cutting through complexity

毕马威全球中国业务
KPMG Global China Practice

Investment in China: Numbers and Trends

Third Quarter, 2013

KPMG Global China Practice

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Executive Summary

In the third quarter of 2013, China's GDP growth rate was 7.8 percent, an increase of 0.3 percentage points from the second quarter. In response to the second quarter slide in GDP growth, the Chinese government introduced a series of economic measures in July to boost growth and stabilize market expectations, including an increase in investment spending and stronger support for exports. Other key takeaways from China's third quarter macroeconomic situation include:

- The manufacturing sector accounted for 34.5 percent of YTD total fixed asset investment; year-on-year manufacturing investment growth was 22.5 percent in August, the highest rate of growth in 2013
- Year-on-year import and export growth increased to 6 percent, reflecting genuine trade growth within China's economy and a global recovery amongst its trading partners.
- As a headwind to growth, consumer prices were marginally higher. In the third quarter of 2013, CPI rose by 3.1 percent, the highest percentage rise since March 2013, and the second highest rate of growth since May 2012

Through the first three quarters of 2013, total FDI into China was USD88.6 billion, up 6.22 percent year-on-year. The manufacturing sector FDI decreased by 2.14 percent year-on-year, receiving USD35.5 billion in FDI funds, while the service sector FDI increased by13.28 percent year-on-year, receiving USD44.7 billion in FDI funds. Since January 2013, FDI has now posted eight 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. The service industry allocation percentage climbed by 1.5 percentage points, to 50.5 percent of total FDI
- FDI from the European Union (EU) climbed by 23 percent year-on-year, while FDI from the US also increased by 21.5 percent year-on-year
- FDI in July recorded a 24 percent year-on-year increase, the single largest monthly increase in over two years
- FDI into the central region of China grew by 12.3 percent; the western region also posted significant growth of 7.4 percent, while the eastern region grew by 5.6 percent year-on-year.

Part I: Macroeconomic Analysis[1]

Another round of economic rebound

In the third quarter of 2013, China's economy grew by 7.8 percent, which was an increase of 0.3 percentage points from the second quarter (7.5 percent). Several economic indicators indicate that this quarter's economic activity show a genuine economic rebound in the third quarter. Sustainable drivers of GDP such as manufacturing investments and exports to developed economies drove the rebound and bullish economic sentiment. However, other data from September, including less sustainable infrastructure investments, persistence of a real estate price bubble, as well as concerns over inflation, all point to possible and projected deceleration in the fourth quarter of 2013.

Third quarter data overview: positive indicators exist

According to the National Bureau of Statistics, the first three quarters of 2013 recorded a total gross domestic product of RMB38.7 trillion, and a year-on-year growth rate of 7.7 percent (based on comparable prices). The third quarter saw GDP growth of 7.8 percent year-on-year, an increase of 0.3 percentage point from the 7.5 percent growth posted in the second quarter. Economic indicators shown in Table 1.1 below, indicate a genuine rebound in the third quarter of 2013.

- Industrial value-added of enterprises with annual operating revenue over RMB20 million: the month of August was the highest recorded level since April 2012. September was second only to August, throughout 2013.
- Electricity generation: third quarter data improved greatly from the previous quarter, August and September levels were the highest and second highest respectively, since February 2013.
- Fixed assets investment: data in July and August indicates a reversal from the slower growth seen in March and April 2013, and the growth continues to pick up.
- Real estate investment: posted significantly higher growth statistics through the first three quarters of 2013, relative to 2012.

Table 1.1: Q3 2013 Economic Data

Economic data (Year-on-year, percent)	Jul	Aug	Sep
1. GDP	Third quarter: 7.8		
2. Industrial value-added			
1) Industrial value-added of enterprises with annual operating revenue over RMB 20 million	9.7	10.4	10.2
2) Electricity generation	8.1	13.4	8.2
3. Investment			
1) Fixed assets investment	20.2	21.4	19.6
2) Investment in real estate development	21.2	13.1	22.3
4. Total retail sales for consumer goods	13.2	13.4	13.3
5. Total imports and exports	7.8	7.1	3.3
1) Exports	5.1	7.2	-0.3
2) Imports	10.9	7	7.4
6. Money supply			
1) Total social financing (unit: RMB trillion)	0.8	1.6	1.4
2) Broad money (M2) balance	14.5	14.7	14.2
7. CPI	2.7	2.6	3.1
1) Food	5.0	4.7	6.1
8. Producer Price Index for Industrial Products	-2.27	-1.62	-1.3
9. PMI			
1) China manufacturing PMI	50.3	51	51.1
2) HSBC manufacturing PMI	47.7	50.1	50.2
10. Fiscal revenue and expenditure			
1) National public fiscal revenue	11.0	9.2	13.4
2) National public fiscal expenditure	-1.8	6.5	10.08

Source: Wind, National Bureau of Statistics of China, People's Bank of China, Ministry of Commerce, State Administration of Foreign Exchange, General Administration of Customs, Ministry of Finance, KPMG analysis

Note: (1) Unless otherwise stated, data in this report was sourced from Wind and KPMG analysis

- Total retail sales for consumer goods: August retail sales level was the highest since March 2013, while September was the second highest level for the year.
- Total imports and exports: imports and exports experienced a strong rebound in July and August, from a weaker second quarter; export and import volume in third quarter reversed the downward trend that began in January, and the negative growth in May and June.
- Money supply - total social financing (RMB1 trillion): July's money supply level was the lowest since 2012, but August and September levels reversed the decline seen in the second quarter.
- Money supply - broad money (M2) balance: the broad money supply in June was the lowest level seen in 2013, an upward trend was observed in July and August.
- Producer Price Index (PPI): although still negative, the extent of decline has been shrinking over the past three months.
- PMI: 'The China Manufacturing PMI (CLFP PMI)' rose above 50 in the third quarter, reflecting growth in the manufacturing sector; the index has now experienced three consecutive months of growth. September's level was the highest since May 2012, indicating a recovery in the manufacturing sector. 'The HSBC China Manufacturing PMI (HSBC PMI)' also climbed for three straight months, reversing the decline in the second quarter and also signifies a genuine rebound in the manufacturing sector.
- National fiscal revenue and expenditure: after fiscal revenue growth dropped to single digits in the first and second quarter, it returned to double digit growth in the third quarter. Revenue growth was 13.4 percent in September, the highest growth level in 2013.

Analysis of factors driving the economic rebound

After a slight downturn in China's economy in the second quarter, a modest rebound in both GDP and aggregate economic activity occurred in the third quarter. To explain how and why the Chinese economy rebound from a sub-standard second quarter, a few factors must be addressed and discussed. During the second quarter, the market had expected the government to address asset bubbles within the Chinese economy: based on China's economic growth trend (7.7 percent for Q1 2013, 7.5 percent for Q2, 7.3 percent for Q3, and a projected 7.1 percent for Q4), full-year GDP growth would be significantly lower than the government's 7.5 percent target. In July 2013, Premier Li Keqiang held a forum that was attended by economic experts and members of the business community. At the forum, he stressed that China's economic growth was within a reasonable overall range of growth. The upper limit of the range involved guarding against inflation and maintaining CPI at about 3.5 percent. The lower limit involved stable growth rates, healthy employment levels, and achieving a GDP growth rate of 7.5 percent. To satisfy these expectations, and assuming that restructuring efforts will not weaken significantly, the new government has launched a series of short-term and structural economic policies to stabilize market expectations and encourage economic growth. This included investments in manufacturing, energy and environmental conservation, public services, urban infrastructure, and the promotion of consumption and foreign trade. Due to the new round of investment objectives, economic growth rebounded in the third quarter of 2013. The details are as follows:

- Investment growth recovered in the third quarter, driven mainly by the manufacturing sector.

As the biggest contributing sector, the manufacturing sector accounted for 34.5 percent of total fixed assets investment during the past three quarters; KPMG data indicates that year-on-year manufacturing investment growth was 22.5 percent in August, the highest rate of growth in 2013, while year-on-year growth in September was second only to August, at 22.1 percent growth.

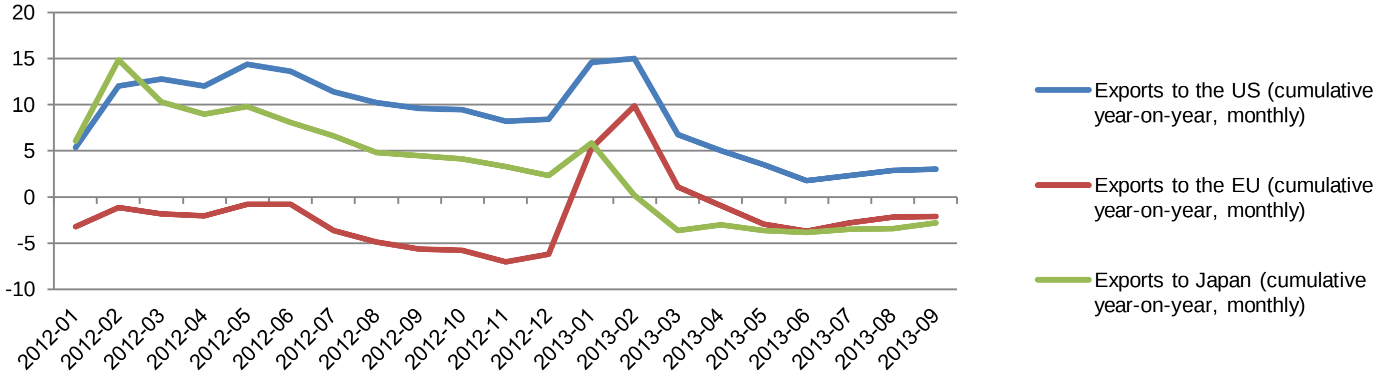
Furthermore, despite the real estate sector witnessing a far higher investment level over the first three quarters of 2013 (relative to 2012), its cumulative year-on-year investment growth has been declining gradually, which shows that real estate investment was not a primary driver of the rebound. Infrastructure investment continues to remain stable, indicating that infrastructure investment was also not a primary driver of this round of rebound.

- Foreign trade rebounded due to the strong recovery seen in developed countries, with exports to major trading partners (US, Europe, Japan) performing better.

In the first quarter of 2013, China's total imports and exports grew 13.5 percent year-on-year. Due to arbitrage[2] activities, it is widely accepted that this figure was not an accurate representation of China's foreign trade. In the second quarter, the Chinese government intensified efforts to combat the reporting of falsified trading numbers, and as a result total import and export year-on-year growth plunged to 4.3 percent. In the third quarter, this number rose to 6 percent, reflecting genuine trade growth within China's economy. In addition, seasonally adjusted export data indicates that the overall export level in the third quarter has already recovered from the slump in May and June. The import data for the third quarter also shows the same trend.

The third quarter rebound in foreign trade was due to the strong recovery in developed economies, hence exports to China's major trading partners (the US, Europe, Japan) also picked up.

Figure 1.1: exports to the US, Europe, Japan - year-on-year growth



Note: (2) As explained in the Q2'2013 report, arbitrage activities were used in the first quarter to manoeuvre around capital controls, earn appreciation of the RMB, and bring foreign capital into mainland China. The result was that the net export trade data was skewed higher.

From July to September, exports to the US continued to rise, and the year-on-year decline in exports to the European Union and Japan also continued to narrow.

Additionally, the Chinese government launched a series of policies in the third quarter to stabilize foreign trade growth; these policies are beginning to take effect. For example, the State Council released the ‘Opinions on Promoting Stable Growth and Restructuring of Imports and Exports’ on July 27, which covered measures such as: credit support, export tax rebates, and customs clearance models. This includes adjustments to export inspection fees and catalogues; 12 measures including the waiving of goods inspection fees for five months (August 1, 2013 to December 31, 2013); reduce in product categories requiring export inspection; increase export tax rebates; accelerate Renminbi cross-border trade settlement and development; improve financing services; expand credit insurance support; expand imports; widen the scope of interest discount products for imports; and increase the scale of interest discounts for imports.

Comparison to 2012 economic conditions

Many similarities can be drawn from the economic conditions for 2012 and 2013, such as a first-half growth slowdown accompanied by the government's follow-up implementation measures to stabilize growth. Based on the statistics, the economy bottomed out in the third quarter of 2012 and rebounded in the fourth quarter. For 2013, the rebound occurred earlier and growth hit 7.8 percent in the third quarter, the highest level of growth in the last six quarters (see Figure 1.2).

