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Chinese direct investment in the U.S. — The challenges ahead

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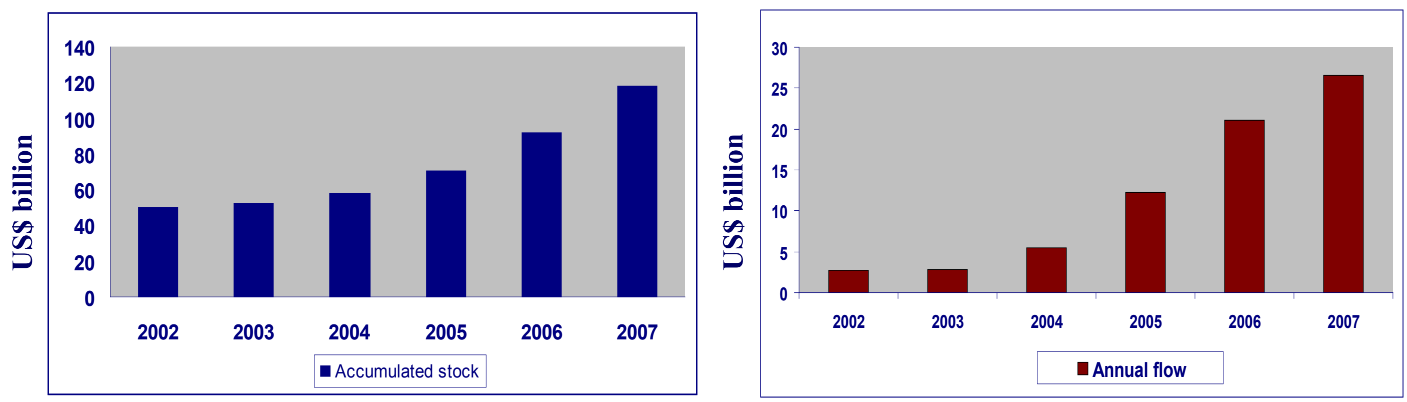
Introduction

Outward foreign direct investment (OFDI) from China is on the rise, and substantially so. In September 2008, China's Ministry of Commerce (MOFCOM) reported that Chinese companies invested a record U.S. $26.5 billion overseas in 2007, up 25% over 2006. Of China's cumulative OFDI of roughly U.S. $118 billion at the end of 2007, US $71 billion (or 60%) has been invested since 2001; it is predicted that annual outflows will rise further in the coming years, reaching U.S. $72 billion as early as 2011.[1]

So far, Chinese investments in the developed economies of North America, Europe and Japan represent a small percentage of the total. For a variety of reasons — not least of which is the use of offshore holding companies — official estimates of Chinese FDI in the U.S. are hard to come by, but a conservative estimate would place the cumulative figure at roughly U.S. $5-7 billion through the end of 2007. Clearly, the less mature markets (and ample natural resources) of neighboring Asia, Latin America and most recently, Africa, have exerted a far stronger pull. Yet as more Chinese companies train their sights on the huge, lucrative markets of the developed world, two major, interrelated challenges will come starkly into relief: building human resource capacity and navigating overseas political environments. The former speaks directly to the readiness of Chinese companies to invest abroad, the latter to the reception they can expect to receive when they get there. Whether a "win-win" situation ultimately emerges will largely depend on how all stakeholders — public and private, U.S. and Chinese — can help Chinese executives mitigate these challenges.

[1] Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (London, UK: The Economist Intelligence Unit Ltd., 2007), available at http://www.vcc.columbia.edu.

Chinese OFDI (2002-2007)



Source: MOFCOM, UNCTAD

Building human resource capacity

At the most basic level, successfully engaging in OFDI is about managing complex, integrated cross-border production systems, consisting not only of parent companies and foreign affiliates but far-flung customers and suppliers as well. This is an extremely difficult task for well-established and aspiring multinationals alike, especially in today's competitive world market. To a great degree, success is predicated on an organization's ability to attract, develop and retain middle and top-level managers with international experience across all key corporate functions. Moreover, these managers need to be able to work in a multi-cultural environment and have a familiarity with the regulatory framework of host countries, how they function politically and the contours of their business culture. Since a substantial portion of Chinese OFDI can be expected to use mergers and acquisitions (M&A) to enter foreign markets (40% of China's OFDI during 2002-2006, according to MOFCOM) , experts in making M&A work will also be in very high demand.[1]

Given their ambitions, Chinese enterprises will need to identify and nurture an entire generation of such managers in very short order. What are the potential tools at their disposal? Chinese enterprises are already adopting a wide range of approaches, from internalizing global best practices for developing human resources to seeking like-minded partners in the external environment. Within their own organizations, senior managers are identifying the next generation of promising managerial talent and increasing their exposure to the most international segments of their business. Once accrued, this experience can be socialized internally, formally and informally, as part of a comprehensive capacity-building program. In addition to growing their own people, the entire process can be accelerated by bringing in individuals with specialized skills and/or global experience, drawing on China's extensive diaspora population as one reservoir of internationalized talent.

