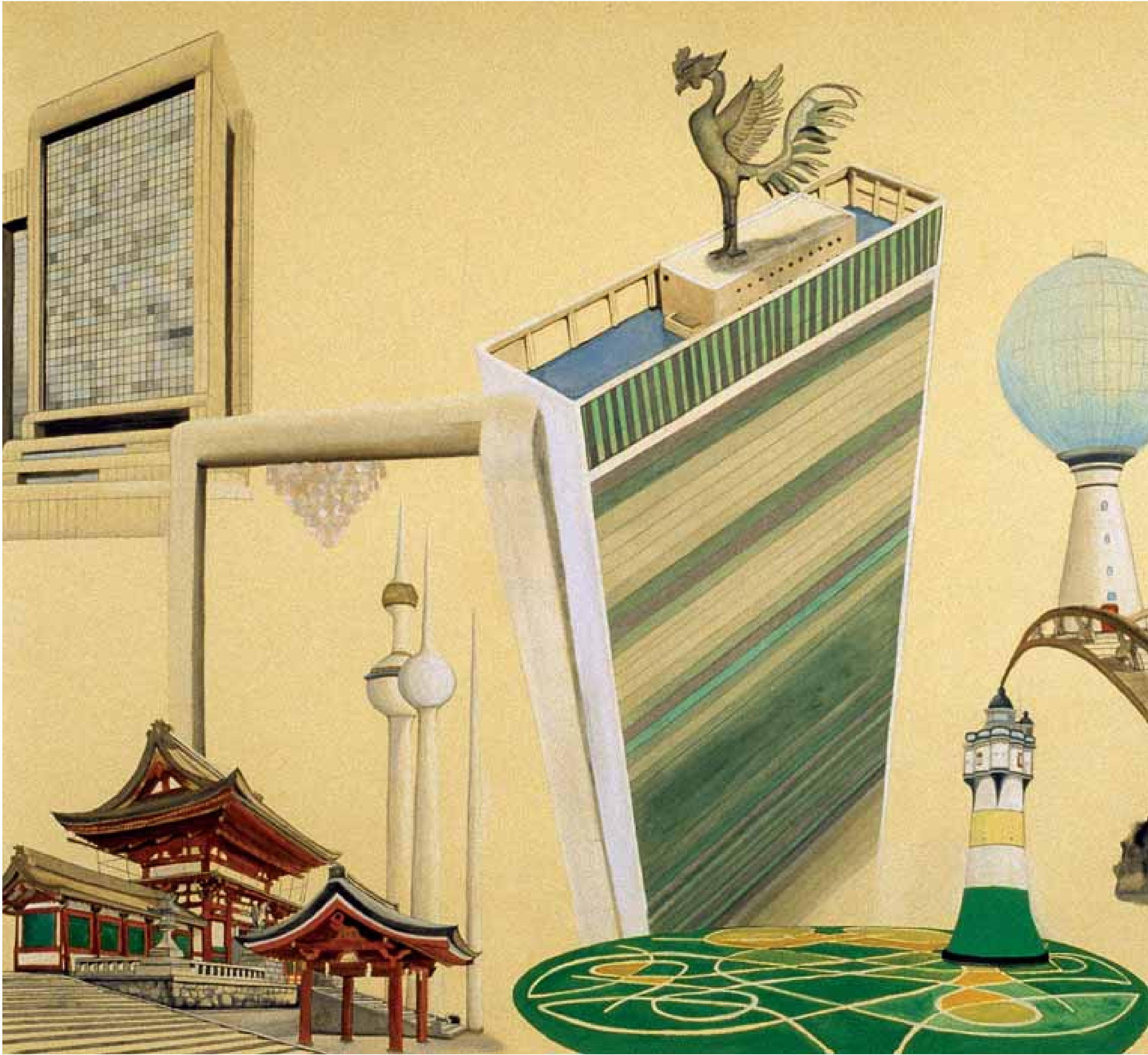

Flight-path, *2004, by Naomi Kawanishi Reis (acrylic gouache and mixed media on paper, 22 inches by 30 inches).*

China Inc., International

How Chinese companies have discretely internationalized their operations.

