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China's Technology Grab

Shifting from being a technology taker to a technology licenser.

By Sebastian Heilmann

The merger and acquisition activities of mainland Chinese firms now make headlines on the front pages of the world's top newspapers. With China accounting for 15 percent of all M&A transactions globally in the first quarter of this year, M&A advisers are understandably enthusiastic about the emergence of China as a major new buyer with deep pockets.

In an open global economy, Chinese foreign direct investment activities should not be much of a concern. Acquiring ownership stakes in large Western firms helps the Chinese get more exposure to global markets, management, and governance practices.

However, some important questions need to be asked. This starts with seeing much more clearly what the funding sources for these deals are. Not only are many of the Chinese companies on the acquisition trail already highly indebted, the actual sources of Chinese FDI are often impossible to determine. They could be private or public (via a state-owned enterprise), or a mix of the two that is impossible to decipher.

The Chinese government operates on the basis of strategically targeted investment plans.

In addition, either source could be used to disguise a politically motivated national agenda. The Chinese government has a hand in many transactions and operates on the basis of very specific, strategically targeted investment plans. Although a lot of attention has recently been paid in Western media to Chinese attempts to go trophy hunting after marquee Western names, specifically in the hotel and tourism sector, such transactions are only a sideshow.

It is much more relevant to consider the country's "Made in China 2025" strategy as a roadmap. The overriding goal of this strategy is to realize China's ambition to move well beyond serving as "the world's factory." China wants to shift from largely being a technology taker to becoming a technology licenser.

The realization of this goal—shared by the leadership and the population at large—involves the acquisition of as many technologies as possible. One key target is niche technologies and so-called "hidden" champions. That is what makes German Mittelstand companies so attractive to the Chinese. The same is true for smaller U.S. firms with promising emerging technologies who are facing the valley of death—that is, running out of money before they can make their technology commercially viable.

Because the targeted acquisitions often are an integral part of China's industrial policy, they are driven by far more than mere commercial considerations. And if this approach ends up wasting some money by making investments in speculative technologies that ultimately don't bear out, so be it.

The reason is that, while China's leaders often talk proudly about the need for (and progress on) domestically generated innovation, they are also acutely aware of its limits. Buying in technologies is a welcome short cut.

The West cherishes the openness of its economies with good reason. But we must also guard against a situation where FDI activities are no longer intended to be a two-way street. The danger is that China's state-owned companies and other Chinese firms use their oligopoly, if not monopoly, power in their huge home market first to go on a strategic shopping spree in Western countries—and then to lock up these technologies for themselves.

Once the technology is transferred into Chinese ownership, that enables other Chinese firms to substitute technology licenses taken from foreign firms with one from the Chinese firm that bought up the relevant Western technology. This effectively locks up the Chinese market by drying out license revenues generated there as a source of income for Western firms. In a subsequent step, Chinese firms can then try to replicate that game globally—perhaps initially by making attractive offers in other large emerging market economies, as well as throughout Asia and Africa.

What all of this points to is a significant gap in the Western world's ability to evaluate FDI propositions properly. As China readies itself for a true overseas FDI wave, the sources of financing of the proposed transactions must draw much closer attention. There is a lot of potential for severe distortions of the marketplace, whether via special financing vehicles offered up at non-commercial terms by state-controlled commercial banks, or by China's development banks or policy banks.

At a minimum, regulators must make sure that the true beneficiaries of the acquisitions proposed by Chinese firms are known. Some high-profile cases have shown that the true beneficiaries of the commercial machinations of Chinese state-owned enterprises are high-ranking members of the Communist Party. Left unchecked, obscure FDI transactions may destroy the governance and eventually corporate viability of (by then formerly profitable) Western assets.

The U.S. government can at least avail itself of the CFIUS process—through the Committee on Foreign Investment in the United States—which is mostly focused on the examination of national security issues and the national infrastructure.

The challenge is steeper for Europe—and Germany in particular. Europe's largest economy, with its medium-sized, family-owned firms, is a key target for the Chinese, but basically lacks any proper FDI screening mechanisms. ◆

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