Figure 1.2: comparison of 2012 and 2013 GDP

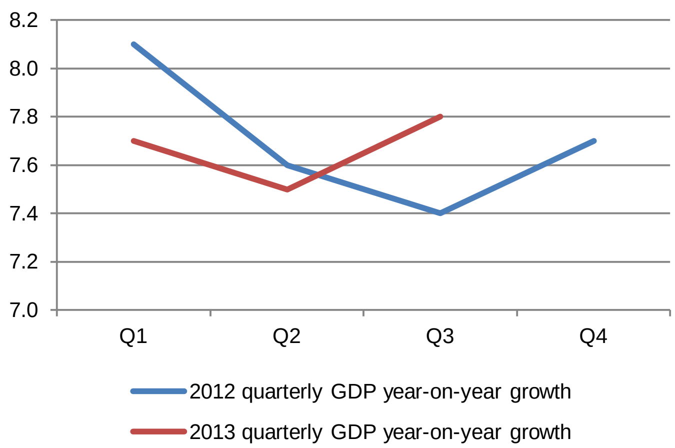
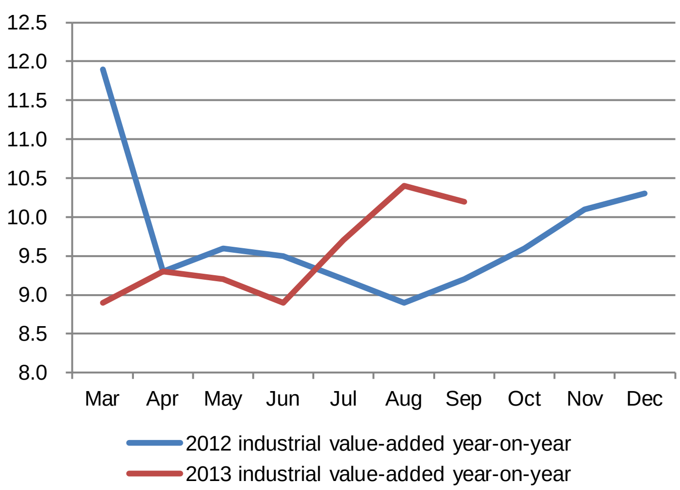


Figure 1.3: industrial value-added growth comparison, 2012-2013



The earlier economic rebound in 2013 was accompanied by a rebound in industrial value-added growth (see Figure 1.3). The rebound of the industrial sector, which accounts for approximately 40 percent of China's economy, will undoubtedly play an important role in the overall rebound of economic output. As a more accurate indicator of economic performance, electricity generation also experienced an early rebound in 2013 relative to 2012 (see Figure 1.4). In 2013, the overall ex-factory price level for all industrial products, which reflects industrial demand, also experienced an earlier rebound. The PMI rebound in 2013 also occurred about three to four months earlier compared to the previous year. In short, the economy's earlier rebound in the third quarter of 2013 was supported by numerous indicators.

Figure 1.4: comparison of 2012 and 2013 electricity generation growth

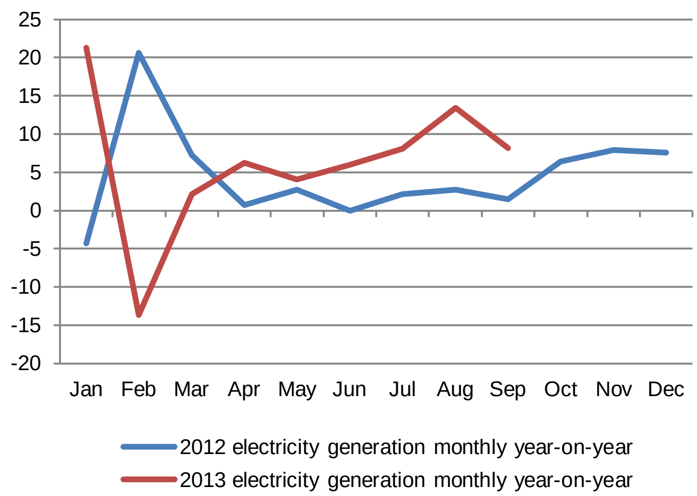
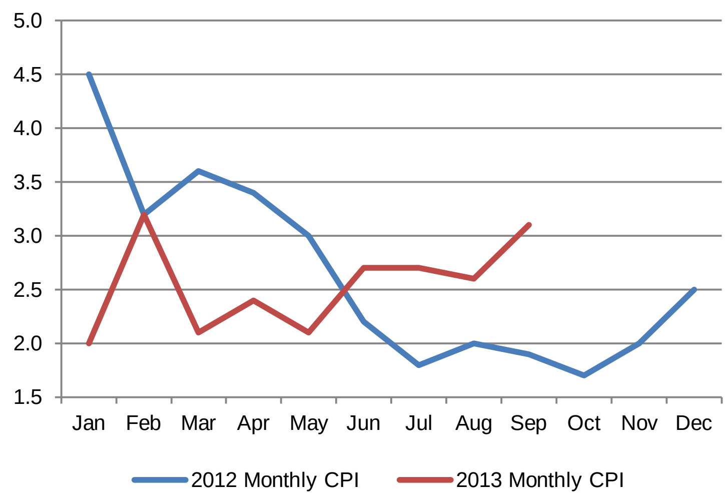
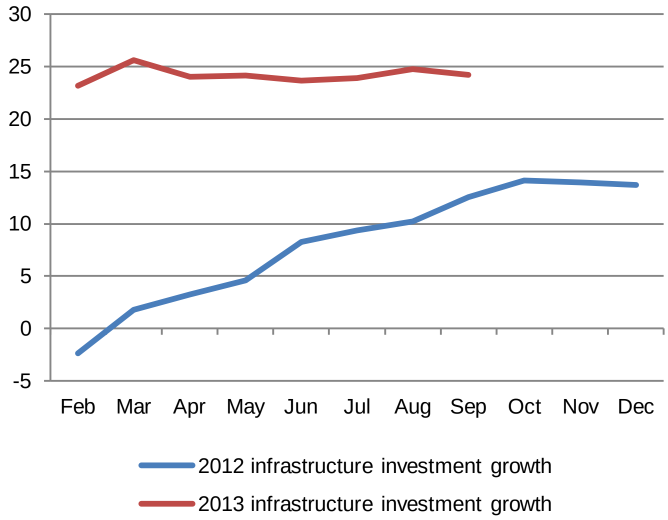


Figure 1.5: CPI growth, 2012 vs 2013



As a headwind to a near-term rebound, consumer prices were marginally higher and heading upward (see Figure 1.5). In the third quarter of 2013, CPI rose by 3.1 percent, the highest percentage rise since March 2013, and the second highest rate of growth since May 2012. In contrast, when the economy rebounded in the fourth quarter of 2012, CPI reached only 2.5 percent growth. Higher inflation will have a negative effect on economic activity and future growth.

Figure 1.6: infrastructure investment growth (%), 2012 vs 2013



The factors driving the rebound in 2012 and 2013 are marginally different. The 2012 economic rebound was driven by the growth in fixed assets investments, particularly infrastructure investments (see Figure 1.6). The rebound in the third quarter of 2013 was also driven by the growth in fixed assets investment, particularly by manufacturing investments, and the rebound in exports to developed economies (see Figure 1.1).

Compared to 2012, the 2013 rebound faces a different series of challenges. This includes:

- After driving the economic rebound in the fourth quarter of 2012, the rapid growth of infrastructure investment carried over into the first three quarters of 2013. At nearly 25 percent, growth, infrastructure investment continues to be at its highest rate of growth since 2010; however, unlike manufacturing investment growth, infrastructure investment growth is not sustainable.
- In 2012, real estate investment saw declining growth rates from 2010 and 2011. This is predominantly due to government policies put in place in 2010 to curb real estate investment, and soften asset bubbles. However, the first three quarters of 2013 saw real estate investment grow by 19.7 percent (on a cumulative basis). Due to the presence of asset bubbles and further speculation in real estate, if investment growth in this sector continues at its current pace, it could exacerbate structural issues inherent in the Chinese economy.
- The economic rebound in the fourth quarter of 2012 benefited from the year-long growth in money supply (see Figure 1.7 for total social financing, and Figure 1.8 for broad money supply); yet that rebound only lasted one quarter. Contrary to 2012, in 2013 the money supply growth rate has decreased, so the economic rebound in 2013 may be even shorter than that exhibited at the end of 2012. Based on our second quarter KPMG China Economy Globalization Review, the amount of additional social financing needed in China for each unit of economic output has been rising since 2005. In 2013, total social financing growth and broad money M2 growth have been declining (Figure 1.7 and Figure 1.8); this implies that economic growth in the fourth quarter of 2013 might not maintain the strong momentum, observed in the third quarter.

Figure 1.7: cumulative total social financing, 2013 vs 2012

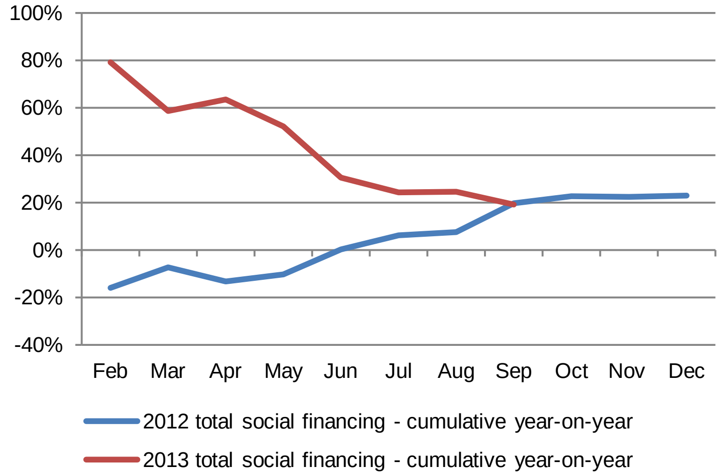
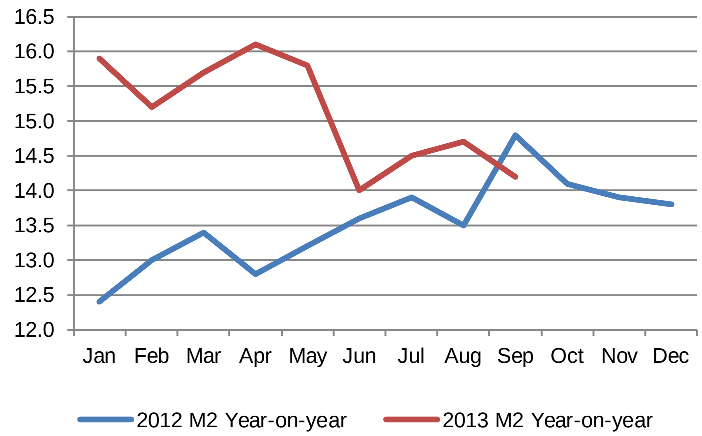
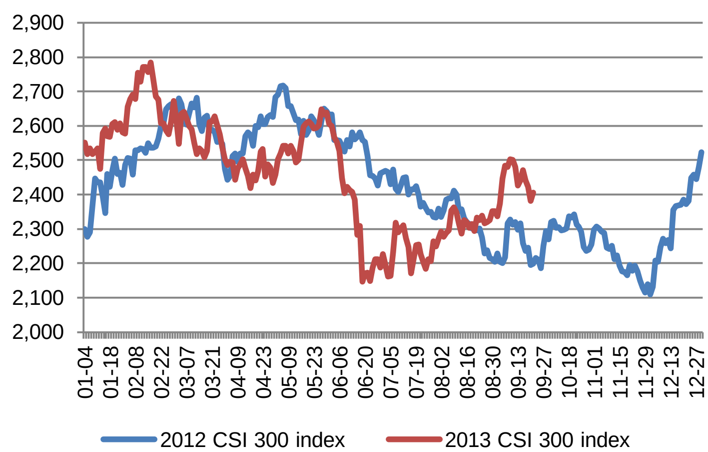


Figure 1.8: M2 money supply growth rate (%), 2013 vs 2012



The CSI 300's movements are linked to the fundamentals of the Chinese economy. When observing the CSI 300's movements between 2012 and 2013, one could make the observation that they are moving with a certain degree of correlation (see Figure 1.9). In 2013, the CSI 300 rebounded about five months earlier compared to 2012 (June 2013 versus November 2012). However, during the last two weeks of September, the index lost nearly 4 percent of its value. This may reflect investor expectations of economic performance, going into the fourth quarter of 2013.