BY FRIEDRICH WU

Recent high-profile international acquisitions and take-over bids by Chinese companies have dramatically shifted media attention from spotlighting China as a "giant sucking vacuum cleaner" for global inward foreign direct investment to characterizing the country as a cash-rich "predator" embarking on a global buying binge. Despite the latest public frenzy stirred up by Chinese companies' accelerated cross-border merger-and-acquisition forays, a large number of these enterprises have actually been discreetly internationalizing their operations for some years without attracting a lot of media limelight.

Since the early 1990s, the Beijing government has been formulating and executing the "Go-Out" strategy as a complementary component of the "Open-Door" policy promulgated more than a decade ago. Between 1991 and 1997, the State Council had assembled a "national team" of 120 state-owned industry-groups—from "strategic sectors" such as power generation, mining, automobiles, elec-

Friedrich Wu is Visiting Senior Research Fellow at the East Asian Institute, National University of Singapore, and concurrently Adjunct Associate Professor of International Political Economy at the Institute of Defence & Strategic Studies of the Nanyang Technological University. He previously served as Director of Economics at Singapore's Ministry of Trade & Industry.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

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tronics, iron and steel, machinery, chemicals, construction, transport, aerospace, and pharmaceuticals—that could spearhead the internationalization of Chinese enterprises. To build the "national team," these enterprise groups were given high levels of protection, generous state financial support, as well as special rights in management autonomy, profit retention, and investment decisions. By 1997, in a reference to the government's drive to nurture globally competitive firms, President Jiang Zemin asserted during the 15th Chinese Communist Party Congress that "the state-owned sector must be in a dominant position in major industries…we shall effectuate a strategic reorganization of state-owned enterprises by managing large enterprises well…. China will establish highly competitive large enterprise-groups with …transnational operations."

With official encouragement, Chinese outward foreign direct investment flows surged to an average of nearly US$3.0 billion per year during 2001–04, compared to US$2.3 billion during 1991–2000. By the end of 2004, according to the United Nations Conference on Trade and Development, accumulated outward foreign direct investment stock by Chinese companies reached US$38.8 billion, which was almost on par with South Korea's US$39.3 billion, a country whose chaebols had a longer track record of internationalization. To facilitate Chinese firms' ability to invest abroad, the Beijing government had signed bilateral investment treaties with 103 countries and double taxation treaties with 68 countries by early 2003.

Today, Chinese enterprises are present in almost every corner of the earth. According to China's Ministry of Commerce, there were 7,470 Chinese foreign affiliates spreading across 168 countries or economies at the end of 2003. In value terms, besides Hong Kong which owing to its unique "gateway" position claimed a significant 40 percent share at the end of 2003, Chinese outward-bound capital seemed to favor developed economies such as North America, the European Union, and Australia/New Zealand, which together accounted for 23 percent of China's outward foreign direct investment stock, with the United States ranking as the second most important destination (an 8.3 percent share). Among developing economies, ASEAN managed to attract more (8.2 percent) Chinese outward foreign direct investment vis-à-vis Africa (8.1 percent) and Latin America (5.8 percent) through 2003. Reflecting a continuous thaw in bilateral relations, resource-rich Russia had emerged as the third most important destination for China's outward foreign direct investment at the end of 2003 with a 4.8 percent share.

As to what motivates Chinese firms to engage in cross-border expansion, according to a 2003 survey of China's fifty largest "industry-leading" firms by the Shanghai office of the Germany-based Roland Berger Strategy Consultants, slightly more than 50 percent of the participating firms (many of them were large trading houses and manufacturers) named "seeking new markets" as the overriding imperative for globalizing their business activities. Among this group of firms, manufacturers in particular cited growing competitive pressure from multinational corporations in the home market, excess capacity, and sliding profit margins as key reasons to search for new markets abroad. Aside from "seeking new markets," the next most compelling reason for China's top fifty firms to look offshore was to "secure resources," which was identified by 20 percent of the participating enterprises in the Roland Berger survey. This was not all together surprising, in view of China's rapid ascent in recent years to become the world's largest consumer of iron ore, aluminum, steel, copper, cement and second largest consumer of crude oil.

