b>	<b>166</b>	<b>6</b>
<b>Africa</b>	<b>50</b>	<b>2</b>

Note: This is an analysis of 'announced' and 'completed' inbound M&A transactions sourced from Thomson One Banker and MergerMarket. Total announced and completed merger activity may differ significantly from what the Chinese government counts as total 'foreign direct investment', as per their Q1 2013 total FDI statistical data, provided by the Ministry of Commerce.

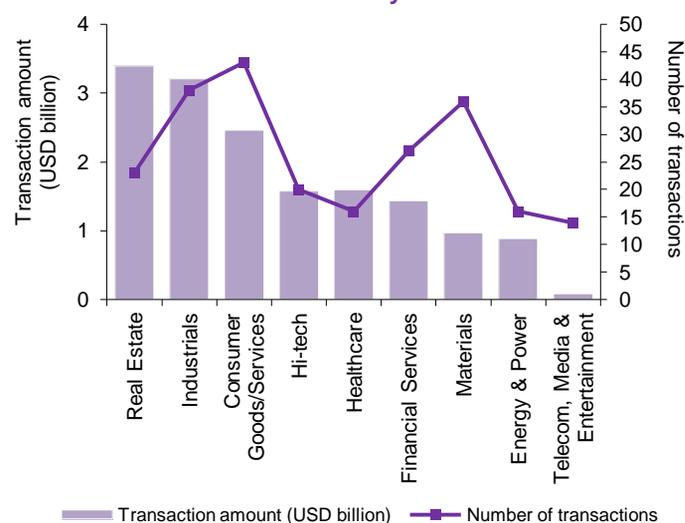
Sources: Thomson One; MergerMarket; KPMG analysis

### M&A industry analysis

Figure 3.3 displays the nine major industries involved in inbound China M&A activity, through the first half of 2013. These industries represent the target firms, not the purchasing firms, as the purchasing firms' industries may differ significantly. As of June 2013, the industry that received the largest inbound M&A deal flow was 'real estate', followed closely by 'industrials'. China's real estate industry was the recipient of USD3.4 billion in the first two quarters, with 23 deals pending or completed by June 30, 2013. Although real estate had the largest total deal flow, the number of transactions was relatively smaller compared to its peers.

Thus, the real estate industry was a recipient of some very large purchases that originated from either Hong Kong or Singapore. The Singapore transaction was the largest in the real estate industry; the purchaser was Cedar Strategic Holdings' acquisition of Hua Cheng Group in Guizhou for USD750 million, or roughly 23 percent of all real estate deal flow year-to-date. The energy and power industry was the largest recipient of ODI from China, receiving approximately USD16.7 billion in the first half of 2013.

**Figure 3.3 YTD inbound M&A in China, by industry**



Sources: Thomson One; MergerMarket; KPMG analysis

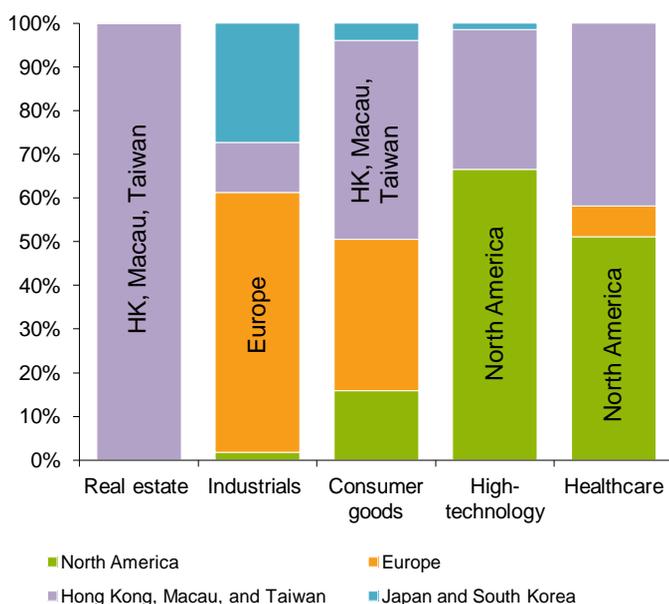
The industrial industry includes: automobile products and services, machinery, transportation and infrastructure, as well as aerospace and defense. The industrial industry was a very close second to real estate, receiving over USD3.2 billion of M&A deal flow through the first two quarters of 2013. However, with 38 total transactions YTD, M&A transaction activity was significantly higher than the real estate industry. The two deals greatly contributed to this total were: AB Volvo's (Sweden) USD900 million investment in Dongfeng Commercial Vehicles, and Daimler AG's (Germany) USD870 million investment in BAIC Motor Company.