Outside the organization, many Chinese enterprises are teaming up with government, academia and other stakeholders with a similar commitment to building China's human capital base. In particular, business schools in China are beginning to embark on intensive efforts to educate internationally-oriented managers — in China itself and in cooperation with well-established programs abroad. Education in the political economy of the U.S., the European Union and other major markets will need to become an important part of the curriculum if Chinese executives are to have the practical knowledge needed to operate effectively overseas.

In any case, this effort at building human resources needs to not only be massive, it has to be fast. Chinese enterprises do not have the time, as their competitors from developed countries once had, to deepen their human resources over years or even decades of experience abroad — they need them now, lest their globalization strategies lead them to make costly mistakes or even failure. Globalization is a highly risky endeavor — second chances for market entry, especially in the United States and other mature consumer markets, are rarely an option. Fortunately, Chinese enterprises have proven time and time again to be exceptionally fast learners.

Creating sustainable value from cross-border M&A

Cross-border M&As can provide Chinese companies with a short-cut to establishing or expanding an overseas footprint (and greatly enhance their competitiveness at home) but they are notoriously difficult to manage. Like their global counterparts, potential Chinese acquirers need to ask themselves five key questions during the deal process if they are to create lasting value from their overseas investments:

- At what point should we walk away from a deal?
- What is an acceptable price to both parties?
- How should the deal be structured?
- Does the deal present a compliance risk?
- How can the acquisition be integrated into the global organization?

Addressing each question is deceptively difficult, requiring specialized knowledge across a wide range of functions, from finance and international tax to compensation negotiation and cross-cultural HR training. These individuals also need to be brought into a rigorous process that not only aims for success at the transactional level but ensures that each individual investment advances the broader strategic goals of the firm. So if their future M&A activities are to generates sustainable value, Chinese companies must make the right human resource decisions today.

[1] Even in the case of cross-border M&A by multinationals from developed countries, many, if not most, are not judged as successes, despite the fact that many of these firms have considerable experience with M&A. A recent high-profile example is Daimler's acquisition (and subsequent disposal) of Chrysler.

Navigating the U.S. and other overseas political environments

Globally, there are indications that the climate for FDI is becoming less welcoming just as Chinese enterprises are appearing on the global stage.[1] In particular, a number of developed countries, including the United States, Japan and Germany, are taking a more cautious approach to cross-border M&A, by far the most important mode of entry into foreign markets by multinationals and increasingly, for Chinese enterprises as well. Particularly since the China National Offshore Oil Company withdrew its bid for Unocal Corp. in mid-2005, cross-border M&A by Chinese firms seem to be attracting special attention, and there is ample indication it will continue to do so for the foreseeable future.

The reasons for this nervous reaction to Chinese OFDI are mixed, but they are largely political in nature. Questions are raised about the governance of Chinese firms and the fear that Chinese acquirers, especially when they are state-owned, may enjoy financing advantages. This is less an issue for the shareholders of acquisition targets than for rival firms competing for the same assets. There is also some concern, especially in Europe, about the ability of Chinese firms to successfully manage cross-border M&A and the implication that any failures would have for host countries, especially in terms of unemployment and the business of suppliers. Most importantly, there is the suspicion that cross-border acquisitions by state-owned Chinese firms are not necessarily driven by commercial motives alone, but are rather the result of political or strategic calculations determined (or at least influenced) by the government that

Chinese M&A activity in the U.S. (2005-2008)