Last but not least, 16 percent of China's top fifty firms specified "obtaining technology and brands" as the critical reason for making international acquisitions. It is a truism that Chinese consumer-product manufacturers suffer from the "twin deficits" in global branding power and advanced technology (including critical design knowledge). However, as the Japanese and South Korean experiences have demonstrated, building these capabilities through in-house, organic growth would take two to three decades and billions of dollars. In these days of rapid technological changes and shorter product cycles, Chinese

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companies simply do not have the luxury of time to pursue this protracted option. Hence outright acquisitions and strategic joint ventures in developed economies such as the United States and the European Union—like the Lenovo-IBM, TCL-Thomson, and the aborted Haier-Maytag deals—become the shortcut route to address the "twin deficits."

After more than a decade of taking the incremental, one-step-at-a-time approach to globalization, some Chinese companies are beginning to attract international attention at the dawn of the new century. In the latest 2005 *Fortune* Global 500 roster, the number of Chinese companies rises, by one, to fifteen. By now, China can boast the largest number of companies on the list among emerging economies (surpassing South Korea's eleven). It also compares favorably with developed economies, overshadowed only by Britain (35), France (39), Germany (37), Japan (81), and the United States (176), but trumping the rest. However, as total revenue, rather than overseas assets and sales, is the ranking criterion for the *Fortune* Global 500, a majority of the fifteen Chinese companies can only be considered as state-owned domestic corporate behemoths, rather than internationally active business concerns. The exceptions are the Bank of China, CNPC, COFOC, Shanghai Baosteel, Sinochem, and SINOPEC, which have all embarked on the globalization trail since the mid-1990s.

While evidence from the 2003 Roland Berger survey of China's top fifty "industry-leading" firms indicated that organic growth was the preferred mode of cross-border expansion (48 percent of participating firms) over strategic alliance/joint venture (39 percent) and outright acquisition (13 percent), more recent trends suggest that the latter two routes are increasingly gaining ascendancy inside China's corporate board rooms. Lenovo's acquisition of IBM's PC business and TCL-Thomson Electronics' strategic alliance in 2004, as well as Haier's aborted takeover bid of Maytag in 2005, illustrate a trend shift in Chinese corporates' globalization strategy.

However, as late entrants—compared to their Asian and Western counterparts—to transnational commerce with less than two decades of globalization experience, Chinese firms are likely to be disadvantaged in a number of ways. Majority government ownership of many of these enterprises can erect additional roadblocks to their international acquisition trails, particularly in foreign assets that may be deemed "strategic resources" by host countries. For example, economic nationalism foiled not only CNOOC's high-profile takeover attempt of Unocal in July 2005, but also derailed China Minmetals' proposed purchase of Noranda, a Canadian mining giant, in early 2005, and SINOPEC's bid for Slavnet, Russia's ninth biggest oil company, in December 2002. As such, Chinese firms are forced to accept the fact that certain politically sensitive cross-border targets are beyond their reach, even if their government ownership is reduced to minority status.

Rapid urbanization, rising car ownership, and accelerated infrastructure construction especially in the western region will spur China's resource companies to scour the world for energy, building materials, and key minerals.

Besides political risk, Chinese enterprises, largely because of their limited mergers and acquisitions experience, have not yet demonstrated the requisite skills to turn around, integrate, or sustain the brands that they have acquired. Failure to address these tasks swiftly and urgently in the post-acquisition phase can prove costly, not only financially but also to the fate of the merged entity. For example, tardiness in repairing joint-venture partner Thomson's bottom line has come at the expense of TCL's own profitability, while successfully integrating and sustaining the IBM brand will be a litmus test of Lenovo's management savvy in the coming critical months.

Notwithstanding the obstacles described above, they would not be formidable enough to deter Chinese firms with global ambitions from internationalizing their operations. On the home turf, accelerating competitive pressure from foreign multinational corporations will remain a relentless "push" factor for Chinese enterprises to "go out." Intense pressure will be felt

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especially by services companies in the next two years as Beijing completes its liberalization schedule by 2007 on the services sector under WTO accession requirements, and allows majority foreign ownership in many services industries, thus inevitably squeezing the profit margins of local services firms and pushing them to look for off-shore growth opportunities. Furthermore, with a predicted medium-term average trend-growth rate of 7–9 percent annually, there will be no abatement in China's ferocious appetite for key commodities. Rapid urbanization, rising car ownership, and accelerated infrastructure construction especially in the western region will spur China's resource companies to scour the world for energy, building materials, and key minerals.