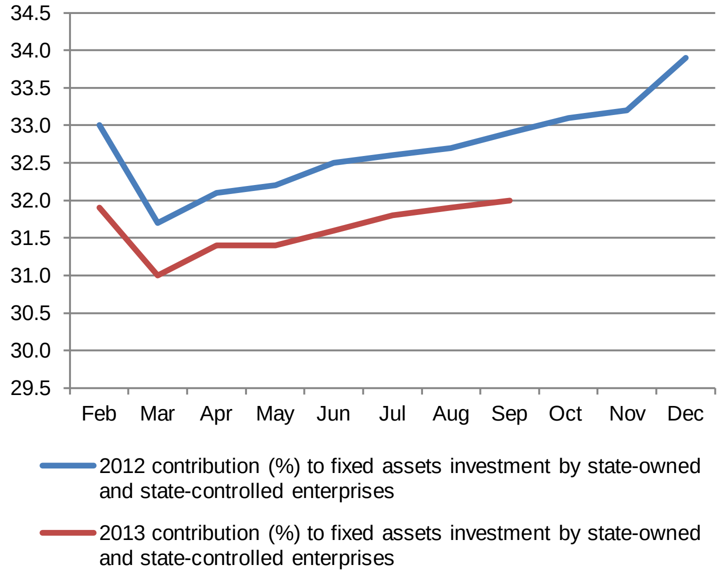
Figure 1.9: CSI index trend, 2012 vs 2013



Inherent Problems

The share of fixed asset investments contributed by State-owned and State-controlled enterprises began to rise in April (See Figure 1.10), and the same trend was also observed in 2012. This reflects the important role of State-owned and State-controlled enterprises in the government's growth and stabilization policies.

Fig 1.10: Fixed asset contribution by State-owned and State-controlled enterprises (%), 2013 vs 2012



Although investments from State-owned enterprises have vastly contributed to economic growth, many studies have shown that investments from the State sector are less efficient versus comparable investments from the private sector. Despite their low economic efficiency, State-owned enterprises have greater access to resources. However, the greater allocation of resources and less efficient use of resources is not sustainable. In the previous KPMG China Economy Globalization Review, we expressed our opinion that "the Chinese economy's slower growth over the past few years is largely attributable to the unsustainable nature of an economic growth model characterized by the misallocation of resources, and the persistent decline in the potential growth rate", and we recommended that "the Chinese economy needs to undergo moderate restructuring".

The PMI rose in the third quarter and has shown signs of strength for three consecutive months. Both the China PMI and HSBC PMI recorded smaller increases in September relative to August. However, despite the improved data in the third quarter, the China Small Enterprise PMI index stayed below 50 since April 2012. In July, August and September, it was 49.4, 49.2 and 48.8 respectively, reflecting an unsustainable recovery despite the improvements seen in the third quarter. As a whole, China's manufacturing sector is recovering, but the climate remains rough for small and micro enterprises. Given that government policy measures targeted at small and micro enterprises may end or change (such as temporary exemptions of VAT and business taxes), contributions from such enterprises to economic growth will not fundamentally change going forward.

In addition, KPMG's data indicates that the real estate sales area grew 22.8 percent year-on-year in September, a strong rebound that followed a 10.1 percent gain in August. Also, completed real estate investment (calculated by KPMG) grew 22.3 percent year-on-year in September, representing a sharp increase from 13.1 percent growth in August. New housing starts area - a leading indicator for the real estate sector - grew 41.3 percent year-on-year in September (calculated by KPMG) compared to -20.1 percent in August. As mentioned above, the real estate sector's recovery is helping to drive economy growth, yet the growing real estate bubble will eventually weaken economic structure. Hence, concerns over this bubble will reduce the room for looser monetary policy in upcoming quarters.

With respect to foreign trade, import and export data indicated weaker year-on-year growth in September (relative to August; import data was seasonally adjusted), possibly indicating weaker growth in the fourth quarter. This might also be indicative of the strength and efficiency of the Chinese government's policy support for foreign trade. Some of the policy measures contained in the 'Document from the State Council' released on July 27, 2013, could fundamentally improve China's foreign trade environment. Policy measures include cross-border Renminbi settlement, trade facilitation measures and cross-border e-commerce trade. However, some measures such as lower inspection fees and export tax rebates are temporary measures that reduce government revenue. They also weaken fiscal policies and are not conducive to domestic demand. Furthermore, measures that involve expanding the range of discount products and increasing the scale of subsidies for imports are considered financial measures. Hence, the resulting increase in imports will not fully reflect corporate expectations regarding China's economic outlook.

Aside from real estate, the other September indicators all indicate weak momentum for a rebound. For example, the September year-on-year increase in industrial valued added was lower by 0.2 percent relative to August; the September year-on-year increase in electricity generation fell 5.2 percent relative to August (this significant drop might partially reflect the increased electricity consumption during the heat wave); the September year-on-year increase in completed fixed assets investments was lower by 0.1 percent relative to August; the September year-on-year increase in manufacturing investment dropped 0.4 percent relative to August; the September year-on-year increase in infrastructure investment was lower by 7.7 percent relative to August; the September year-on-year increase in total retail sales for consumer goods fell 0.1 percent relative to August; the September year-on-year increase in total social financing also entered negative territory; the September year-on-year M2 growth was 0.5 percent lower relative to August; PMI also rose by a mere 0.1 in September from August, far lower than the increase of 0.7 from July to August. In addition, inflation has started to cause concern. The Consumer Price Index (CPI) hit 3.1 percent in September, reaching a new high for the quarter - food prices rose by 6.1 percent, the highest since June 2012. Pressure from rising consumer goods and food prices might constrain monetary policy and thereby constrict economic growth in the fourth quarter.

Fourth Quarter Forecast

Based on the above analysis, we project GDP growth to decline (relative to third quarter) to 7.6 percent in the fourth quarter of 2013. We reiterate our opinion in the KPMG China Economy Globalization Review Q2'2013, regarding the Chinese economy's declining potential growth rate, and believe that the impact of reform dividends will raise the potential growth rate of the economy. With this in mind, the Third Plenary Session of the 18th CPC Central Committee will be closely monitored for policy changes and opinions of government leaders that could lead to economic direction changes.

Shanghai Free Trade Zone set to deepen China's economic reform

The China (Shanghai) Pilot Free Trade Zone (hereinafter known as the "FTZ") was officially launched on September 29, 2013. The pilot zone covers four special customs supervision zones, namely: Waigaoqiao Bonded Zone, Waigaoqiao Bonded Logistics Park, Yangshan Bonded Port Area, and Pudong Airport Comprehensive Bonded Zone, spanning a total area of 28.78 square kilometers.

Positioning of the FTZ

According to the "General Plan for China (Shanghai) Pilot Free Trade Zone" (hereinafter known as the "General Plan") approved by the State Council, the overall objectives of Shanghai FTZ include: accelerate the transformation of government functions; promote the expansion and opening up of the services sector, reform of the foreign investment management system; rigorously develop the headquarters economy and new forms of trade industry, speed up the exploration of capital account convertibility and complete opening up of the financial services sector; explore and establish the categorized regulation model over goods status; strive to develop a policy support system to promote investment and innovation; cultivate an internationalized business environment governed by the rule of law; and endeavor to build a pilot free trade zone with world-class investment and trade facilitation, with full currency convertibility, efficient and agile supervision, and standardized legislative and regulatory environment. These policies will help China explore new thoughts and avenues to deepen reform and better serve the nation.

Specifically, the new reform measures include: accelerating the transformation of government functions; larger scope and broader use of investments; driving the transformation of trade development approaches; further opening up and innovations in the financial sector; and enhancing institutional safeguards in the areas of legislation and regulation.

- Accelerating the transformation of government functions mainly refers to deeper administrative regime reform. One of the key measures is to shift of emphasis of government administration from ex-ante approval to ex-post supervision.
- Larger scope and broader use of the investment sector includes: more flexible financial services, shipping services, commerce and trade services, professional services, cultural services and social services; establishing a negative list management model, for example "all investments are allowed unless explicitly prohibited"; and adopting a record-filing system to manage foreign investment.
- Driving the transformation of trade development approaches includes: actively monitoring new forms and functions of the trade industry, and establishing a new competitive advantage in foreign trade with emphasis on technology, brand, quality and service; accelerating the rise of China's status along the global trade value chain, and encouraging multinational companies to set up Asia Pacific headquarters in the FTZ for the purposes of building operational centers that integrate various functions such as trade, logistics and settlement; and actively boosting international shipping services through the use of the Waigaoqiao Port, Yangshan Deepwater Port, and Pudong Airport.
- Opening up and innovating within the financial sector includes, under the premise of controllable risks: creating conducive conditions in the FTZ for pilot implementation and testing of RMB convertibility under the capital account, interest rate liberalization for the financial markets, and cross-border use of RMB; completely opening up the financial services sector to qualified private capital and foreign financial institutions, and supporting the establishment of foreign-funded banks and Sino-foreign joint venture banks.
- Enhancing institutional safeguards in the areas of legislation and regulation includes: temporary adjustments to the relevant administrative approvals provided under the "Law of the People's Republic of China on Foreign-funded Enterprises", "Law of the People's Republic of China on Sino-foreign Equity Joint Ventures" and "Law of the People's Republic of China on Sino-foreign Cooperative Joint Ventures", and accelerating the formation of high standard investment and trading rule systems in line with the requirements for the development of the pilot zone.

Premier Li Keqiang outlined that the establishment of Shanghai FTZ is a key measure taken by the current government to create an upgraded version of the Chinese economy. Based on the common practice of a free trade zone, goods can be loaded, unloaded, manufactured, reprocessed and even re-exported without interventions from the customs authorities. But if the goods are moved from the Shanghai FTZ to other regions in China, then they will be subject to customs restrictions.

From the above, we can see that the reform measures setup for the Shanghai FTZ are not limited to only boosting trade, but they also include support for investment and financial liberalization, and advancing the transformation of government functions and administrative regime reform. The objective is to spur the economic development in Shanghai and its neighboring regions, as well as across China. Therefore, the term "Free Trade Zone" may not have fully depicted its functions and positioning.

The FTZ should boost Foreign Direct Investment (FDI), Outbound Direct Investment (ODI), and the offshore RMB market

Shanghai FTZ should boost FDI and ODI in the following aspects:

- The scope of foreign investment in China will be expanded. According to the provisions of the "General Plan", the access restriction measures such as investors' credential requirement, equity ratio restriction, and business scope restriction on investments into sectors including financial services, shipping services, commerce and trade services, professional services, cultural services and social services will be suspended temporarily or cancelled. The financial services sector will be fully opened up to foreign financial institutions that meet the criteria, and support will be provided to the establishment of foreign-funded banks and Sino-foreign joint venture banks in the pilot zone. (See appendix for details)
- The negative list management system will allow foreign funds to enjoy the same treatment as local nationals.
- The approval system for foreign-funded investment projects will be changed to a record-filing system and the national security review, involving foreign funds, will be conducted within the FTZ. This will simplify the investment procedures, shorten project commencement times, and reduce related costs.
- Market-based reforms in the financial system include interest rate liberalization and full RMB convertibility. These will benefit foreign enterprises where factors of production are

priced by the market, hence reducing the uncertainty in production and operation.

- For enterprises engaged in production and producer services in the FTZ, the importation of required machineries and equipment will be exempted from duties.

The benefits of Shanghai FTZ to Chinese enterprises in their internationalization efforts are demonstrated in the following aspects:

- For enterprises registered in the zone, the record-filing system is adopted as the principal approach to manage overseas investment. This will greatly simplify the ODI procedures and reduce the uncertainty of the investment arising from the excessively long approval process.
- Companies specialized in overseas equity investment will receive special incentives. The policy will encourage PE/VC enterprises that specialize in overseas equity investment, to register in the zone, and Chinese enterprises that may have aspirations to invest overseas, would also be encouraged to register their overseas investment headquarters in the FTZ. There may be a surge in overseas M&A activities by Chinese enterprises as a result.
- Full and free RMB convertibility will help drive RMB internationalization, and this may spur Chinese enterprises to expand overseas.
- For enterprises or individual investors registered in the pilot zone, the income tax on 'asset revaluation due to asset reorganization activities' such as outward investment involving non-monetary assets, may be paid in installments over a period of no longer than five years.
- Micro, small and medium enterprises will especially benefit

In addition, it is reported that foreign companies may be permitted to sell shares, to raise capital in the Shanghai FTZ. Considering that foreign companies are not allowed to issue IPOs in China, this new policy could give a tremendous boost to the convertibility of RMB, and the development of the offshore RMB market. Moreover, the offshore RMB market in the Shanghai FTZ may also benefit the development of Dim Sum bond market.