The consumer goods and services industry in China was also a significant recipient of foreign direct investment through the first two quarters. This industry includes food and beverage products, educational services, retail products, as well as household and personal products. China's consumer goods and services industry was the recipient of approximately USD2.5 billion YTD, with 43 M&A deals pending or completed by June 30, 2013. The deal of note was Carlsberg AG's (Denmark) USD600 million acquisition of the Chongqing Brewery Company.

The materials industry also lends interesting analysis. This industry includes construction materials, chemicals, as well as metals and mining. Through the first six months of 2013, the materials industry received approximately USD1 billion from external investors, but reported 36 announced or completed deals, which ranks third in number of transactions, but third to last in transaction amount. The two reasons behind this are: 1) many deals announced or completed were small, due to the implicit value of the company being acquired and 2) many of the deals were announced without stating a financial value of the deal, and are still awaiting completion. Thus, the chart shows a relatively low deal value but relatively high number of deals being completed or announced.

Figure 3.4 displays the top five M&A industries in China, as well as the regional acquirers responsible for the majority of purchases. It should be noted again that these categories reflect the target (Chinese) firms' industries, not the foreign firms' industries. Through the first two quarters of 2013, 'real estate' received the largest amount of M&A investment (see Figure 3.3); the majority of real estate transactions were sourced from Hong Kong, while the other large portion of real estate acquisitions came from Southeast Asia – Singapore. (See Figure 3.4 and Table 3.2 below).

**Figure 3.4 YTD 2013 top 5 inbound investment industries, by regional acquirer**

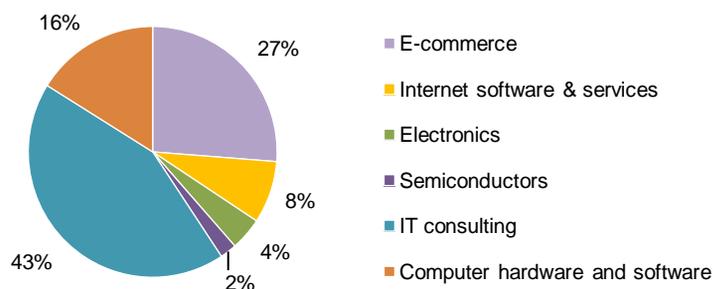


Sources: Thomson One; MergerMarket; KPMG analysis

For a more diversified M&A industry view, the consumer goods and services regional M&A may be examined. Total consumer goods and services M&A activity through the first two quarters of 2013 was USD2.5 billion. Hong Kong, Macau, and Taiwan represented the majority share of consumer goods and services investment during the first quarter with approximately USD1.07 billion of investment, but the European Union was a very close second with USD810 million. In addition, North America, Southeast Asia, and Japan and Korea all took interest in China's consumer goods and services industry in the first quarter, which makes this industry a globally diversified focal point of interest for ongoing future investment. North America continued to retain supreme interest in China's high-technology and healthcare industry, along with Hong Kong, Macau, and Taiwan.

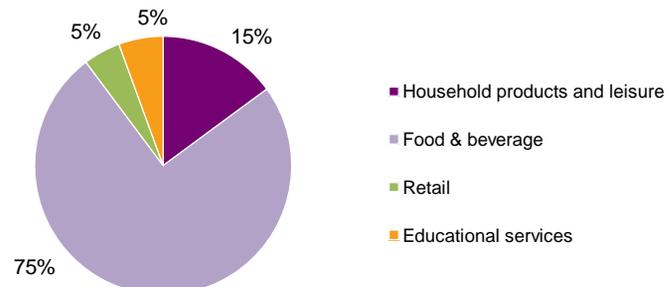
Within the analysis of any industry, analysis can be further drilled down into its sub-industries (or sectors) to look more specifically at where foreign investment is flowing. For this quarterly report, high-technology and the consumer goods and services is detailed due to the diversity and potential foreign interest of the respective industries. The results can be seen in Figures 3.5 and 3.6.