Select deals, by deal size

Date/Deal Status*		Acquirer	Acquirer's Business	Investment (US$ million)	% Acquired/ Sought	Target Company	Target's Business
7/05	W	China National Offshore Oil Company	Oil & Gas	18,500	100	Unocal Corp.	Oil & Gas
12/07	C	China Investment Corp.	Sovereign wealth fund	5,000	9.9	Morgan Stanley Inc.	Investment banking
6/07	C	China Investment Corp.	Sovereign wealth fund	3,000	9.9	Blackstone Group L.P.	Private Equity
5/05	C	Lenovo Group LLC ?	Computers	1,400	100	IBM's PC Division	Computers
6/05	W	Haier America Trading LLC ?	Appliances	1,280	100	Maytag Corp.	Appliances
10/07	W	CITIC Securities Co. Ltd.	Securities brokerage	1,000	9.9	Bear Stearns Cos. Inc.	Investment banking
9/07	W	Huawei Technologies Co. Ltd. ?	Telecommunications	363	16.5	3Com Corporation	Telecommunications
10/07	C	China Minsheng Corp.	Banking	317	10	UCBH Holdings Inc.	Banking
3/08	P	Mindray Medical Intl. Ltd.	Medical devices	202	100	Datascope Corporation's patient monitoring unit	Medical devices
1/08	C	WuXi PharmaTech Co. Ltd.	Biotechnology	151	100	AppTec Laboratory Services Inc.	Biopharmaceuticals & medical devices
5/07	P	Jiangxi Greatsource Display Technology Co.	LCD Technology	95	70	I/OMagic Corporation	Data storage products
07/07	P	Wanxiang Group Corp.	Auto parts	25	30	American AI Corp.	Auto parts
09/07	C	Fushi International Inc.	Bimetallic wire manufacturer	23	100	Copperweld Bimetallics LLC	Bimetallic wire manufacturer

** C= Completed; P=Pending; W=Withdrawn, as of March 18, 2008*

= Indicates deals with financial investor involvement

Source: Thomson Financial

1 - With Texas Pacific Group, General Atlantic LLC & Newbridge Capital Group, 100% acquisition for US$1.75 billion – firms took a 10.2% stake in Lenovo
2 – With undisclosed backing from Blackstone L.P. and Bain Capital Partners LLC
3 - With Bain Capital Partners LLC, 100% acquisition for US$2.2 billion

[1] See Karl P. Sauvant, "A backlash against foreign direct investment?," in Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2010: Boom or Backlash?* (London, UK: The Economist Intelligence Unit Ltd., 2006), pp. 71-77, available at http://www.vcc.columbia.edu. Also see Karl P. Sauvant, "Regulatory risk and the growth of FDI," in Kekic and Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (London, UK: The Economist Intelligence Unit Ltd., 2007), pp. 67-79, available at http://www.vcc.columbia.edu.

U.S. Regulatory environment — Formal barriers to entry

When contemplating U.S. market entry, Chinese companies need to perform due diligence on the evolving regulatory environment in the U.S., particularly as it may apply to Chinese investors

National security concerns can derail cross-border deals in the U.S., particularly since 9/11:

- U.S. Exon-Florio Amendment (1988) to the Defense Production Act (1950)
  - Gives U.S. President the right to review and potentially block transactions with implications for U.S. "national security"
  - 12-member, interagency Committee on Foreign Investment in the United States (CFIUS) conducts reviews, with the U.S. Treasury taking the lead role
  - First (and only) formal block by U.S. President — 1990 bid by China's CATIC for MAMCO, a U.S. aerospace parts maker
  - July 2007 revisions presume a CFIUS review for any deal involving foreign government-controlled acquirers; adds "critical infrastructure" as a national security criterion
  - U.S. Treasury estimates that just 8% of the 21,700 cross-border deals into the U.S. between 1998 and 2006 filed notices with CFIUS, with just 33 deals investigations — yet seven of those investigations (21% of the total) came in 2006 alone

Although it is generally deemed one of the world's most open investment environments, the U.S. does impose limitations on foreign investment in certain industries, for example:

- Jones Act (1936) — prohibits foreign investment in coastal and inland shipping
- Federal Power Act (1935) — restricts licenses to own, operate or maintain certain power generation and transmission utilities to U.S. citizens or companies organized under U.S. law
- Communications Act (1934) — imposes strict corporate governance requirements on foreign companies seeking federal approval to acquire broadcasting & radio companies

U.S. anti-trust legislation can add to the compliance costs of large cross-border deals:

- U.S. Clayton Anti-Trust Act (1914) — prohibits large acquisitions if they "substantially lessen competition or tend to create a monopoly"
- U.S. Hart-Scott-Rodino Anti-Trust Improvements Act (1976) — Requires prior notification to Federal Trade Commission & Justice Dept. if transaction is between large parties, transfer of voting securities is substantial or either party is engaged in U.S. commerce

controls them. The formal launch in September 2007 of the China Investment Corporation, China's new sovereign wealth fund with U.S. $200 billion in foreign exchange reserves at its disposal, has only fuelled speculation about the link between Chinese OFDI and the country's wider geopolitical goals.