The FTZ is set to deepen China's economic reform

The biggest expectations for the Shanghai FTZ may stem from the reform measures for the financial sector, which include interest rate and capital account liberalization. The assumption is that the financial reform measures in the FTZ will lead to a more competitive market, with respect to financial institutions and enterprises in China. Interest rate liberalization is an influential factor in regards to rebalancing the Chinese economy, while the liberalization of capital account will help optimize resource allocation and support the internationalization of Chinese economy.

On July 19, 2013, the People's Bank of China announced the removal of the lending rate floor for loans other than residential mortgage loans. About one year earlier, the central bank had already relaxed the lending rate floor to 70 percent of the benchmark interest rate. The next reform measure is likely to be the liberalization of deposit rates: market-driven interest rate liberalization will be a positive step towards the rebalancing of China's economy. First, if deposit rates are liberalized, banks and non-banking savings institutions may compete with each other by offering higher rates to attract deposits, and the competition among financial institutions will lift the deposit rate, and increase household income. Based on the given household savings rate, private consumption should also rise.

Second, although the deposit rate regulation provides support to the operating profitability of the Chinese banking sector, the low funding cost is very likely to prevent banks from pricing loans accurately, and these factors may lead to misallocation of resources. A higher deposit rate will add pressure on banks, and the competition among banks may result in transferring some of the costs to the borrowers. For the borrowing enterprises, increased cost of funding implies that an investment may incur loss if the rate of return is not high enough. This will promote healthier investment activities and limit less efficient investment decisions, which are a common phenomenon across various industries in the Chinese economy. This will also ease the abnormally high investment-to-GDP ratio, and alleviate the misallocations of resources.

Finally, the regulated deposit rate is lower than the market level and is even lower than the inflation rate, investors are therefore encouraged to put their money into higher risk (higher expected return) asset classes, such as wealth management products and real estate. This can be used to explain the rapid growth of the wealth management products business in China over the past few years and the continuously rising real estate prices. With deposit rate liberalization, the growth in the scale of wealth management products may be constrained and the extent of real estate bubble may also be restricted.

Capital account liberalization is also viewed as a measure that can raise resource allocation efficiencies. For example, a research study conducted by Tahsin Saadi Sedik and Tao Sun of the International Monetary Fund in 2012 opined that the liberalization of capital account could lead to faster economic growth. Also, the International Monetary Fund expressed its official opinions on capital account liberalization in November 2012, which stated "capital flows can bring huge benefits to a country, including increased efficiency, higher competitiveness in the financial sector, promoting larger productive investment and positively affecting consumption." For a country that has been regulating the capital account on a large scale and for a long period of time, an orderly capital account liberalization will yield benefits. Furthermore, accelerating the liberalization of capital account can further enhance the current account convertibility level. This will boost foreign trade and investment, quicken the pace of FDI and ODI, and help China to further integrate into the global economy.

Implied risks of the FTZ

As mentioned earlier, Shanghai FTZ is trying to create an entirely different economic market from any environment outside of the FTZ, which could give rise to the so-called "dual track system". For example: the interest rates and exchange rates within the FTZ will be different from rates outside the FTZ, and there will also be a significant difference in the income tax rate inside and outside the FTZ. In terms of the history of reforms in the Chinese economy, a dual track system may incur additional risks.

Take the dual track price system from 1985 to 1993. During this period, the State allowed enterprises to independently sell products on their own after accomplishing the planned targets, and at a price determined by the market. Some scholars believed that the dual track price system generated 'Pareto' improvement in China, whereby the living standards of the majority of people improved under that premise, and that the interests of the others were not negatively affected.

However, some studies viewed that a partial reform, such as the dual track price system, will create interest groups that profit from the system, making it even harder to implement further reforms. In addition, Chinese energy enterprises reap huge profits by virtue of their monopoly status, but they incur very little resource tax. In fact, the existence of monopolistic enterprises has exacerbated income inequality. The dual track system in pension and household registration has also widened the income gap. Implications of a larger income gap include: a greater number of low income earning Chinese citizens unable to contribute to China's economy, which may increase the savings rate but decrease the consumption element of GDP, thus exacerbating the imbalance between the wealthy and poor, and between investment spending and consumption spending within China's GDP. This could eventually lead to a deterioration of social morality and give rise to other socio-economic destabilizing factors.

The dual track interest rate system, which still exists in the financial sector, has led to arbitrage activities. Due to the current monopoly in the financial sector, low-cost funding has exited from the conventional banking system and entered sectors with higher funding costs of funding. This is the underlying reason for the formation of the shadow banking system.

In addition, and to a certain extent, the interest rate liberalization in the FTZ will increase the interest rate arbitrage activities between the FTZ and regions outside it. If the capital account is liberalized, then the exchange rate within the Shanghai FTZ will differ from that outside the zone, and the dual track exchange rate system will encourage institutions to transfer funds in and out of the zone, to profit from the difference in exchange rate.

Appendix: Measures for further opening up the six major categories and 18 sub-categories of the services sector in the China (Shanghai) Pilot Free Trade Zone

1. Financial services sector

1) Banking services

- Allows qualified foreign financial institutions to set up foreign-funded banks, and qualified private capital to establish Sino-foreign joint venture banks with foreign financial institutions. When the conditions are in place, limited-license pilot banks will be set up in the pilot zone at an appropriate time.
- Under the premise that the relevant administrative measures are perfected and the effective supervision is strengthened, qualified Chinese banks are allowed to engage in offshore businesses within the pilot zone.

2) Specialized health and medical insurance:

- Set up foreign-funded pilot specialized health and medical insurance institutions.

3) Finance leasing

- No minimum registered capital requirement for single-equipment or single-vessel subsidiaries set up in the pilot zone by finance leasing companies.
- Allows finance leasing companies to engage in commercial factoring business which is related to the principal business.

2. Shipping services sector

4) Ocean cargo shipping

- Relaxes the shareholding ratio restriction on foreign funds in international shipping enterprises which are Sino-foreign equity and cooperative joint ventures. The trial administrative measures are formulated by the relevant authorities of the State Council which oversee transportation affairs.
- Allows non-five-star flag (non-Chinese) ships which are owned or controlled by domestic-funded companies to pilot the coastal shipping business between domestic coastal ports and Shanghai port.

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5) International shipping management:

- Allows incorporation of wholly foreign-owned international shipping management enterprises.

3. Commerce and trade services sector

6) Value-added telecommunications:

- Subject to network information security, foreign-funded enterprises are allowed to operate some of the value-added telecommunication services in specific forms. If it falls outside the scope of current administrative regulations, approval from the State Council is required.

7) Sales and services for entertainment and gaming equipment:

- Foreign-funded enterprises are allowed to engage in the manufacturing and sales of entertainment and gaming equipment. Equipment which has passed the content censorship by the cultural authorities can be sold in the domestic market.

4. Professional services sector

8) Legal services:

- Explores the approach and mechanism for closer cooperation between Chinese law firms and foreign law firms (Hong Kong, Macau and Taiwan).

9) Credit check:

- Allows incorporation of foreign invested credit check companies.

10) Travel agencies:

- Allows qualified Sino-foreign joint venture travel agencies registered in the pilot zone to engage in overseas tourism business excluding Taiwan.

11) Recruitment agency services:

- Allows the establishment of Sino-foreign joint venture recruitment agencies, with the foreign party allowed to hold no more than 70% of the equity. Service providers from Hong Kong and Macau are allowed to set up wholly-owned recruitment agencies.
- The minimum registered capital for foreign-funded recruitment agencies will be reduced from USD300,000 to USD125,000.

12) Investment management:

- Allows the incorporation of foreign-funded joint stock investment companies.

13) Engineering design:

- For foreign-funded engineering design (excluding engineering survey) enterprises registered in the pilot zone that provide services in Shanghai, the investor will be exempted from the requirement for submission of engineering design track record during the initial application for the relevant qualification.

14) Construction services:

- When undertaking a Sino-foreign joint construction project in Shanghai, wholly foreign-owned construction enterprises registered in the pilot zone are not subject to the foreign shareholding ratio restriction in the project.

5. Cultural services sector

15) Entertainment artist agency:

- Removes the shareholding ratio restriction on foreign-funded entertainment artist agencies and allows the establishment of wholly foreign-owned entertainment artist agencies to provide service in Shanghai.

16) Entertainment facilities:

- Allows the establishment of wholly foreign-owned entertainment facilities to provide service in the pilot zone.

6. Social services sector

17) Educational training and vocational skills training:

- Allows the setting up of Sino-foreign cooperative joint venture educational training institutions.
- Allows the setting up of Sino-foreign cooperative joint venture vocational skills training institutions.

18) Medical services:

- Allows the incorporation of wholly foreign-owned medical institutions.

Note: The opening up measures above are applicable only to enterprises registered within the China (Shanghai) Pilot Free Trade Zone.

Part II:
Industry Analysis, Foreign Direct Investment into China

Financial Services

Foreign financial services companies showing continued interest in China's insurance market[1]

In the third quarter of 2013, The BNP Paribas Cardif SA Group of France agreed to acquire a 50 percent interest in ING BOB Life Insurance Co Ltd, from ING Insurance. The ING BOB Life Insurance is an insurance agency and a 50/50 joint venture between ING Insurance International BV and The Bank of Beijing; it operates eight branches in seven provinces and municipalities in China, offering savings and protection products.

ING has been divesting its insurance and investment management businesses to reimburse the Dutch government for the Euro 10 billion assistance it received in 2008. The selling of ING's investment in ING BOB is part of ING's divesting strategy across Asia. However, these divestitures have been occurring in other countries around the world: in April, ING South Korea agreed to sell its 49 percent stake in life insurer KB Life Insurance, to its joint venture partner KB Financial Group, while ING India also agreed to sell its 26 percent stake in ING Vysya Life Insurance.

China's market for inbound foreign insurance companies has been particularly difficult in the past few years. Market share recently dropped from its peak level of 8.9 percent in 2005, to 4.9 percent as of May 2013. Yet, as foreign insurance company market share declined, the share of commercial or investment bank companies with insurance subsidiaries rose from 0.8 percent in 2011, to 1.4 percent in 2012. Insurance companies, with banks as a major shareholder or parent company, may be able to gain a competitive advantage in the market partly due to their ability to withstand greater macroeconomic volatility. For BNP Paribas, this represents an opportunity to grow its insurance business across Asia, backed by its investment banking unit.

Sources: (1) http://www.otcmarkets.com/news/otc-market-headline?id=15260743

Healthcare

China's medical devices market continues to gain government support, foreign investor interest[2]

The Ministry of the Pharmaceutical Industry has mentioned special support plans for medical devices and equipment companies in 2013. The medical device and equipment market is also mentioned in China's 12th Five-Year Plan, and has been occupied by, and a major interest of, foreign players and private equity companies for quite some time now. And while foreign investment opportunities are becoming more popular in China's healthcare industry, the market for servicing and repairing quality medical devices is still wide open to outside investment. Private equity, investment firms, and other medical device providers are viewing this as opportunity by committing investment to expand the service element of the medical devices industry in China.

Servicing medical devices in China remains a top opportunity for foreign investors, but also a steep challenge. According to Baird Capital, "many US and European healthcare instrument and equipment makers are finding it very difficult to provide the kind of quality maintenance service and spare parts to hospital customers across China."In the third quarter of 2013, Baird Capital, the private equity arm of Robert W. Baird in the US, partnered with local Chinese medical equipment services provider Kedu Healthcare. Kedu is a medical device servicing and repair provider, has a broad network of more than 400 service and sales engineers across China, and has installed more than 23,000 pieces of equipment in more than 10,000 hospitals across China. Kedu represents not only a compelling solution to the services and parts maintenance problem in China, but an expert and trusted partner to large OEMs as well.

