Investment Abroad: The Dragon Steps Out

More Deals, More Players

By Tom Miller

The face of China's outward investment is changing: state-owned firms still pour plenty of money into big-ticket resource deals, but private firms are rapidly catching up, investing in consumer goods, technology and services. And developed countries, not emerging markets, are the big beneficiaries.

"Blood, oil and sand" sounds like the title of a Hollywood film—a thriller in Iraq, perhaps, or a hostage drama in the Niger Delta. But it also sums up the focus of China's overseas investment in 2013, which was dominated by two giant deals. First came CNOOC's US$15.1 bn acquisition of Nexen, a Canadian oil and gas company with global offshore production sites and major holdings of oil sands. Next up was the US$7.1 bn purchase of US pork producer Smithfield Foods by Chinese meat firm Shuanghui International (since renamed WH Group).

CNOOC's acquisition is the largest ever by a Chinese company, topping Chinalco's US$12.8 bn investment in Rio Tinto in 2008. And it follows the same, well-trodden path: China's state-owned enterprises (SOEs) have long scoured the globe for natural resources to feed the nation's economic boom. By contrast, WH Group's purchase marks a new stage in China's "going out" process. WH Group, a meat processor based in Henan province, is the first private company to vault over the US$5 bn foreign-investment bar. Its takeover of Smithfield puts it in the same bracket as state-backed oil majors like CNPC and Sinopec.

Tom Miller is editor-at-large of the *China Economic Quarterly* and author of *China's Urban Billion* (Zed Books, 2012).

What do these giant deals tell us about the changing pattern of Chinese overseas direct investment (ODI)? First, despite reports to the contrary, they show that the eagerness of state-backed firms to secure massive resource deals is not waning. In 2013, SOEs made 15 resource deals each worth in excess of US$1 bn—more than during the spending sprees of 2008 and 2009. Second, private firms are now entering the fray on a large scale, and their interests are more diverse. The raid on Smithfield followed Dalian Wanda's US$2.6 bn purchase in 2012 of AMC Entertainment, owner of the biggest chain of movie theaters in the US. Energy and metals remain the plum targets for SOEs, but a growing share of ODI comes from private firms engaged in real estate, agriculture, finance and technology.

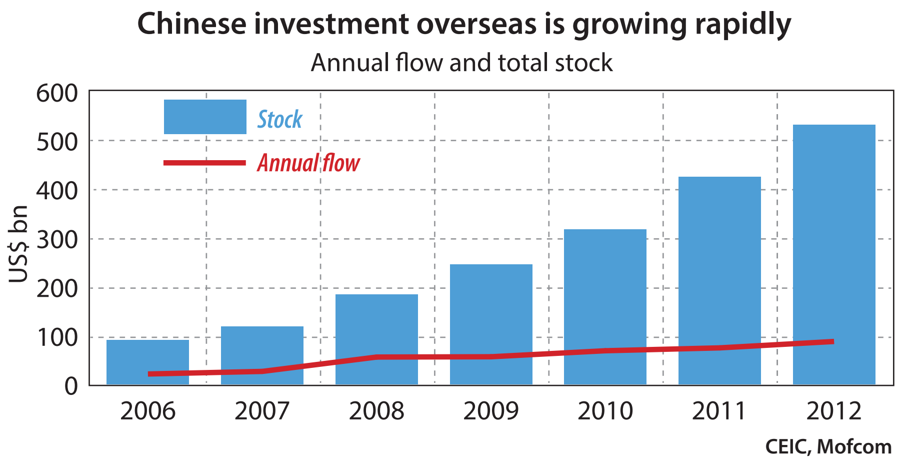
And finally, developed countries are now the top destinations for Chinese investment. China is a big investor all over the globe, but more firms are looking to established markets to tap wealthy consumers or acquire things lacking at home—whether that means expertise, technology or safe meat. China's stock of outward investment remains small, at around a tenth of the United States' US$5 trn. But on a flow basis China has firmly established itself alongside the US and Japan as one of the top three sources of cross-border investment flows.