If this were not enough, Chinese enterprises are seeking to enter the global FDI market at a time when economic tensions between China and its major trade partners are at an all-time high. In the U.S., currency valuation has emerged as a lightening rod issue while fast-growing trade imbalances with the U.S., Europe and more recently, Japan, have increased frictions as well. In fact, many observers trace a direct link between China's trade surplus and the rapid growth of Chinese OFDI, especially its state-financed portion.[1] Other issues unrelated to Chinese OFDI have helped sour public perceptions of Chinese business, especially last year's product recalls involving Chinese-made goods. To the average American or European, unfamiliar with even the largest Chinese companies, it becomes quite easy to allow negative associations to fill the void, with very predictable consequences in the political arena.

Given the speed at which Chinese firms are expected to "go global," and the fact that state-owned enterprises still account for a substantial portion of China's OFDI, Chinese firms are encountering a rapidly-evolving political environment in the U.S. and other developed markets. In July 2007, the U.S. revised the Exon-Florio Amendment, including a presumption that filings relating to acquisitions by state-controlled foreign entities will require investigation by the Committee on Foreign Investment in the United States (CFIUS).[2] Notifications to CFIUS were up 30% in 2007 (147 vs. 113 in 2006 and up from just 65 in 2005) and while no deals were blocked, six were subject to investigation (after a record seven investigations in 2006.) In February 2008, a filing involving a minority Chinese investment in a U.S. telecoms firm was actually withdrawn in the face of U.S. national security concerns. In Europe, investment policy reviews are now in full swing — in August 2008, the German cabinet approved changes to its Foreign Trade Law which introduce national security reviews for acquisitions of stakes larger than 25% by non-EU companies, joining the UK and France which already have such CFIUS-like mechanisms in place. Pending German parliament approval, the system could be in place within months.[3] With Japan recently strengthening its oversight of cross-border M&A and political pressure building in Canada, South Korea and elsewhere, the global investment environment seems to be tightening just as Chinese enterprises are poised to enter it.

[1] It should be noted that, while a substantial revaluation of the RMB would reduce the trade surplus, it would further encourage OFDI from China as it would make U.S. and other foreign assets cheaper in terms of that currency.

[2] It is worth noting that in perhaps the most famous failed deal involving a Chinese acquirer — China National Offshore Oil Company Ltd.'s (CNOOC) U.S. $18.5 billion bid for Unocal Corp. in 2005 — it was not the CFIUS process but more generalized political pressure, including a 398-15 vote in U.S. House of Representatives demanding that the deal be reviewed, which ultimately caused CNOOC to withdraw its bid.

[3] In the case of Europe, OFDI from Russia and the recent proliferation of sovereign wealth funds are factors shaping the debate as well.

The way forward for all stakeholders

What to do in light of the vulnerability of Chinese OFDI? It is only natural that, with the reemergence of China as a major economy, its firms spread their wings and become major players in the world FDI market.[1] The world needs to accept that Chinese multinationals are here to stay, and that OFDI is another aspect of the country's integration into the world economy. The issue for all stakeholders is how to handle this process smoothly.

At the most basic level, it is essential that the non-discrimination principle — which is central to the international laws governing cross-border investment — is applied by the U.S. to Chinese OFDI as it is applied to the investments of other countries. If need be, this

U.S regulatory environment — On-going compliance the example of U.S. workplace conditions

When operating in the U.S. market, Chinese companies will need to stay in compliance with a regulatory system every bit as complex as their own, only more strictly enforced and in the context of a highly litigious society.

U.S. laws determining employment relationships and workplace conditions can be especially challenging for foreign investors, who, in many cases, have faced a disproportionately higher number of lawsuits compared with U.S. firms. Given differences in culture and business practice, Chinese companies will need to close the gap quickly in the face of close scrutiny by U.S. regulators, media and the public-at-large for compliance with these and other federal laws:

- U.S. Occupational and Health Act (1970)
  - Sets minimum standards for health and safety in the workplace and empowers authorities to launch investigations and penalize violations
- National Labor Relations (1935)
  - Protects the right of employees to self-organization and collective bargaining
- Civil Rights Act (1964)
  - Prohibits employment discrimination on the basis of race, color, national origin, religion and sex (including sexual harassment and pregnancy)
- Age Discrimination in Employment Act (1967)
  - Outlaws employment discrimination against individuals 40 year-old or older, as well as most forms of mandatory retirement
- Americans with Disabilities Act (1990)
  - Prohibits discrimination against persons with disabilities and requires employers to make "reasonable accommodations" for these individuals in the workplace

Chinese companies should also keep in mind that any differential treatment afforded their own expatriate staff — whether real or perceived — could become grounds for lawsuits alleging discrimination. Lastly, many state and local jurisdictions have similar (but subtly different) laws on the books and are usually just as keen about enforcement.