Medical devices in China account for only 10 percent of the pharmaceutical market revenues, yet in developed markets they represent around 50 percent of the total source of healthcare revenue. Based on government support of healthcare and medical device industry, one could expect foreign investment in medical device servicing to increase.

Energy

China announces new policies to support renewable energy[3]

On August 31, 2013, The National Development and Reform Commission (NDRC) announced new policies to ramp up support for renewable energy products, in a bid to curb air pollution. The NDRC issued new subsidy standards for distributed solar power generation projects, such as photovoltaic power (PV) projects. The policy stipulates an RMB0.42 (USD0.7) subsidy for every kilowatt-hour of electricity produced by photovoltaic, or PV power units. This represents a first-of-its-kind policy, as PV units were previously subsidized on a project-basis only. The government will also lower the price of the power generated by some PV stations and the policy will be applied to projects registered after September 1, 2013.

This new policy will likely be a boost to China's overall PV industry, "as China not only plans to provide incentives for power plants that reduce air pollution emissions, but also punish those that fail to reduce air polluting emissions", said Li Caihua, who is an official with the NDRC. The NDRC also emphasized that power producers' costs will not increase significantly, despite the fact that other energy prices such as gasoline and diesel continue to climb. The effects of these policy statements seem to be attracting more activity in the PV industry.

One PV industry first is the multinational energy conglomerate, Total Corporation. In the third quarter of 2013, the multinational energy conglomerate began to invest in China's first solar PV plant project. Although this is Total's first time into China's PV market, it aims to advance the layout of the PV industry in China. Citing China's extraordinarily large market potential and government support, senior management at Total Corporation is optimistic about the PV market's growth opportunities. They expect the PV market to exhibit and maintain double digit growth from 2013 until 2017, and hope to reap further benefits of government subsidies in the PV industry.

Natural Resources

China continues its support for foreign businesses in waste and water management[4]

In the past few years, China has taken a number of steps to improve environmental conditions. One of the ways it is doing so is by cleaning up its water resources. China's government has introduced policies in the past few years, and has given support to activities and investment that will enhance its ability to produce cleaner water, energy, and other natural resources. One of the ways China plans to clean up its water resources is with the introduction of its 'go green' environmental policies.

The increasing standards for China to go green have created vast opportunities for companies seeking to profit by helping China achieve this goal. Individual provinces and cities have now begun rolling out plans and strategies to encourage the development of waste and water treatment. Among the most appealing aspects of China's waste and water treatment sector is its remarkable degree of openness to foreign investment. Since introducing policy initiatives in China's 11th Five-Year Plan (2006-2010), and reiterating ongoing support for cleaner water and resources in China's 12th Five-Year Plan (2011-2015) in 2011, China has seen a number of foreign firms enter and aggressively compete for expansion opportunities in this industry.

In the third quarter of 2013, Singaporean energy and water provider Sembcorb announced the expansion of its water business in China's Liaoning province with two new waste water treatment projects in industrial parks in Panjin city. Sembcorp has been operating in China for the past 20 years, and its presence spans across 15 provinces. Sembcorp is committed to serving China with its strong emphasis on environmental protection, in accordance with China's 12th Five-year Plan. Sembcorp also plans to develop an industrial wastewater treatment plant with an initial capacity of 22,000 cubic meters per day to serve customers in the industrial park. The plant will be capable of treating highly concentrated industrial wastewater, and is expected to cost around RMB185 million. It is targeted for completion by the first quarter of 2015.

Sources: (2) http://www.rwbaird.com/ab/news/baird-news/article.aspx?ID=yaK2sb9bJj6jk84N5t3MPV9flHPbpBI9
(3) http://www.best-news.us/news-4946349-Total-multinational-energy-companies-to-accelerate-China-39s-PV-industry-layout-Adversity.html; http://bbs.isvoc.com/38581.html; http://news.xinhuanet.com/english/business/2013-09/31/c_132678835.htm
(4) http://www.sembcorp.com/en/news-detail-print.aspx?NewsId=1012#; http://rightsite.asia/en/article/investment-opportunities-china-wastewater-treatment; http://www.ccchina.gov.cn/WebSite/CCChina/UpFile/File1324.pdf

Logistics

Foreign investment in China's logistics sector is set to be flourish amidst exponential expansion of domestic consumption as well as fresh opportunities in Shanghai's Free Trade Zone[5]

In August, The Carlyle Group, a global asset management firm, and Townsend Group, a US premier real estate investment management service provider, announced a strategic partnership with Shanghai Yupei Group, one of the largest Chinese logistics warehouse developers, to invest a total of USD400 million in 17 warehouses in China. The warehouses will be leased to retailers and e-commerce companies and located in major logistics hubs across China including Shanghai, Beijing, Guangzhou, and other second-tier cities such as Shenyang, Tianjin, Chongqing, Zhengzhou and Hefei.[6] Backed by government policy that puts greater focus on China's consumption-driven economy, more foreign investors are expected to speed up corporate acquisitions and warehouse constructions to expand geographical coverage in China's logistics sector.

In addition, the establishment of the Free Trade Zone in Shanghai will further encourage trade and boost the shipping and logistics sectors. The government is going to alter certain laws and administrative approval measures for foreign investment in the Free Trade Zone to help ease access to markets.[7] It is also reported that some tax incentives may be offered to lure foreign companies to set up offices and warehouses in the zone.

Foreign companies in the transportation and logistics sector stand to benefit from China's logistics market opportunities and favorable policies, however, foreign companies still face stiff competition from local competitors. These local players are able to take advantage of closer local government relationships, more cost effective operations, and well-connected local employees. Possible strategic advantages foreign companies may include: running an in-depth localization program, investing and expanding in inland China provinces (also supported by the central government), aligning with domestic players and industry leaders, and recruiting provincially-based graduates and local talent.

Manufacturing

China remains competitive manufacturing base while some foreign manufacturers moved out and relocated to Southeast Asia[8]

Recent reports show quite a few foreign manufacturing companies have moved their orders or production lines out of China and into neighboring Southeast Asian countries. This has raised debate that whether China has lost edge as world's factory. In recent years, the average income in China has steadily gone up as China's labor cost has grown by over 60 percent since 2009. However, Vietnam's labor cost is 40 percent of that in China, while in Bangladesh and Myanmar labor costs are as little as one-fifth of China's labor cost.[9] Other factors are also contributing to foreign manufacturers' profit decline in China, such as: the appreciation of the Renminbi, variability of various local tax rates, stricter regulations on environment protection, as well as government's policies towards a more service-based economy.

In addition to cheaper labor cost, some Southeast Asian countries have put more effort into attracting foreign investment, such as lowering or exempting import tariffs on equipments required by manufacturing activities. However, unsettled political situations, undeveloped infrastructure, unskilled workers, incomplete industry chain systems, and a smaller domestic market in the Southeast Asian countries remain the biggest concerns for foreign investors.

Throughout the years, foreign manufacturers have formed relationships with the Chinese government and customers while operating in China. Some foreign manufacturers said they would keep close observation on both China and Southeast Asia and they would like to stay in China if operation costs do not inflate to unsustainable levels. Meanwhile, China continues to introduce favorable policies for high-end and value-added manufacturing. These policies, along with China's immense population, continue to drive foreign sentiment in regards to operating locally within China's market.

Real Estate

Commercial property market attracts greater attention from foreign investors[10]

Over the past three quarters, foreign investors have sped up their investments in China commercial real estate. As of August 31, 2013, land transfer fees in Shanghai have reached over RMB100 billion, and foreign investors were the primary contributors. Recent deals include: The Blackstone Group recently acquired Tysan Holdings Ltd. in an effort to expand its business coverage in China. In addition, Century Bridge Capital also injected USD44.4 million to set up a joint venture with Coastal Greenland Ltd. for the purposes of investing in middle class residential property in Wuhan.

Commercial property is gaining favor as of late, due in part to the heightened policy risk and restricted market of residential real estate. A market shift is occurring whereby residential real estate is no longer the first choice of foreign investors. Foreign investors are now turning to more diversified targets and market segments and that includes commercial property. Another reason for the shift is primarily due to the expected rate of return on property in China's largest cities, Beijing and Shanghai. The actual office building rate of return in these cities is between 8 and 12 percent, higher than the 5 percent average of comparable global cities.[11]

The commercial property market should continue to benefit from ongoing market dynamics specific to expected rates of return and future policy trends, which should also promote further cooperation between foreign investors and domestic market players. The likely benefactors include: logistical warehouses, office building, hotels, and shopping malls.

Sources: (5) http://cn.wsj.com/gb/20130904/bog142915.asp; http://www.bloomberg.com/news/2013-08-23/chinese-ports-hotels-rally-on-free-trade-zone-shanghai-mover.html
(6) http://www.chinadaily.com.cn/cndy/2013-02/04/content_16197275.htm; http://www.carlyle.com/news-room/news-release-archive/carlyle-group-and-townsend-group-invest-us200-million-strategic
(7) http://www.eeo.com.cn/2013/0917/249926.shtml
(8) http://finance.sina.com.cn/china/20130821/140816518005.shtml
(9) http://finance.sina.com.cn/stock/t/20130813/202916444429.shtml
(10) http://www.scmp.com/business/money/markets-investing/article/1310466/foreign-funds-return-china-real-estate-market; http://gegu.stock.cnfol.com/130829/125,1332,15876614,00.shtml; http://finance.qq.com/a/20130819/013529.html
(11) http://www.cnr.cn/hxcx/gdxw/201308/t20130807_513257241.shtml

Private Equity (PE)

Sequoia Capital makes a strong play into China's financial internet terminals[12]

In September, American private equity (PE) company Sequoia Capital made additional capital investment into Cardniu, a mobile internet and high-technology innovation company. Cardniu is a newly incorporated internet credit card management application, developed by Feidee.com. The application is designed to collect short messages from banks to capture the credit card consumption behavior in order to help customers to better record their expenses and manage their credit card account. Cardniu's aggregate user base has reached 20 million accounts, while total active users are approximately 600,000 (3 percent user efficiency). According to Sequoia Capital, its total accumulated investment in Cardniu has reached about USD10 million, and the investment will further fund research and development expenses to advance systematic function and ease-of-use services. This follows previous Sequoia Capital investments in other Chinese financial and technology projects such as: Noah Wealth, PPDai, Mo9, and Rong360.

The seed investment by Sequoia Capital represents lofty future expectation for Chinese financial internet terminals, and specifically the expectation for Cardniu's future. Cardniu's already large user base and efficient development speed helped increase investment demand. Yet, despite Cardniu's large user base, its main developmental obstacle will be how it plans to setup a commercialization model to capture ongoing revenue streams, as well as how to create more predictable user demand for their product. The potential to briskly grow its 'active' user base, and its ability to efficiently utilize R&D funds to improve functionality will determine the future investment plans for Sequoia Capital. The current trend supports a solid foundation for further growth and development at Cardniu.

Technology and Machinery

Hi-tech multinationals continue to expand investment in China, eyeing southwest China as a strategic area[13]

On August 26, Singapore manufacturer Flextronics International Ltd. announced that it launched a second round of investment to build its world-class machinery facilities in Chengdu, Sichuan province. It completed the first round of investment two months prior to the end of August and its new plant is slated to begin operations in the first quarter of 2014. The first round of financing focused on manufacturing high-precision injection moulds for electronic equipment such as smart phones and PC tablets, while the second round aims to build facilities for metal stamping, as well as machinery and mechanical assembly services for renewable energy and related products. The total plant area covers approximately 23,000 square meters, and is part of the government's go west strategy and progressive policy to continue developing high-technology and renewable energy products in second and third tier cities/regions of China.

Flextronics has long been known for its industrial strength in electronic manufacturing services (EMS). However, EMS industries in China may be facing further issues related to rising labor costs, automation difficulties, the cost of upgraded machinery, and increasingly competitive markets. For these reasons, Flextronics recently decided to reallocate resources from its traditional 3C business (computer, communication and consumer electronic), and further invest in businesses such as: auto parts, aerospace equipment, and medical devices and other high-end equipment. These high-end EMS have the potential to bring higher added value, which should help Flextronics lower its operational risks related to increased cost for upgraded equipment and steadily rising labor costs.