Half a trillion and counting

Measuring the direction of the rising tide of Chinese investment is trickier than it should be. Official data are released by the Ministry of Commerce (Mofcom), which estimates that China's ODI flows hit US$88 bn in 2012, taking the total stock of outward investment to US$532 bn. Less helpfully, they show that more than two-thirds of ODI is channeled through the tropical tax havens of Hong Kong, the British Virgin Islands and the Cayman Islands, where it flows into "leasing and business services"—weasel words for tax dodging and siphoning funds to subsidiaries and shell companies. They do not record its final destination.

Fortunately, several other sources have attempted to fill in the record. A Capital, a European midcap growth fund, publishes an index (www.acapital.hk/dragonindex) tracking all Chinese outbound investment since 2001. It estimates that total ODI in 2013 was US$96 bn, of which US$56 bn was plowed into M&A in foreign companies and US$40 bn into greenfield investments. State-owned enterprises accounted for 80% of M&A investments, of which two-thirds were in resources. Nearly half of M&A activity was in North America, driven by the giant Nexen and Smithfield deals.

The Heritage Foundation, a conservative think tank in Washington DC, maintains a China Global Investment Tracker (www.heritage.org/



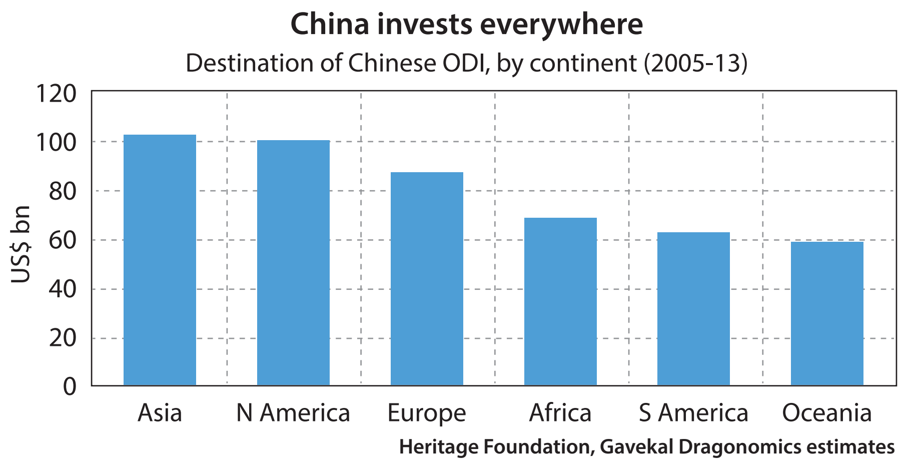
research/projects/china-global-investment-tracker-interactive-map) that records all Chinese direct investments exceeding US$100m since 2005, gathered from newspaper reports and company filings. It finds that the stock of Chinese ODI in 2005-13 was US$479 bn, just US$53 bn shy of the total stock recorded by Mofcom. Chinese companies invested in nearly 100 countries, making 545 deals of over US$100m and 141 over US$1 bn. These were evenly split between the rich group of OECD nations and less developed economies, according to our calculations.

A more detailed database of Chinese investments in the US is maintained by Rhodium Group, a New York-based economic consultancy (see "America, Land Of Opportunity" on page 15). And the Economist Intelligence Unit has a "China Going Global Investment Index," which uses a combination of data and surveys to track trends in Chinese outward flows.

Rich countries, not poor, are the prime targets

There are material discrepancies between these data sources, making precision impossible. But the broad outlines of the direction of Chinese investment are clear. Contrary to the common view that Chinese money mostly goes into resource-rich, governance-poor African countries, the biggest destinations are probably the US and Australia, which according to Heritage have both received inflows of nearly US$60 bn (Rhodium Group's more conservative estimate for the US is US$37 bn).