[1] See Jeffrey D. Sachs, "The rise of TNCs from emerging markets: the global context," in Karl P. Sauvant, ed., *The Rise of Transnational Corporations from Emerging Markets: Threat or Opportunity?* (London: Edward Elgar) (forthcoming).

principle should be strengthened, either in the framework of a U.S.-China bilateral investment treaty, in the regional context of APEC or even through a multilateral arrangement within the WTO.

Chinese companies too, need to be mindful of managing their international growth in light of the sensitivities that exist — rightly or wrongly — about the transnationalization of Chinese business. This begins, as already discussed, with the training of executives not only in matters related to the management of their firms, but also in those related to the political economy and culture of the U.S. and other major host countries. Furthermore, any acquisition by a state-owned enterprise and/or investments with a potential impact on national security will need particularly careful preparation. The same goes for acquisitions in sectors which are perceived to be off-limits to foreign investors in China. On the public relations front, the message needs to get out that Chinese OFDI is fundamentally no different from that of other countries — and hence contributes to the economic growth and development of its host countries. Naturally, this message will be better received if Chinese companies behave as scrupulously good corporate citizens when operating abroad, not only by observing the laws and regulations of these countries, but by exercising exemplary corporate social responsibility as well.[1]

Nonetheless, in a post-9/11 world, cross-border M&A will continue to be a sensitive matter, and whatever the overall impact and perception of Chinese ODFI, Chinese firms may want to draw from the experience of Japanese firms in the U.S. When Japanese companies burst onto the world FDI market in the 1980s (partly through high-profile M&A deals), there was widespread fear that they would come to dominate the world economy, and attitudes in the U.S. in particular were quite defensive. Not coincidentally, much of the regulation that still governs foreign investment in the U.S. dates to this period. Some of these fears began to dissipate as Japan entered a period of stagnation in the 1990s. Yet perhaps more importantly, Japanese firms began to change their basic approach to investing in the U.S. Their understanding of the U.S. market and ability to build key relationships with governments and communities grew. In addition to M&A, Japanese companies began to establish assembly facilities in the U.S. and later, full production units. And as their readiness to address U.S. market entry challenges increased, they found that the receptivity of the U.S. business environment rose as well in a sort of virtuous cycle. Under the best of circumstances, Chinese firms will embark on a similar trajectory in a more compressed time frame, thus draining the fear creeping in to the cross-border investment environment before it firmly takes hold.

[1] Many Chinese firms are already taking steps in this regard. As of October 2008, for example, 161 Chinese companies had associated themselves with the UN Global Compact, the voluntary code of sustainable and socially responsible business conduct launched in 1999. For a list of these companies, go to www.unglobalcompact.org

Conclusion

What does this all add up to? Two things seem to be particularly urgent:

- Chinese companies — by themselves and/or with the help of experts — need to take a hard look at their readiness to invest overseas, especially in the U.S., the world's most competitive market. Where they need to strengthen their capabilities, especially with respect to the capacity to execute cross-border M&A, they will need to do so as rapidly as possible.
- Chinese companies will also need to familiarize themselves with the regulatory and institutional environment of the U.S. in order to determine their receptivity and better navigate the political processes. This is particularly important now that attitudes toward cross-border M&A, especially from China, are hardening. Chinese managers can help meet this challenge by building positive social capital for their companies, including by being good corporate citizens.

To explore these and other challenges faced by globalizing Chinese companies, the Chinese Services Group of Deloitte LLP has teamed up with the Vale Columbia Center for Sustainable International Investment and Tsinghua University in Beijing on a year-long study to assess the readiness of Chinese firms to enter the U.S. and the investment environment which they are likely to encounter when they get here. Research results are expected to be made public in the near future.

Further Information

Whether you are a company that is looking to expand into the U.S. or already operating there, having access to accurate and timely information on taxation and other business issues is critical to your success.

To learn more on the complexities involved in doing business in the U.S., please contact us for a copy of United States of America Country Guide.

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