Other leading EMS market players, such as Foxconn and Jabil Circuit, are following the trend of strengthening their product line in China towards high-end equipment. Jabil recently invested RMB620 million to built robot-related industries in Jiangsu Province and entered the plastic production market via local acquisition in the first half of 2013, while Foxconn announced the restructuring of its business groups and applied for a 4G license to expand its network communication layout. Given the higher labor costs in China, and the government's support for high-technology, it would be likely to see more activity in high-tech manufacturing.

Automotive

Daimler Announces EUR2 billion China Expansion[14]

In August, Daimler AG announced that it planned to invest approximately EUR2 billion to improve the production capacity of its China joint venture, Beijing Benz Automotive, over next couple of years. The carmaker will set up its "first fully fledged engine factory outside Germany" in China, which is expected to export engine parts back to the company's German factories.

Daimler hopes that the increased localization level will support its expansion in China. Currently, the company is facing fierce competition from China's burgeoning luxury car market, and has lagged behind its major rivals. According to media reports, sales of Mercedes-Benz rose 3.5 percent year-on-year in China, during in the first seven months of 2013, while BMW's sales rose by 18 percent in the same period. Insufficient local production capabilities have long been blamed for Daimler's moderate China growth. In 2012, Mercedes-Benz sold 206,000 cars in the country, of which more than half were imported from overseas, bearing higher prices. BMW and Audi, on the contrary, have achieved much better localization rates, which give them considerable cost advantages.

The establishment of an engine factory is an important step for Daimler's China localization plan. When Daimler's China engine factory begins operations, it will be able to export critical engine parts back to Germany, which means that the quality level of Daimler's China joint-venture will depend solely on the plant, design, and equipment from Germany. The first-class quality, combined with reduced costs brought by localization, should enhance the competitive positioning of the company versus rival luxury manufacturers in the world's largest auto market.

Retail

International retailer Tesco commits to JV in China[15]

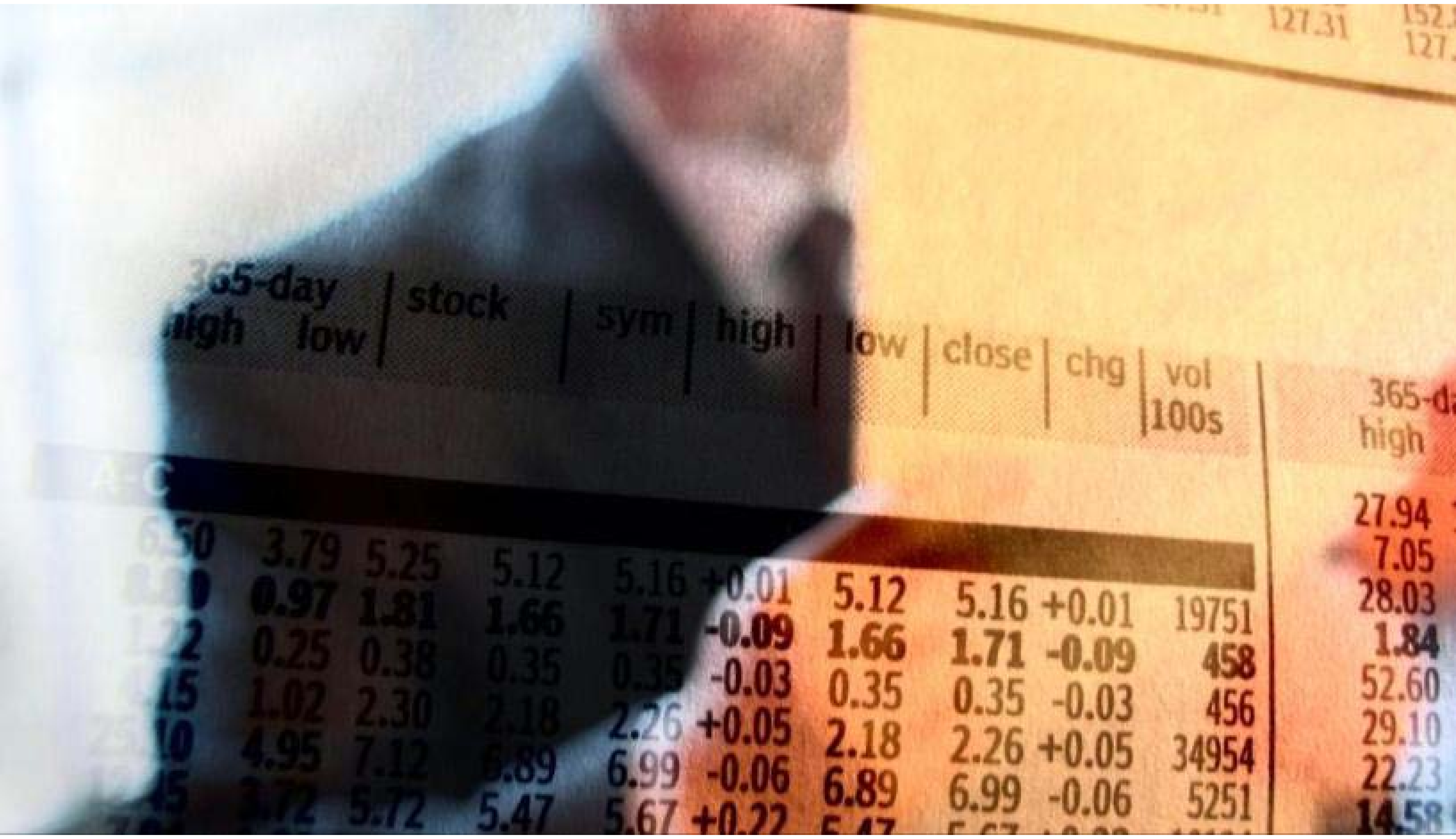
UK retailer Tesco and China Resources Enterprise signed a memorandum of understanding in August, agreeing to merge their Chinese retail operations to create a leading supermarket chain in the country. The proposed joint venture, combining 2,986 stores operated by China Resources Vanguard with 131 Tesco China stores, is expected to generate over USD15 billion

Sources: (12) http://news.chinaventure.com.cn/11/7,11/1379227645.shtml
(13) http://news.163.com/13/0731/03/9536F7GN00014Q4P.html; http://stock.sohu.com/20130320/n369476469.shtml; http://www.yicai.com/news/2013/08/2963904.html; http://news.hexun.com/2013-07-17/156237987.html
(14) http://www.ft.com/cms/s/0/29ecaef0-0efc-11e3-ae66-00144feabdc0.html; http://www.caam.org.cn/guojijiaoliu/20130829/1005099937.html
(15) http://news.163.com/13/0910/19/98EFE5Q200014AEE.html

in annual revenue. China Resources would own 80 percent of the venture and Tesco would own the remaining 20 percent.

The signing of the memorandum indicates that Tesco is trying to readjust its China strategy. Currently, foreign retailers have a strong presence in the country's large metropolitan cities, but encounter difficulties when entering second- or third-tier cities. In addition to consumer tastes and preferences, which differ greatly among various Chinese provinces, government policy and local public relations also poses a major challenge to multinationals. However, if the joint venture is executed, it could be a win-win situation for both companies. For example, Chinese Resources' national networks will enable Tesco to gain greater access to second- and third-tier cities, offer insights and preferences of the Chinese consumer, provide a better understanding of China's regulatory landscape, and offer well-developed connections with local suppliers. Meanwhile, Tesco's influence in first-tier cities could help China Resources increase its shares in larger markets, as well as its brand value. Moreover, the UK retail giant could contribute international retail knowledge, global sourcing scale, and supply chain capabilities that China Resource could leverage from future overseas investment possibilities.

Joint venture risks are also prevalent to both companies. Most evidently, Tesco is a western multinational company, while Chinese Resources is a State-owned conglomerate. Thus, in terms of business philosophy, management methods, and culture, there may be vast differences between the two companies. As witnessed from less successful foreign multinational/China integrations, careful attention should be paid towards synthesizing the cultural and managerial differences between the two parties.



Part III: Overview of Foreign Capital Utilization[16]

A general overview of China's utilization of foreign capital

Through the first three quarters of 2013, total foreign direct investment (FDI) into China was USD88.6 billion, up 6.22 percent year-on-year. China's service sector attracted the majority share of FDI, at 50.5 percent totaling USD44.7 billion, increasing by 13.3 percent year-on-year, and increased its allocation percent from 49 percent of the total FDI in the second quarter of 2013. China's manufacturing sector attracted USD35.5 billion, down 3.96 percent from a year earlier, or 40 percent of total FDI. The manufacturing sector experienced a 2 percent decrease in its allocation percentage from the second quarter of 2013, which further evidences a shift in FDI from manufacturing to services. 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 nine 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 FDI in the final three months to continue its steady growth". In comparison, China's outbound direct investment (ODI) totaled USD61.6 billion, an increase of 17.4 percent year-on-year. Although total ODI was still less than total FDI, ODI growth continued to outpace FDI growth.

The eastern region of China once again reigned as the largest regional recipient of FDI, totalling USD74.2 billion, accounting for 83.7 percent of the national total, and growing by 5.63 percent year-on-year. The central region utilized USD7.8 billion of foreign capital, representing 12.29 percent year-on-year growth, while accounting for 8.85 percent of the national total. The western region of China continued to attract foreign investment as well, receiving USD6.6 billion, accounting for 7.4 percent of the national total, growing by 6.07 percent year-on-year. The eastern region produced solid year-on-year FDI growth, but 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 by 23 percent through the first nine months of 2013, to USD5.94 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. Now, through the first, second, and third quarters of 2013, EU FDI investment has been flowing back into China, and has been 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 21.3 percent through the third quarter of 2013, while FDI from the top 10 Asian economies, including Hong Kong, Japan, and Singapore increased by 7.47 percent year-on-year.

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 336 announced or completed transactions totaling slightly over USD25 billion of M&A activity. Thirty countries and regions invested in China year-to-date, while a substantial majority of total M&A investments came from Hong Kong (approximately 170 total deals worth over USD11 billion). The Europe Union accounted for the second largest amount of M&A activity (59 deals worth approximately USD5.67 billion). The US had the largest average deal size (excluding countries with less than 10 deals), totaling 26 deals worth over USD2.5 billion. Deals originating from Hong Kong were spread across multiple industries, primarily targeting China's real estate, high technology, healthcare, and energy and power industries, while deals from the US were primarily targeting the healthcare/biotech and high-technology industries.

The two sectors that received the largest M&A deal flow through the first half of the year were consumer goods and services and real estate, with consumer goods and services also generating the most total transactions (74 transactions). Amongst the top 10 largest M&A deals, three of the top 10 deals were made in China's industrial and manufacturing industry, as foreign companies from Europe were looking to expand their automotive manufacturing capabilities. The largest transaction year-to-date (USD1.3 billion) was an acquisition that occurred in China's energy and power industry during the third quarter.

Sources: (16) Thomson One; MergerMarket; Ministry of Commerce, People's Republic of China

M&A transaction size was also quite variable; M&A transactions were grouped according to the following structure: USD1 billion and above, 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 (one transaction above USD1 billion, and 14 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 is trending higher through nine months in 2013. Consistent monthly growth points to possible record breaking numbers

Going back to January 31, 2013, foreign direct investment into China had declined every month since May, 2012, which included 14 out of 15 of the previous months. Total FDI in 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, the last 8 months have provided a different tone to China's FDI. Foreign investors have seemed to have regained confidence in China's Greenfield and M&A market, and are now committing more FDI into the region. We resume our FDI trend analysis as of September 30, 2013, and identify the current indicators that now confirm our previous optimistic FDI trend, which will likely round out 2013 and break new FDI records that were set in 2011.

Total FDI for the first three quarters of the year posted a robust USD88.6 billion, growing by 6.22 percent year-on-year, which also outpaces the 4.58 percent year-on-year growth exhibited through the first six months of the year. As we pointed out in previous trend summaries, currently there is a structural shift that continues to develop, whereby greater investment and government focus is being given to China's service industry. Service industries that are receiving the largest interest include new energy and power, high technology, healthcare, and consumer goods and services. Through three quarters, China's service industry continued to post impressive FDI numbers, receiving USD44.7 billion in FDI, gaining 13.28 percent versus YTD Q3'2012. The service industry allocation continued to increase as a percentage of total FDI, to 50.5 percent, up from 49 percent in the first half of the year. 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 products, and food and beverage service sectors. While Hong Kong and Singapore continued to show interest in China's real estate (services), high technology, consumer goods and services, and energy and power sectors.