Through 2012, the data suggested that the investment tide was turning decisively away from emerging markets, as the share of investments in OECD countries rose from 29% in 2005 to 73% in 2012. But this figure slipped back to 35% in 2013, suggesting that Chinese capital flows are reasonably opportunistic. On the whole, however, it seems likely that as Chinese ODI becomes more driven by the private sector, it will tend to flow



to economies with large markets, stable investment regimes, and strong technology assets. The EIU's latest survey shows that the destinations most favored by Chinese investors (excluding the entrepôt cities of Hong Kong and Singapore) were the US and Japan; the only emerging market on the top-10 list was Russia.

Private sector flows are growing fast

Turning to sectors, a great shift is underway. A decade ago, almost every deal involved energy or mining, and the stock of Chinese ODI remains concentrated in natural resources—oil and gas, high-grade coal mines, hydropower, metal ores. But the past five years have seen a rapid diversification into technology, consumer goods and services, agriculture and real estate. More companies are keen to acquire foreign brands and technologies for use at home, or simply to access new markets as growth in China slows.

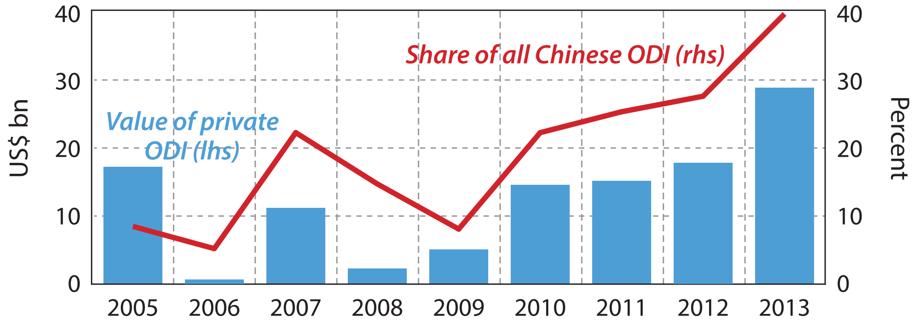
This shift reflects the rapidly growing role of the private sector in powering Chinese ODI. Based on Heritage data, we estimate that private firms now account for nearly 30% of annual ODI flow by value, double the proportion in 2010, and fully 40% of the number of deals. Since many private-sector investments are small scale and ignored by news reports, the true private share of transactions (not value) almost certainly exceeds 50%.

Private firms are becoming bolder: their average M&A deal size jumped 50% to US$529 mn in 2013, according to A Capital. Around 80% of private investment was in industry, and 20% in services. By contrast, almost all M&A deals in natural resources were made by SOEs. Big private firms favor North America and Europe, where they account for nearly one-third of all Chinese M&A by value.

Taken together, the trends suggest that Chinese ODI is becoming more "normal" and less scary than it seemed a few years ago, when a breathless

Private firms' share of investment is rising

Overseas direct investment by private Chinese companies



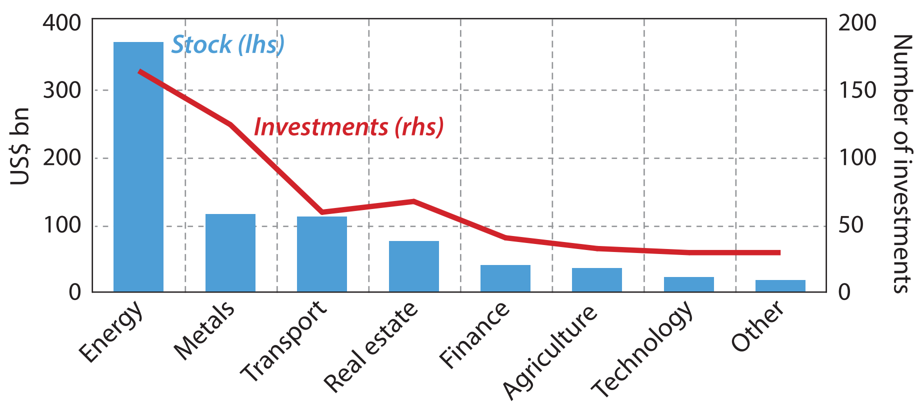
The Heritage Foundation, Gavekal Dragonomics estimates

media and political scaremongers suggested that unstoppable state firms, backed by a bottomless treasury, were embarked on a mad quest to "lock up" scarce natural resources. For one thing, China still punches well below its economic weight in global direct investment flows: according to the EIU, its annual contribution to global ODI (7%) is rather less than its share of global output (12%). On a flow basis, China still invests less abroad than Japan, and only about a third as much as the US. Its stock of ODI is only one-tenth that of either the US or the combined European Union.