Foreign acquisitions will be backed by massive financial resources from the government, which had amassed US$711 billion in official foreign exchange reserves as of mid-2005. During just the eighteen months between the end of 2003 and mid-2005, such reserves had risen at an astonishing pace averaging US$17.0 billion per month. (Such a sum would allow China to bid for more than sixteen Unocals over this period!). Moreover, with the renminbi's recent modest revaluation and switch to a peg against a basket of currencies instead of the U.S. dollar, market consensus (Bloomberg survey, August 2005) expects the renminbi would move on to a trend appreciation trajectory, hitting RMB 6.8/US$1.0 by 2010, from RMB 8.3 before the change in the exchange-rate regime in July 2005. Hence, with a stronger renminbi going forward (like Japan's surging yen after the 1985 Plaza Accord), Chinese companies are anticipated to speed up their pace on the international acquisition trail.

Finally, the Beijing government is not expected to relent in its support for the "Go-Out" policy in the medium term. If anything, it has recently enacted policies that will make outward foreign direct investment by Chinese companies easier. In October 2004, for instance, China's Ministry of Commerce announced not only it would start to accept outward foreign direct investment applications and issue approvals online, it would also cease to scrutinize the feasibility of each proposal. This was followed by the announcement nine months later that the Export-Import Bank of China would receive a substantial capital injection in order to enable it to support Chinese companies' cross-border expansion.

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Consequently, recent high-profile international acquisitions and takeover bids by Chinese companies can be seen only as the tip of the iceberg. The world community is merely witnessing the beginning step of Corporate China's ascent to the international business stage. Its outsized global ambitions have been fittingly illustrated by a recent issue of the *China Entrepreneur* magazine. On its cover, it posts the brash question: "Should China Buy Wal-Mart?" Despite getting a bloody nose from the foiled take-over bid of Unocal, there is no reason to doubt why ambitious and tenacious Corporate China would not one day take aim at the top company on the *Fortune* Global 500 scoreboard. That day may come sooner than anybody can expect.

Overall, the emergence of China as a significant capital exporter, through a continuous recycling of its huge domestic savings and external surpluses, should be beneficial to the global economy, resulting in a win-win situation for all.

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In developed markets, Chinese acquisitions of distressed assets—should they manage to turn them around—could help resuscitate failed or near-failed companies and prevent job losses. Such successful turnarounds would in turn generate political good will in the host countries, instead of hostility and suspicion as in the case of CNOOC's takeover bid for Unocal.

Relocation of labor-intensive light manufacturing facilities to emerging economies by Chinese producers would translate into a deepening of capital investment, as well as employment creation, skill transfers, and wage improvement for the poor and unskilled workers in these capital-scarce economies. This would in turn raise China's stature among developing economies, which it had already successfully cultivated during the 1960s and 1970s through its generous technical assistance programs.

Investing in commodity-rich countries by China's resource companies would help revitalize some once-moribund industrial sectors, spur commodity prices, and raise export earnings of these countries. While some of the recipient economies of Chinese investment such as Australia, Canada, and South America are Washington's long-standing political allies, over time they might refrain from leaning toward the United States when bilateral disputes between Beijing and Washington arise. Some more neutral countries such as Indonesia and Russia could even side with China.

Last but not least, Chinese companies operating in developed markets would benefit from the need to conform to higher standards of corporate governance, accountability, transparency, and social responsibility, for failing which they would be disciplined by foreign market regulators as in the case of China Aviation Oil in Singapore. Thus over time, many Chinese transnational corporations would come to accept, and implement, international best business practices if they wanted to be regarded as respectable global corporate citizens. Parent companies domiciled in China would also feel the transnational pressure which would spur them to accelerate enterprise reforms at home. ◆