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 continued to retreat through the third quarter of 2013. Manufacturing inflows for the first half totaled USD35.5 billion, decreasing 3.96 percent from a year ago. The manufacturing industry's market share as a percentage of total FDI also declined to 40 percent through three quarters, down from 42 percent in the first half of the year. 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.

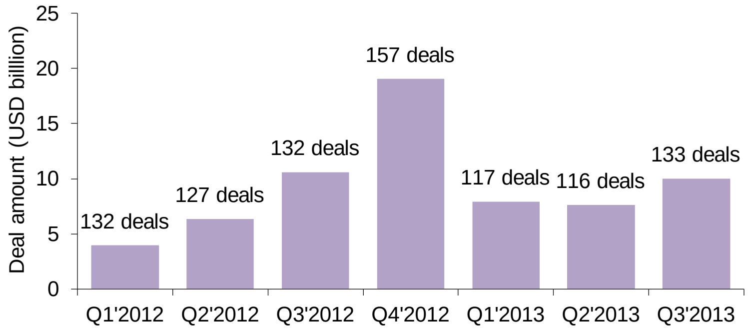
It would also be useful to examine first half trends by looking at individual monthly results. In the first quarter, January FDI declined by 7.3 percent year-on-year. However, February and March posted robust single digit gains of 6.3 and 5.7 percent respectively. In the second quarter, April and May 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. It took only one month to best that record statistic; China's FDI flows increased by 24 percent in July, and continued to modestly increase in August (0.62 percent), and post decent growth in September (4.88 percent). The moderate to high growth statistics now seem to be a recurring theme for FDI, and the lack of negative growth (or substantial volatility) suggests that FDI growth trends are here to stay for the short- to medium-term. China has now posted eight straight quarters of FDI growth. It would be reasonable to conclude that FDI will continue to grow, but that also depends on the health and stability of the global economy, as well as the continued attractiveness of the Chinese market and its government supported industries. If the global market continues to grow, and China's service industry continues to develop, one could expect China's FDI to continue to grow beyond the goal set by China's central government at USD120 billion.

M&A deals overview

Year-to-date overview: There were a total of 366 'announced' or 'completed' inbound M&A deals through Q3 2013, versus 391 deals through the third quarter of last year. Year-to-date M&A deal flow into China was USD25.63 billion, which compares favorably to USD21.02 billion received through the three quarters in 2012. Although the total number of deals declined year-on-year, the total investment amount of inbound M&A deals increased by approximately 22 percent. In regards to outbound domestic investment (ODI), there were 316 announced or completed deals through the first three quarters of 2013, versus just 193 through the first three quarters of 2012. In addition, outbound M&A deal value greatly expanded, totaling USD55.65 billion through the first three quarters of 2013, versus USD43.84 billion through the first three quarters of 2012. This represents an increase of approximately 26.94 percent year-on-year.

Quarterly overview: There were a total of 133 deals in the third quarter of 2013, versus 132 deals in the third quarter of 2013. Both the number of deals and M&A investment amount was relatively flat in the third quarter, compared to the same quarter last year. Q3'2013 deal amount was slightly above USD10 billion, while clearing USD10.5 billion in the same period last year. Both Q3'2013 and Q3'2012 exhibited hefty percentile increases over the previous quarter, with Q3'2013 deal amount up by over 30 percent versus the second quarter of 2013. After adjusting for extraordinary deals[17], the last six quarters produced a deal average of approximately USD8 billion. M&A deal flow for the first, second and third quarter was USD7.97, USD7.6 billion, and USD10.01 billion respectively, exceeding the average quarterly deal size by USD0.5 billion. If the past year is any indicator of future deal flow, then deal flow would be expected to increase further in the fourth quarter of 2013.

Figure 3.1 Quarterly deal summary

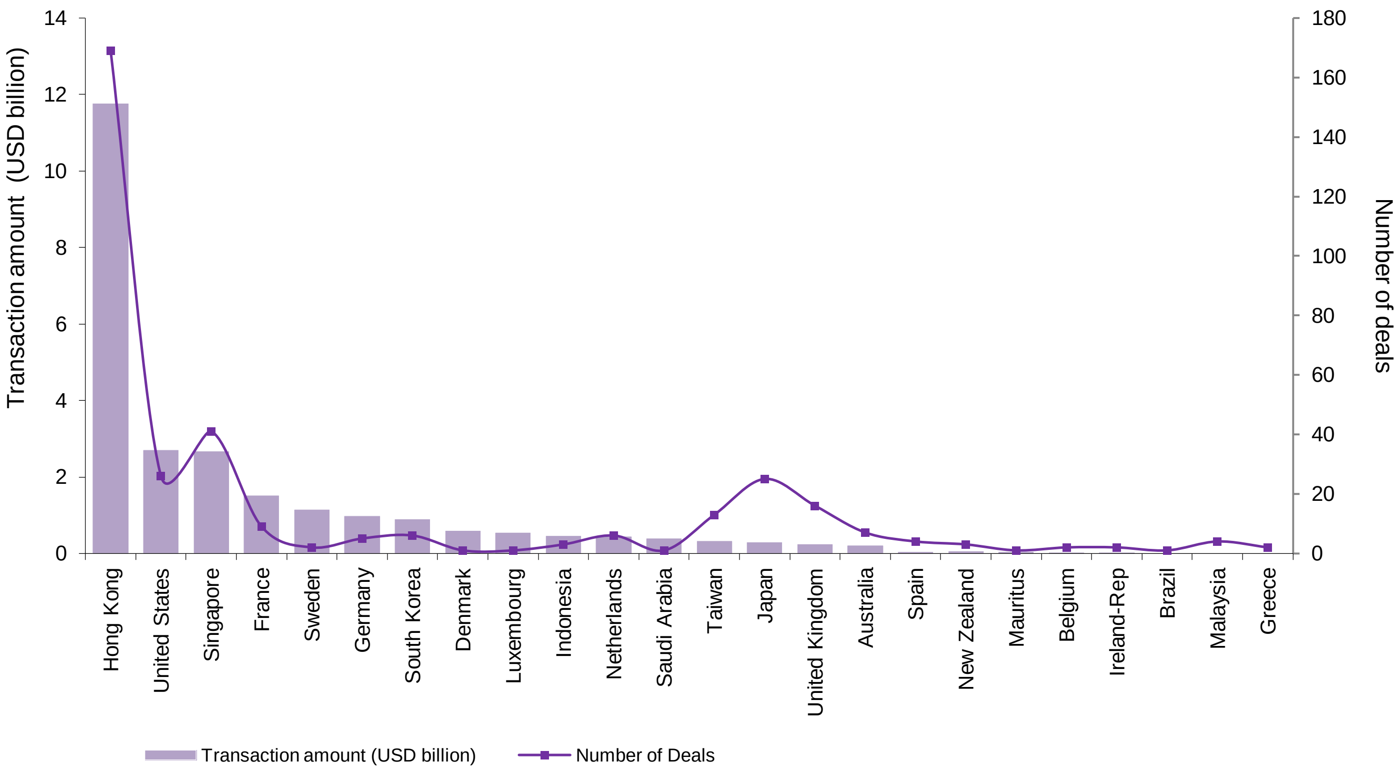


Sources: Thomson One; MergerMarket; KPMG analysis

M&A regional analysis

Through the third quarter of 2013, a total of 30 countries and regions (22 listed in figure 3.2 below) invested in China companies, via inbound M&A. These M&A transactions primarily originated from Hong Kong, the US, Singapore, and a select few EU countries. As shown in Figure 3.2, Hong Kong engaged in more deals than any other country – nearly 170 deals in the first three quarters, totaling over USD11.7 billion – for an average deal amount of USD69 million. The US engaged in only 26 deals during through the first three quarters, totaling over USD2.7 billion, for an average deal amount of USD104 million. The US average deal size was far greater than any other regional acquirer with 10 or more deals. Singapore was second only to Hong Kong in total number of deals, engaging in 41 transactions, while investing USD2.6 billion into China through the third quarter. Comparatively there were a total of 60 countries and regions that were recipients of outbound M&A investment from China through the third quarter. The largest region was North America, receiving USD13.5 billion from China.

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



Sources: Thomson One; MergerMarket; KPMG analysis

Source: (17) 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 66 percent of YTD M&A activity (USD16.88 billion) and 72 percent of the total number of deals (264 deals). Hong Kong, Macau, and Taiwan accounted for the lion's share of YTD Asian M&A investment (USD12.1 billion and 183 deals).

The Europe Union accounted for the second largest amount of M&A activity (USD5.67 billion). Key countries include: Sweden and its investment of USD900 million in Dong Feng Commercial Vehicles; France and its investments of USD843 million and USD631 million in Magic Holdings and Tian Ping Auto Insurance respectively; Germany and its investment of USD873 million in BAIC Motors; Denmark and its investment of USD600 million in Chongqing Brewery Company. These five deals accounted for over 67 percent of all deals originating from the EU. North America was third, deals originating from the US contributed the majority amount of North America deals (USD2.72 billion); Canada participated in a few M&A deals, but the deal sizes were significantly smaller.

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

Region	Transaction amount (USD million)	Number of transactions
Global	**25,613**	**366**
Asia	**16,882**	**264**
HK, Macau, Taiwan	12,100	183
Southeast Asia	3,174	49
Japan & South Korea	1,208	31
South Asia & Middle East	400	1
America	**2,742**	**30**
North America	2,720	29
Central, South America	22	1
Europe	**5,666**	**59**
EU member countries	5,666	56
Non-EU member	-	3
Oceana	**269**	**10**
Africa	**54**	**3**

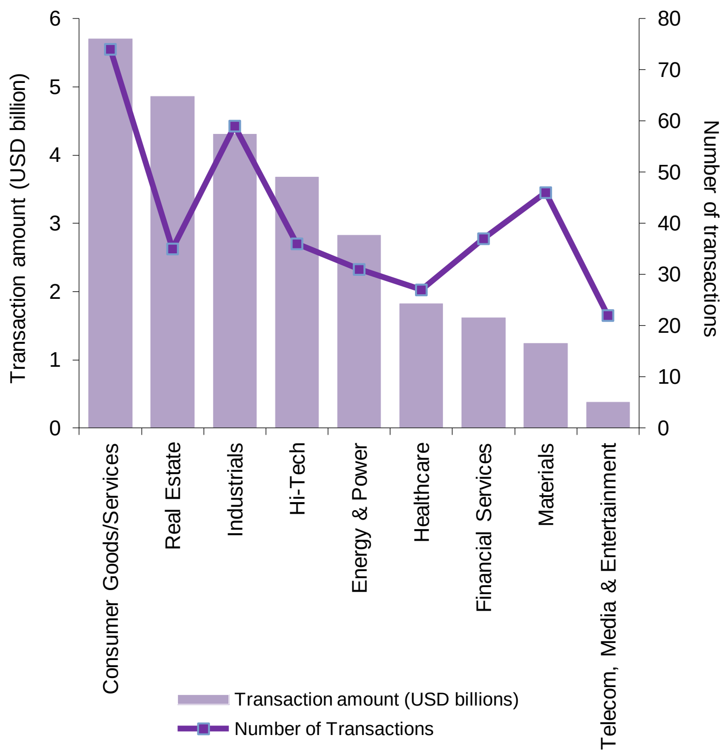
Note: This is an analysis of 'announced' and 'completed' inbound M&A transactions sourced from Thomson One Banker and MergerMarket. Total announced and completed merger activity may differ significantly from what the Chinese government counts as total 'foreign direct investment', as per their Q1 2013 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 three quarters of 2013. These industries represent the target firm, not the purchasing firm, as purchasing firm industries may differ significantly. As of September, 2013, the industry that received the largest inbound M&A deal flow as well as the greatest number of deals was 'consumer goods and services', followed closely by 'real estate'. The consumer goods and services industry was the recipient of USD5.71 billion through the first three quarters; it had 74 deals pending or completed by September 30, 2013. This reflects central government's support for developing the services industry in China and shifting from an investment and net export-driven economy, to one that is driven more by consumer spending. The consumer goods and services industry was the focus of M&A investment for regions such as Hong Kong, the EU, and the US. Within consumer goods and services, sub-sectors of interest include: retail products, food and beverage, textiles and apparel, hotels and lodging, as well as the professional services sector. All of these sectors should continue to receive significant government support, and external investment interest in the short- and long-term. The deals of note were L'Oreal AG (France) USD873 million acquisition of Magic Holdings International in the third quarter, and Carlsberg AG's (Denmark) USD600 million acquisition of the Chongqing Brewery Company in the first quarter.