Looking ahead, it is probable that SOE investments in resources, and private investments in a diverse array of consumer, technology and service projects, will grow in tandem. Two takeovers announced on the same day in April 2014 highlight the current face of Chinese investment. State-owned MMG's US$5.9 bn deal to buy a copper mine in Peru from the Anglo-Swiss commodity trader Glencore Xstrata is of the old school.

Most of the money's still in mining

Chinese ODI by sector (2005-13), by type

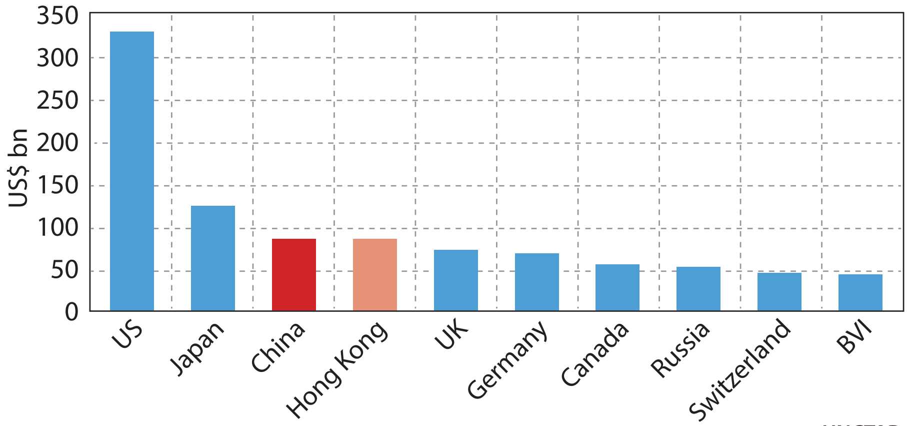


The Heritage Foundation, Gavekal Dragonomics estimates

Meanwhile, the purchase of UK department store chain House of Fraser by Nanjing Cenbest—a subsidiary of the private, Jiangsu-based conglomerate Sanpower—reflects the broadening scope of Chinese ODI. Sanpower's chairman Yuan Yafei, who claimed it was the "largest overseas acquisition in the retail sector by a Chinese business," said he would replicate House of Fraser's model in China. As the tide of Chinese investment rises, many more Western brands will find themselves washing up on eastern shores.

China is now the world's third biggest annual investor...

Top 10 investor economies by ODI flow (2012)



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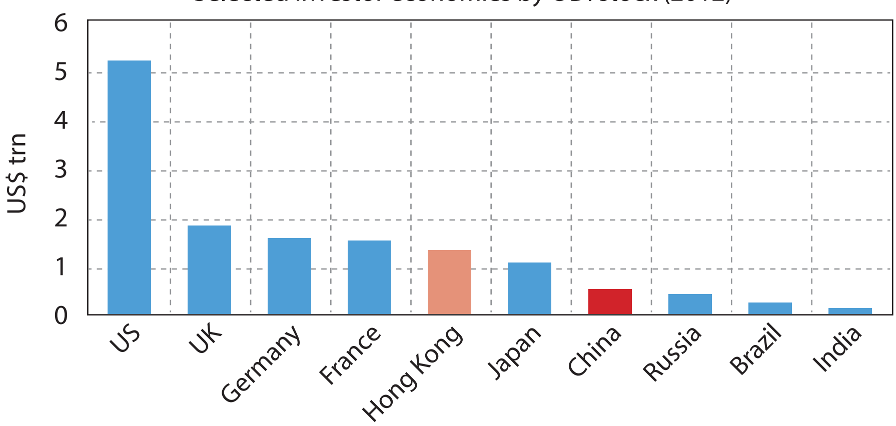
...but its stock of investment remains small

Selected investor economies by ODI stock (2012)



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Investment Abroad: The Dragon Steps Out

America, Land Of Opportunity

By Thilo Hanemann and Daniel H. Rosen

China's outward direct investment is rising rapidly, and the United States is getting a bigger share of those flows—US$14 bn last year. But unless China opens its own doors wider to foreign investment, a political backlash could emerge.