**Figure 3.5 YTD high-technology industry transaction, by sub-sector**



Sources: Thomson One; MergerMarket; KPMG analysis

**Figure 3.6 YTD consumer goods/services, by sub-sector**



Sources: Thomson One; MergerMarket; KPMG analysis

The aggregate development of a strategic high-technology industry is supported by the objectives of China's 12th Five-Year Plan (the Plan). The Plan specifically states that China supports technology development trends pertaining to an active and orderly development of a new generation of information technology across many areas; these areas include but are not limited to: finance, environmental protection, new energy and energy saving, and healthcare. The government supports inbound M&A transactions that will make greater efforts to enhance competitiveness, promote industry dynamics, and increase economic efficiency.<sup>22</sup> This analysis breaks down the technology sub-industries, and identifies any such trends that are in accordance with the Plan.

The M&A transactions in the high-technology industry look fairly diverse; the top three sub-sectors: IT consulting, e-commerce, and computer hardware/software display relatively strong market demand during the first half of the year. IT consulting was the top sub-sector within high-technology. The largest transaction to date was a USD677 million acquisition of Pactera Technologies by a consortium of investors, led by the Blackstone Private Equity Group. E-commerce also received a substantial purchase from a consortium of investors, led by Kingdom Holdings in Saudi Arabia, in a deal to purchase the online e-commerce company 360buy's shares for USD400 million. The two largest investments accounted for 70 percent (or USD1.08 billion) of total technology investments through the first half of the year. There were two other large deals from Hong Kong and Australia looking to enter the computer hardware and internet software and services sectors.

Source: (22) 'Implications of China's Latest Five-Year Plan on Mergers and Acquisitions'. Global Intelligence Alliance, April 11, 2013. <http://www.globalintelligence.com/insights-analysis/bulletins/implications-of-china-s-latest-five-year-plan-on-m>

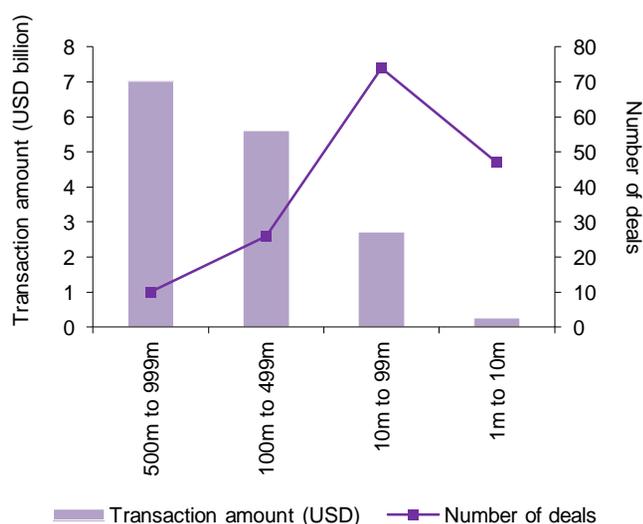
The 12<sup>th</sup> Five-Year Plan states that high-end software, new generation information technology, and high-end manufacturing and services will be the key drivers of growth and as such, will be supported by the government. In accordance with this strategy, more activity from diversified countries can be seen flowing into China to foster high-end software and services partnerships. Analysis suggests that a larger amount of M&A activity will continue to occur in the technology sector, due to ongoing governmental support of this industry.

The consumer goods and services industry may be one of the more interesting and important industries for China's future economic development. As the name implies, it includes businesses where consumers spend on disposable or discretionary items (for either goods or services) and is correlated with the Chinese consumer's willingness and ability to purchase products/services in the marketplace. Consumer goods and services sectors include but are not limited to: retail, household and personal products, food and beverage products, educational and employment services, and textiles and apparel. The development and ongoing external investments into this industry should provide a leading indicator of what foreign companies consider sustainable and/or high growth industries.

Shown above, transactions in the first half of the year were heavily weighted in the food and beverage sector. In this sector, there were a total of 16 deals worth over USD1.8 billion. Deals originated from various countries, including Denmark, Hong Kong, the US, Malaysia, and Singapore. Size of investment was equally diverse, ranging from USD0.11 million to USD600 million. The overwhelming interest in the food and beverage industry may indicate that foreign companies are anticipating a more prosperous middle class Chinese consumer, with a high propensity to purchase a variety of products/services.