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

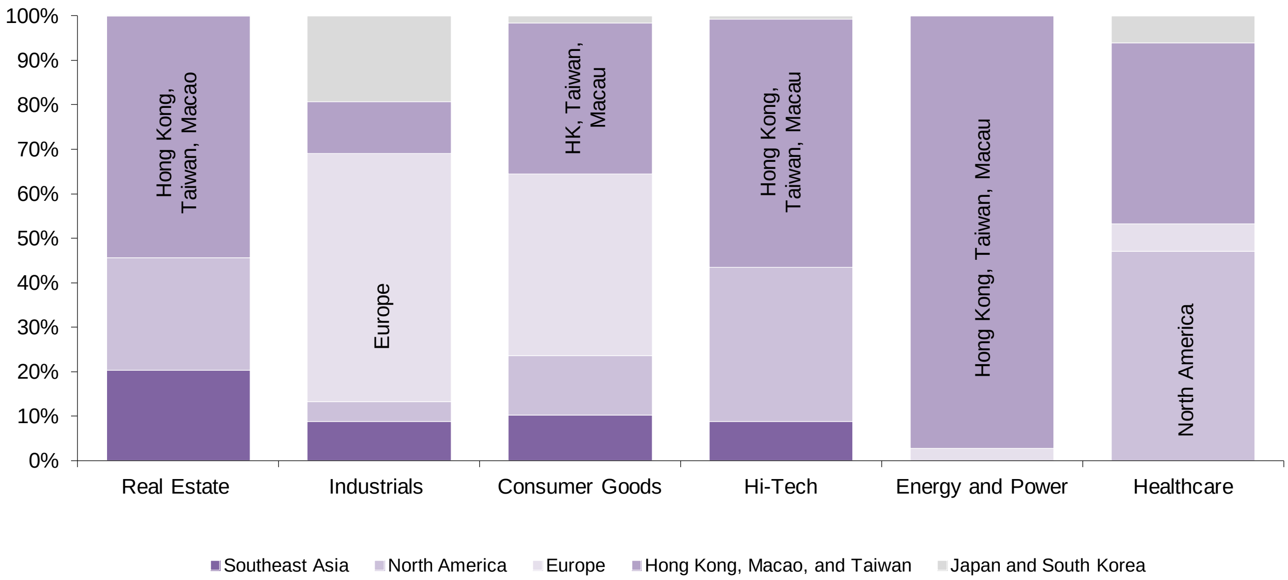


Sources: Thomson One; MergerMarket; KPMG analysis

The 'materials' industry also provides interesting analysis, not because of the size of its transactions, but because of the total number of transactions. Sub-sectors include: construction materials, chemicals, and metals and mining. Through the first nine months of 2013, the materials industry received approximately USD1 billion from external investors, but reported 46 announced or completed deals, which ranks third in number of transactions, but second to last in transaction amount. Reasons for this distinction include: 1) many deals that 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) firm industry, not the foreign firm industry. Through the first three quarters of 2013, 'consumer goods and services' received the largest amount of M&A investment (see figure 3.3). Not only did it receive the largest amount of foreign interest, but transactions were sourced from a number of diverse locations/regions including, but not limited to: Hong Kong, Europe,

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



Sources: Thomson One; MergerMarket; KPMG analysis

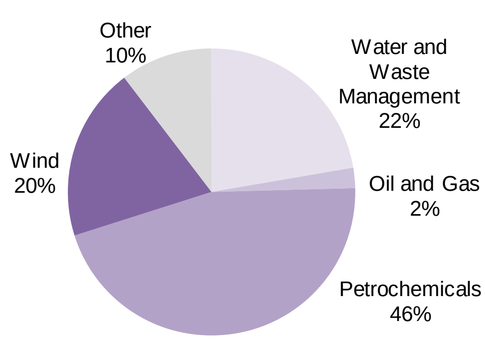
Southeast Asia, and the US. China should expect to see more FDI flows from diverse locations due to the government's support for developing the consumer goods and services industry in China. The largest M&A contributor towards consumer goods and services was Europe (USD2.32 billion).

In addition to consumer goods and services, the high technology and healthcare industries are also supported by China's central government. The majority of hi-tech transactions came from Hong Kong, Macau, and Taiwan (USD1.28 billion), followed by North America (USD758 million). Healthcare was equally diversified between the two regions, with North America leading the way completing USD838 million worth of M&A transactions through three quarters, followed closely by Hong Kong, Macau and Taiwan with USD734 million. Real estate M&A was more dominated by Hong Kong, Taiwan and Macau regions, and almost all transactions in the energy and power industry originated from Hong Kong, Macau, and Taiwan (USD2.73 billion out of USD2.81 billion). Japan and Korea were more focused on industrial M&A investment into China, while Southeast Asia (Singapore mainly) spread investment across a number of industries, including: real estate, industrials, consumer goods, and high technology.

Within the analysis of any industry, we can further drill down into its sub-industries (or sectors) to look more specifically at where foreign investment is flowing. For this YTD quarterly report, and due to the diversity and potential foreign interest of the respective sectors, the energy and power and consumer goods and services industries are broken out into further detail. The results can be seen in figure 3.5 and 3.6 below.

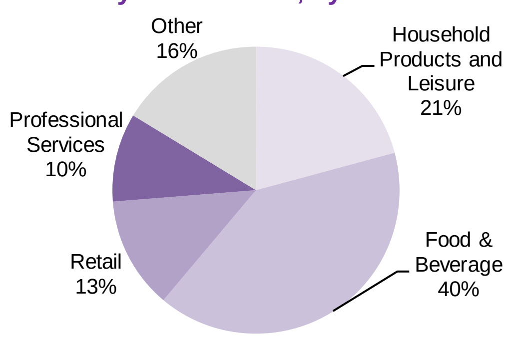
The aggregate development of a cleaner, more efficient energy and power industry is supported by the objectives of China's 12th Five-Year Plan (the Plan). The Plan states that the government supports technological advancements in the energy and power industry, stating that "China will make advancements in strengthening and promoting energy conservation, actively developing hydro and wind power sources, developing nuclear power in a safe and efficient manner, and actively making use of solar energy".[18] Through the first three quarters of 2013, there were a diverse number of transactions that align with the strategy and support of central government initiatives. The largest individual sub-sector within energy and power was the petrochemical industry. However, there was only one transaction in this sub-sector and the transaction was Rising Vast Ltd., a Hong Kong Company acquiring Shiyi Investments for over USD1.2 billion. The other sub-sectors, specifically water and waste management, and wind power both were the recipients of multiple deals that occupied a large minority of inbound M&A investment, in accordance with the Plan and the central government's support.

Figure 3.5 YTD energy and power industry transactions, by sub-sector



Sources: Thomson One, MergerMarket

Figure 3.6 YTD consumer goods and services industry transactions, by sub-sector



Sources: Thomson One, MergerMarket

Source: (18) http://www.globaltimes.cn/content/740169.shtml

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 areas 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 products, household products and leisure, food and beverage products, professional services (such as educational or employment services), and other goods and services (such as 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 nine months of the year were fairly distributed through multiple consumer goods and services sectors. The leading sector was food and beverage; there were a total of 24 deals worth over USD2.3 billion. Consumer goods and services 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.

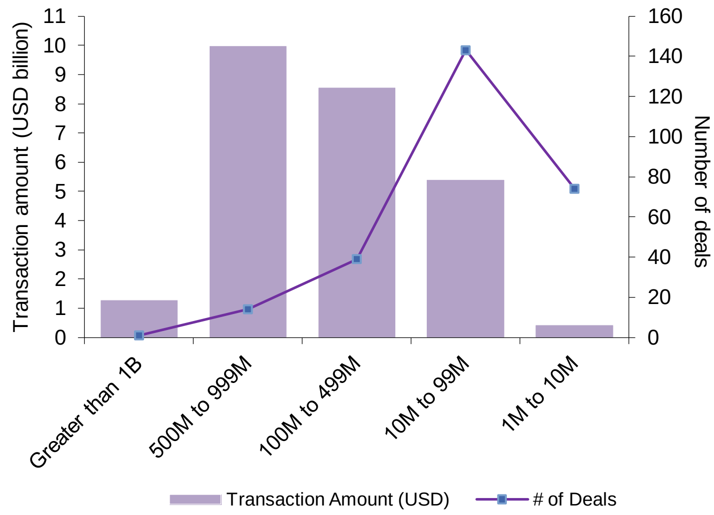
The largest purchase occurred in the first quarter in the food and beverage industry. Carlsberg AG's USD600 million purchase of Chongqing Brewery Company (Food and Beverage) adds to its already substantial 30 percent ownership of the Chongqing Brewery Company. This purchase makes Carlsberg a majority owner of the Chongqing Brewery Company, and further solidifies its strategy of expanding in China.[19]

M&A analysis of transaction size

Figure 3.7 shows M&A transactions for the first nine months of 2013. Through the third quarter, there was 1 deal over USD1 billion, 14 deals between USD500 million and USD999 million, 39 deals between USD100 million and USD499 million, and 47 deals between USD1 million and USD10 million. Most of the deals (143 deals) were announced or completed in the 'USD10 million to USD99 million' range, with financial services, materials, and telecom, media and entertainment (TME) lacking 'substantial' transaction size (see figure 3.3).

Industrials, consumer goods and services, and real estate are three industries that had relatively higher deal value through the first three quarters, 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 hi-tech (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 through 2013 and into 2014, one should expect to see more investment in commercial real estate, 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.

Figure 3.7 YTD transaction amount, by size of transaction



Sources: Thomson One; MergerMarket; KPMG analysis

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. Seven 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 two of the top five deals were located in China's industrials industry. The largest transaction occurred in energy and power industry and also was announced in the third quarter. It is the only M&A deal this year to attract greater than USD1 billion. 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, 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.

Other significant deals include: L'Oreal SA acquisition of Magic Holdings for USD843 million, and Nan Fung Development's acquisition of Sino Ocean Land Holdings. These deals were in the consumer goods and real estate industries respectively, and both were announced or completed in the third quarter of 2013. AB Volvo of Sweden represents the second largest deal in 2013. Volvo bought Dong Feng Commercial Vehicles in the second quarter. The deal is said to strengthen the positions of both Volvo Group and Dong Feng in the mid to heavy-duty truck market, and also make Volvo the world's largest manufacturer of heavy-duty trucks.

Source: (19) http://www.bloomberg.com/news/2013-03-04/carlsberg-offers-to-raise-stake-in-china-s-chongqing-brewery.html
(20) http://www.volvogroup.com/group/global/en-gb/newsmedia/pressreleases/_layouts/CWP.Internet.VolvoCom/NewsItem.aspx?News.ItemId=137906&News.Language=en-gb

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

Rank	Acquiror			Acquiree		Deal value (USD million)
	Acquiror	Industry	Country	Target	Industry	
1	Rising Vast Ltd	Financials	Hong Kong	Shi Yi Investments Ltd.	**Energy and power**	1,289
2	AB Volvo	Industrials	Sweden	Dongfeng Commercial Vehicles	**Industrials**	902
3	Daimler AG	Industrials	Germany	BAIC Motor Co., Ltd.	**Industrials**	873
4	L'Oreal SA	Consumer goods/ services	France	Magic Holdings Ltd	**Consumer goods/services**	843
5	Nan Fung Development Ltd.	Real estate	Hong Kong	Sino Ocean Land Holdings	**Real estate**	808
6	China Public Procurement Ltd.	High Technology	Hong Kong	Fortress Paradise Ltd	**High-technology**	773
7	Stryker Corp	Healthcare	United States	Trauson Holdings Co., Ltd.	**Healthcare**	764
8	Cedar Strategic Holdings Ltd.	Real estate	Singapore	Hua Cheng Group	**Real estate**	748
9	Conglomerate Investor Group	Financials	United States	Pactera Technology International Ltd.	**High-technology**	676
10	WSP OTC Group	Industrials	South Korea	WSP Holdings	**Industrials**	654

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.

cutting through complexity

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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