When Chinese firms started investing abroad, they focused on resource extraction in developing countries. But this is changing rapidly. China's investments in developed economies have surged in recent years, driven by greater private-sector activity and an increased appetite for assets such as brands, technology and consumer capabilities. The US has become one of the biggest recipients of Chinese outward direct investment (ODI) in the developed world, with inflows from China soaring from an annual average of less than US$1 bn before 2008 to more than US$14 bn in 2013.

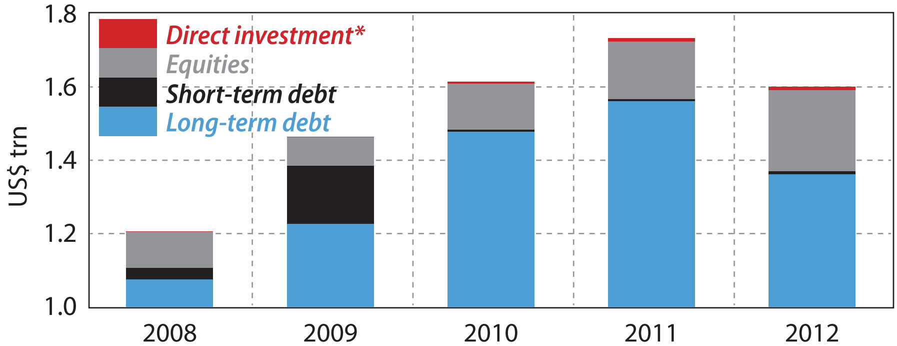
Even though China's economy is slowing, the boom in Chinese ODI will continue, thanks to market-oriented structural reforms and a less restrictive regulatory environment for private firms. We expect that China's ODI stock will at least double from its present level of US$530 bn by the end of this decade. The US, which will get a big share of these flows, welcomes Chinese investment and only screens for a narrow set of national security concerns. But if China fails to address concerns about the economic impact of these investments, curb the advantages for its state-owned enterprises, and correct inequities in market access, there could be a broader backlash against Chinese ODI in America.

China has been a significant exporter of capital to the United States since the early 2000s. In the early years, the vast majority of this capital

Thilo Hanemann and Daniel H. Rosen are respectively research director and partner of Rhodium Group, a New York-based research and consultancy firm.

By all means, be a lender

Stock of Chinese capital in the US



*Historical cost and ultimate beneficiary ownership basis

US Bureau of Economic Analysis, Treasury International Capital System, Rhodium Group

took the form of central-bank purchases of US Treasury and agency debt. By the end of 2012 China's official holdings of US debt were nearly US$1.4 trn. Since 2008, portfolio equity holdings grew as Beijing allowed sovereign vehicles (and, to some extent, banks and other investors with special quotas) more freedom to invest in equities outside of China. By the end of 2012, Chinese investors held around US$221 bn of US equities.