The largest purchase in the first quarter was from Denmark in the beverage industry. Carlsberg AG's 600 million purchase of Chongqing Brewery Company (food and beverage) adds to its already substantial 30 percent ownership of the Chongqing Brewery Company. This purchase makes Carlsberg a majority owner of the Chongqing Brewery Company, and further solidifies its strategy of expanding in China.<sup>23</sup>

**Figure 3.7 YTD transaction amount, by size of transaction**



Sources: Thomson One; MergerMarket; KPMG analysis

## M&A analysis of transaction size

Figure 3.7 shows M&A transactions for the first quarter of 2013. Through the first half of 2013, there were 10 deals between USD500 million and 999 million, 26 deals between USD100 million and 499 million, and 47 deals between USD1 million and 10 million. Most of the deals (74 deals) were announced or completed in the USD10 million to 99 million range, with financial services, materials, and telecom, media and entertainment (TME) lacking 'substantial' transaction size (see Figure 3.3).

Industrials and consumer goods and services were the two industries that encompassed the higher echelon of deal size, they also occurred with much greater frequency than the previously aforementioned industries (except materials). This suggests that smaller company acquisitions in industries such as materials (commodities) and high-technology (electronic products) continue to add value for global purchasers, and should continue to receive M&A interest in the future, as encouraged by the Plan. It also suggests that as 2013 progresses, one should expect to see more investment in industrials and consumer goods and services, especially concerning such deals that may enhance manufacturing infrastructure/efficiency as well as target consumer spending across China's service industry.

## Analysis of top 10 M&A deals

Table 3.2 lists the year-to-date, top 10 M&A deals in China, by deal value. Eight of the top ten deals were from different countries, spread across seven different industries, clearly depicting the diversity of large-scale M&A investment demand into China. The industry showing the most prominent activity was industrials, as the top two deals were located in China's industrial industry. Real estate was a close second with two deals in the top six. The main identifiable trend to note was the re-emergence of substantial M&A activity from the EU-27 countries. The EU was absent from the top 10 acquisitions during the full-year 2012 numbers and trends report. Yet, EU countries from Sweden, Germany, Denmark, and France all participated in a number of large deals in diversified industries. Their re-emergence toward large scale M&A in China may signify further potential economic recovery in the region, and even greater interest to invest in China.

The largest inbound M&A deal in Q1 2013 belongs to AB Volvo of Sweden; a USD902 million acquisition of Dongfeng Commercial Vehicles. The deal is said to strengthen the positions of both Volvo Group and Dongfeng in the mid- to heavy-duty truck market, and also make Volvo the world's largest manufacturer of heavy-duty trucks.<sup>24</sup> The second largest acquisition also belongs to the industrials industry; Daimler AG of Germany and its USD873 million investment in BAIC Motor Company Ltd., making Daimler the first non-Chinese manufacturer to take a stake in a Chinese OEM.<sup>25</sup> Industrial manufacturing M&A investments occupied three of the top seven spots.

Sources: (23) Fletcher, Clementine. 'Carlsberg Offers to Raise Stake in Chongqing Brewery'. *Bloomberg*, March 5, 2013. <http://www.bloomberg.com/news/2013-03-04/carlsberg-offers-to-raise-stake-in-china-s-chongqing-brewery.html>;

(24) 'Volvo to become world's largest heavy-duty truck manufacturer following strategic alliance with Chinese company Dongfeng Motor Group'. *Volvo*, January 26, 2013. [http://www.volvogroup.com/group/global/en-gb/investors/\\_layouts/CWP.Internet.VolvoCom/NewsItem.aspx?News.ItemId=137906](http://www.volvogroup.com/group/global/en-gb/investors/_layouts/CWP.Internet.VolvoCom/NewsItem.aspx?News.ItemId=137906)

(25) 'Daimler AG to invest in BAIC Motor for a twelve percent stake'. *Daimler*, February 1, 2013. <http://www.daimler.com/dccom/0-5-7153-1-1571316-1-0-0-0-0-9293-0-0-0-0-0-0-0-0.html>

