China OFDI: Going Global Responsibly

When China announced a reduction in outward FDI, there were fears the well of Chinese money would dry up. But China's refinement of its overseas investment should spell greater prosperity for enterprises savvy to the new deals available.

– By Gina Miller

In its fifth annual outbound investment report, called "China Go Abroad – Sound risk management builds a solid foundation for Chinese enterprises to navigate the global landscape", EY's China Overseas Investment Network (COIN) reported that "China's outward foreign direct investment (FDI) in 2016 rose 30% year-on-year to a record high of US$188.8 billion." Much of that was outbound M&A into Europe and North America.

The massive purchasing power came at a cost: downward pressure on the reminbi (RMB) and China's foreign exchange reserves, which spurred even more capital flight. In response, China moved definitively to crack down on capital flight, signalling in late 2016 a regulators' crackdown on "irrational" outbound foreign direct investment (OFDI).

Following banner years of multi-billion dollar real estate transactions and multi-million dollar sports franchise sales, China's halt on this relatively unrestricted OFDI, aimed to reverse the course.

Subsequently, new deal activity dropped swiftly, with the number of newly announced outbound M&A transactions (by Chinese companies) falling by 20% in the first six months of 2017, compared to the same period in 2016.

By the end of the first half of 2017, China's changes slowed the pace of Chinese outbound M&A activity and re-shaped the composition of deal flow in terms of investors, industries and other characteristics.

Quality over quantity

China's global reach wasn't about to stop in its tracks; rather, it was about to shift rails.

In February 2017, China's Ministry of Commerce (MOFCOM) said that "China's outbound direct investment (ODI) will steadily slow, but be of better quality in 2017." From the off, China signalled that it would demand stricter regulatory approval, with outbound deals valued above US$10 billion likely to be rejected, while any deal valued above US$1 billion to be rejected if it was outside or unrelated to the acquirer's core business, or acquisitions made by newly established entities with no business operations.

Tighter capital outflow control was also established, with the State Administration of Foreign Exchange (SAFE) vetting cross-border money transfers worth over US$5 million (down from US$50 million previously). Finally, longer processing times would be applied; existing rules would be strictly followed, doubling the outbound filing and approval process times from two to three months (as in 2015 and 2016) to three to four months or longer in 2017.

In August, China's State Council published a set of investment guidelines prepared by four key regulators – the National Development and Reform Commission, Ministry of Commerce, People's Bank of China and Ministry of Foreign Affairs (collectively, PRC Regulators). These guidelines offered the most important clarification on Chinese outbound investments since late 2016, when Chinese authorities first clamped down on so-called "irrational" or "non-genuine" investments.

Specifically, the guidelines classified overseas investments into three main categories of:

- Encouraged investments;

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- Restricted investments; and
- Prohibited investments.

"Prohibited investments" (and industries) include those in the military, gambling and sex industries. "Restricted investments" include real estate and hotel deals, film and entertainment, sports, and investments that do not comply with environmental standards.

Finally, "Encouraged investments" include deals that promote the Belt and Road initiatives, improve China's technology or R&D, and expand oil, mining, agriculture and fishing industries.

Such clarifications were urgently needed, particularly when previous investments were publically tagged as spurious, such as Chinese appliance retailer Suning Holding Group's purchase of Italian soccer club Inter Milan, a company that had lost money in the five years prior to purchase.

"I think many overseas acquisition deals have a low chance of generating cash flow, and I cannot exclude the possibility of money laundering", said Yin Zhongli, a researcher with the Chinese Academy of Social Sciences, to the host of a TV show on state-owned China Central Television in July 2017. Sports deals were increasingly perceived as a means for Chinese companies to move assets out of the country, but they now shared "restricted" space with the real estate sector.

According to the Ministry of Commerce, overseas direct investment in the property sector fell by 82% in the first half of 2017, and should decline further as the new measures specifically restrict firms' acquisitions of real estate in foreign markets. According to CBRE, state-owned enterprises especially reduced their activity in overseas real estate.

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Against the tide

Sector-related restrictions were intended to improve China's economic health, and as of September, it appears they might be working. China's capital outflow stopped in September after a 22-month flight, and the People's Bank of China bought a net RMB850 million (US$128 million) of foreign exchange in September, marking the first net increase since October 2015.

The prevention of overseas investment in the gambling and sex industries, restrictions on investments in the real estate and entertainment, are designed to reduce overseas holdings in sectors that are not central to China's government directives and its long-term objectives.

During the People's Congress in October, Pan Gongsheng, the head of the State Administration for Foreign Exchange, said that China's foreign exchange market had suffered risks and shocks in early 2017, but overall, the market situation was stable.

After the squeeze, where is the opportunity?

Weighing the risks and challenges ahead, PRC Regulators outlined the concerns informing the categorisation of overseas investments and the policy measures. These include a "be more careful" approach – demanding careful and systematic planning, analysis and decision-making; "benefits to China" – specifically investments that contribute to China's economic development and increase capital outflows; and "benefits to the host nation" – including environmental protection, energy consumption, safety and other standards.

Following these basic principles, Chinese companies are encouraged to engage in:

- Infrastructure investments that will further the Belt and Road Initiative and related infrastructure and connectivity;
- Investments that promote the export of Chinese quality production capacity, high-quality equipment and technical standards;
- Investments that strengthen cooperation with foreign high-technology and advanced manufacturing enterprises, including the establishment of research and development centres overseas;
- Prudent participation in the exploration and development of overseas oil and gas, minerals and other energy resources;
- Agriculture cooperation with other countries; and
- Investments in business and trade, culture, logistics and other services, and establishment of branches by qualified financial institutions.

Where do we fit in?

Hong Kong is the natural conduit for such investments. According to the Hong Kong Trade and Development Council, some 60% of Chinese outbound investments (thus far) have been directed to or channelled through Hong Kong. Hong Kong's position as a world-class professional services and global investment hub, its legal regime and diversified funds-raising platform, and its international connectivity means that Hong Kong is the natural bridgehead to OFDI, particularly for those companies seeking to invest in Belt and Road initiatives and high-tech enterprises.

According to an EY COIN survey of Chinese enterprises involved in or intending to get involved in outbound investments, 71% of Chinese enterprises said the stability of legal systems, tax policies and industry-entry barriers are considered critical political and economic risks. Some 86% of respondents said a lack of professional consultants with extensive experience in outbound investments posed the greatest market risk, with 82% citing a lack of understanding or misunderstanding by foreign markets towards Chinese enterprises as the second-greatest risk.

Hong Kong is uniquely placed in that it offers the legal, professional and cultural erudition to manage risks such as these, with a transparent, coherent system of law, a sophisticated professional services profile and a familial sensitivity to China's market place. Moreover, Hong Kong's international vision and fluency in global markets provide a bulwark for risk management.

In our own hands

"Our risk management and dispute resolution capabilities are especially crucial to the success of Belt and Road investments. If Hong Kong is to be the financial and risk management hub for the Belt and Road, our financial policies, regulators and the sectors need to support with relevant policies" said Vincent HS Lo, Chairman of Hong Kong Trade Development Council in October.

"If Hong Kong does not seize the opportunities offered to us here and now, and approach it with an open mind, we may miss this golden opportunity to reinvent ourselves", he said.

Ultimately, because of China's reduction in quantity of outbound investments, in favour of quality, any short-term pain suffered by Hong Kong companies should be parlayed rapidly into opportunities for future deals. Ultimately, it's up to Hong Kong companies to position themselves accordingly.