



BY BRENT HANNON



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Clearing up **the Confusion**

Looking at foreign direct investment in China and China's attempts to invest abroad.

The dialogue on foreign investment in China generates a lot of heat, whether it transpires in blogs, bars, the media, or boardrooms, and often the issue appears vast, opaque and confusing. There are several reasons for this.

One is the frequent release of new investment-related rules and clarifications, some of which are complicated. Speculation and opinion follow in the wake of these releases, further muddying the waters. The high-profile cases that occur every few months are another source of confusion; the latest was Coca-Cola's rejected attempt to purchase

Huiyuan Juice Group. Predictably, that case fueled talk of protectionism and speculation that China was turning inward, accompanied by much chatter about what the verdict would mean for foreign businesses in China.

But in reality, most of the rules that govern foreign direct investment (FDI) are easy to understand, and even when the rules are complicated, the intent behind them is straightforward. "[The Chinese government] has made it very clear how the foreign investment system works," says Steven M. Dickinson, a Tianjin-based attorney with the firm Harris & Moure.

Understanding the rules

There are two types of FDI in China: greenfield investment, which is fresh investment in new projects and accounts for 70 percent of all FDI in the country, and merger and acquisition (M&A) investment. Of the two, greenfield is more straightforward and generally more welcome than M&A.

Both methods of investment abide by the Catalogue Guiding Foreign Investment in Industry. In its four categories – prohibited, restricted, ‘permitted,’ and encouraged – the catalogue provides a clear assessment of which investments are likely to be approved and which are not. Prohibited sectors, such as weapons factories and most forms of media, are never approved, and restricted investments, such as banking and telecommunications, are only selectively approved. Encouraged investments, especially if they are greenfield, are almost always approved, while ‘permitted’ investments are often approved.

The sentiment behind the catalogue is a desire to attract and absorb knowledge-intensive services and industries that China currently lacks. Examples include sophisticated logistics and back-office setups, nuclear power plants and modern factories that produce chemicals, machine tools, diesel engines and the like.

“The government is going to be supportive of anything that allows it to get technology transfer,” explains Ben Cavender, senior analyst at the China Market Research Group in Shanghai. “A good example would be energy. China is going through a major reform of its energy system, and they’re investing a lot of money into hydropower, nuclear power and wind power, so a lot of foreign companies have come to China and gotten involved in that.”

Difficulties in gaining approval arise when would-be greenfield investors either don’t follow the foreign investment catalogue or attempt to squeeze into a restricted sector. Such attempts typically end in failure, says Dickinson, adding, “If it’s restricted, don’t do it.”

But the catalogue does have its problems. For

example, there is no genuine ‘permitted’ category. That category is really comprised of a miscellaneous grouping of all businesses that are not listed in the remaining three categories; the ‘permission’ is only assumed. While permission is often granted, those investments are assessed on a case-by-case basis, leaving a gray area that affects some 5 percent of companies that are covered by neither category nor precedent.

In addition, the guidelines can shift or change as the government promotes certain industries and demotes others. “The government is now looking to develop the service industry, and they are looking at areas where there is potential for intellectual capital development,” says Cavender. “You see tech companies doing well because they come in and they create jobs for white collar workers, so the government is going to be very supportive of investments like that.”

M&A framework

M&A investment is more complicated, as Coca-Cola recently discovered. The starting point for would-be M&A investors is still the Foreign Investment Catalogue, but they must also refer to the M&A rules revised in 2006 and the 2008 Antimonopoly Law, while a secondary guide would be the 11th Five Year Plan on Utilization of Foreign Investment.

The rules may be complex, but the intent behind them remains straightforward. Understanding that intent means looking at precedent and in China, a pattern has emerged. When it comes to M&A, Dickinson’s experience has led him to observe three unwritten rules.

Rule One: companies that are small in size or do not hold a dominant position are permissible targets. Rule Two: a company that is in trouble and needs to be restructured can be acquired if the buyer is willing to invest in fixing it, he says. Rule Three dictates that only minority stakes are permissible in successful or large companies, and even then will only be approved if the buyer brings some other collateral benefit with that minority interest, something that is good for China. Such collateral benefits tend to be either technological

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innovations or access to a new foreign market, says Dickinson.

Examples are easy to find. Coca-Cola's planned acquisition of Huiyuan Juice violated rule number three: Huiyuan was too big and too successful, and Coke was trying to buy too much of it.

“If you look at what happened earlier this year with Coke and Huiyuan, a big reason for the M&A failure is that the government didn't want to see a foreign company have that much power in the market here,” says Cavender.

However, in mid-June, private equity firm Kohlberg Kravis Roberts (KKR) announced that it had acquired a 20 percent share in Ma Anshan Modern Dairy, one of the largest dairy producers in China. Approval of that deal also conforms to the three rules: the dairy industry is reeling from the tainted milk scandal, and KKR will provide production, food safety and distribution expertise that will benefit the country. The KKR stake is also a modest one, while Coke sought a majority stake.

With M&A, problems also often arise when legalistic American companies comb the rulebooks looking for loopholes. That approach is doomed, says Dickinson. “China doesn't do loopholes,” he says. “They know what they intend the law to mean, and if it is written inadequately and someone finds a loophole, they don't care; it won't get approved.”

Looking forward


When Chinese companies attempt to buy into companies overseas, they face the same sentiment: an unwillingness to allow key domestic companies or resources fall into foreign hands. The latest example occurred on June 4, when Australian mining giant Rio Tinto pulled out of deal that would have permitted state-owned Aluminum Corporation of China, or Chinalco, to pay US\$19.5 billion for an 18 percent share of Rio Tinto, along with stakes in its copper, aluminum and iron mines. That acquisition sparked heavy political opposition in Australia, which helped scuttle the deal. Similar sentiment also crippled China National Offshore Oil Company's (CNOOC) failed attempt to buy Unocal in 2005.

Given the macroeconomic dynamics, many more such cases will emerge in the near future. FDI into China declined by US\$35 billion in the first five months of the year, compared to the same period in 2008. With exports also falling, the government has loosened some restrictions on FDI and has again embraced FDI as a key pillar of the economy.

“The government wants to encourage more FDI because of the recent decline,” says Dr. Wensheng Peng, head of China research at Barclays Capital in Hong Kong. “Only one year ago, China was facing a large balance of payment surplus, and some people were arguing that the FDI inflow was too great. But now the situation has changed because of the weak exports, and FDI has declined, so now the tone has changed and the government has become positive again about FDI inflows.”

Such support from Beijing adds to the likelihood that FDI projects will be approved, although it does nothing to help Chinese companies pursue overseas investments. But those attempts will continue as well. China has a large trade surplus, and those earnings must be invested overseas in a way that maximizes the return and acquires valuable assets.

“The government is promoting foreign direct investment abroad by Chinese corporations,” says Dr. Peng. “This helps secure the foreign market for Chinese producers, and it is also a way to ensure a supply of resources.”

As a result, the two-way tug-of-war will no doubt continue. China's expanding economy requires immense quantities of natural resources, and Beijing will naturally use its investment clout to secure the resources it needs. As for FDI into China, greenfield investment is likely to remain attractive both to China and to foreign investors, while M&A investment will remain more problematic. But given China's continuing allure, and its ongoing economic growth, additional high-profile test cases cannot be far away. 

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