Table 3.2 YTD top 10 foreign M&amp;A inbound deals to China

Rank	Acquiror			Acquiree		Deal value (USD million)
	Acquiror	Industry	Country	Target	Industry	
1	AB Volvo	Industrials	Sweden	Dongfeng Commercial Vehicles	Industrials	902
2	Daimler AG	Industrials	Germany	BAIC Motor Co., Ltd.	Industrials	873
3	Stryker Corp	Healthcare	United States	Trauson Holdings Co., Ltd.	Healthcare	764
4	Cedar Strategic Holdings Ltd.	Real estate	Singapore	Hua Cheng Group	Real estate	748
5	Conglomerate Investor Group	Financials	US	Pactera Technology International Ltd.	High-technology	676
6	WSP OTC Group	Industrials	South Korea	WSP Holdings	Industrials	654
7	AXA SA	Financials	France	Tianping Auto Insurance Co., Ltd.	Financials	631
8	Shenzhen Investment Ltd.	Real estate	Hong Kong	Shenzhen Silicon Valley	Real estate	611
9	Carlsberg A/S	Consumer goods/services	Denmark	Chongqing Brewery Co., Ltd.	Consumer goods/services	600
10	China Resources Power Holdings Co., Ltd.	Energy	Hong Kong	Wind Farm Group	Energy and power	553

Sources: Thomson One; MergerMarket; KPMG analysis

# International definition of foreign direct investment



According to the International Monetary Fund's (IMF) definition, foreign direct investment (FDI) refers to an investment by an investor from one country, in the production and business operations located in another country, with the investor holding a certain amount of control over the business operations. In other words, FDI is an investment made by residents or entities (foreign direct investors or parent companies) of one country (region) in enterprises (foreign direct invested enterprises, branch enterprises or overseas branch offices) in another country, where the investors establish long-term relationships with the invested enterprise and hold a permanent interest in and control over the invested enterprise. According to the United Nations Conference on Trade and Development (UNCTAD), foreign direct investment can be categorized into outward foreign direct investment (outward FDI) and inward foreign direct investment (inward FDI) according to the direction of the relevant cash flow.

According to the UNCTAD's definition, FDIs can be categorized into two types according to the nature of the investment transaction: greenfield FDIs and cross-border M&As. Greenfield FDI projects require the establishment of new entities overseas, including offices, buildings and factories. Greenfield FDIs involve capital flow. Cross-border M&As involve taking over or merging with the overseas enterprise's cash, assets and liabilities. In the past few years, cross-border M&As have been the main driving factor for FDIs, particularly in developed countries and in some developing countries, where the value of many large-scale M&As account for the majority of total FDIs. In practice, it is difficult to distinguish between greenfield FDIs and cross-border M&As, and in the long-term, the difference in impact of the two on economic development will become even more indistinguishable.

## About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 156 countries and have 152,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture license in Mainland China. It is also the first accounting firm in Mainland China to convert from a joint venture to a special general partnership, as of August 1, 2012. The firm’s Hong Kong operations have additionally been established for over 60 years. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the firm’s appointment by some of China’s most prestigious companies.

Today, KPMG China has around 9,000 professionals working in 14 offices: Beijing, Shanghai, Shenyang, Nanjing, Hangzhou, Fuzhou, Xiamen, Qingdao, Guangzhou, Shenzhen, Chengdu, Chongqing, Hong Kong and Macau. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently and rapidly, wherever our client is located.

## About KPMG’s Global China Practice (GCP)

KPMG’s Global China Practice (GCP) was established in September 2010 to assist Chinese businesses that plan to go global, and multinational companies that aim to enter or expand into the China market. The GCP team in Beijing comprises senior management and staff members responsible for business development, market services, and research and insights on foreign investment issues.

There are currently over 50 China Practices in key investment locations around the world, from Canada to Cambodia and from Poland to Peru. These China Practices comprise locally based Chinese-speakers and other professionals with strong cross-border China investment experience. They are familiar with Chinese and local culture and business practices, allowing them to effectively communicate between member firms’ Chinese clients and local businesses and government agencies.

The China Practices also assist investors with China entry and expansion plans, and on both inbound and outbound China investments provide assistance on matters across the investment life cycle, including market entry strategy, location studies, investment holding structuring, tax planning and compliance, supply chain management, M&A advisory and post-deal integration.

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