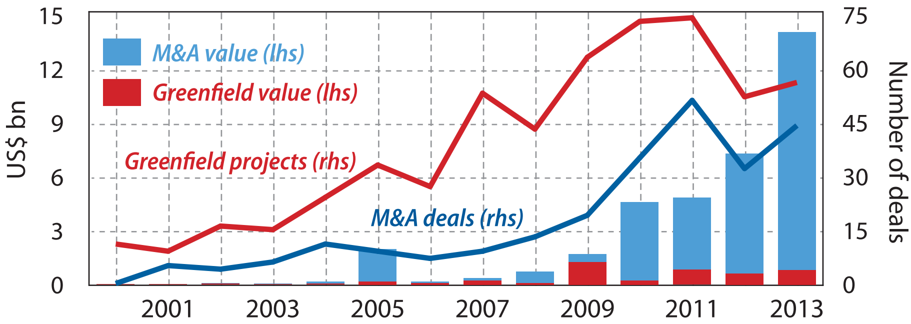
Inflows of direct investment (usually defined as long-term investment in 10% or more of the target company or project) were negligible for most of the past decade, as Chinese firms had neither the capacity nor the motive to invest in US operations. According to official data, China had an FDI stock in the US of just US$10 bn in 2012—only a tiny fraction of China's total holdings in the US and less than half a percent of the United States' total inward FDI stock of US$2.65 trn. But since 2008, Chinese direct investment in the US has been growing fast, signaling the start of a major structural shift.

Officially uncaptured

For a variety of reasons (mostly the extensive use of offshore vehicles and a significant time lag), official data fail to capture much of this activity. Researchers have therefore come up with alternative datasets that describe trends and patterns based on transactional data. One such dataset is Rhodium Group's China Investment Monitor, which tracks acquisitions and greenfield projects by ultimately Chinese-owned companies in the US. This shows that the annual value of FDI transactions was far below US$1 bn before 2008 (except for 2005 when Lenovo acquired IBM's personal computer unit). Since then, annual investment has soared, to a total of US$14 bn in 2013, driven by large-scale transactions in food, oil and gas

The beginning of a big wave

China's direct investments in the US, by type



For sources and methods, visit http://rhg.com/interactive/china-investment-monitor

Rhodium Group

and real estate. We estimate the total value of Chinese ODI transactions in the US from 2000-2013 to be at least US$37 bn.

What accounts for this dramatic shift? One factor was China's liberalization of its restrictions on ODI. Recent decisions to simplify outward investment approvals will give further momentum to ODI growth. But the bigger reason is a changing Chinese marketplace, which is pushing more and more Chinese firms to invest overseas in an ever broadening array of sectors.

Energy tops the list. The failed 2005 effort by China National Offshore Oil Corp (CNOOC) to take over Unocal chilled Chinese enthusiasm for natural resource projects in the United States for several years. But the unconventional energy boom has made the US a prime frontier for global oil and gas investments and revived Chinese interest in North American energy plays. Another driver was a greater awareness of political risks related to resource investments in politically unstable countries, triggered by developments in Sudan and Syria. Since 2010, the US energy sector has been a major recipient of Chinese investment, attracting US$8 bn from Chinese firms eager to expand their overseas production bases and involvement in cutting-edge extraction techniques.

A more recent trend is Chinese investment in American technology and advanced manufacturing, fueled by structural adjustment at home. Increasing competition, rising factor input costs (especially labor), environmental compliance and remediation costs, and local impediments to consolidation to achieve economies of scale have spelled the end of the old Chinese business model. These new operating realities encourage Chinese firms to acquire US assets to increase their competitiveness at home and preserve access to US customers abroad. The growing number of invest-

Not just about oil wells

Cumulative value of Chinese ODI transactions in the US, by sector (2000-13)

	US$ mn	% of total
Coal, oil and gas	7,936	22
Food processing and distribution	7,123	19
Technology	7,091	19
Other energy (including utilities)	3,925	11
Consumer services and products	3,878	11
Real estate	3,053	8
Other	3,660	10
Total	**36,665**	

Rhodium Group

ments in industrial machinery, electrical equipment and components, automotive, alternative energy, medical devices and communications equipment illustrates the strong desire to invest in technology, brands, human talent and other competitive assets. Looking forward, access to technology and know-how will become a major driver of Chinese investment in the US. In the first quarter of 2014 alone, Chinese investors announced deals worth more than US$6 bn in US high-tech sectors, with targets such as Motorola Mobility, IBM's x86 server business, Wright Medical's Orthorecon business and Fisker Automotive.

A related trend is the increasing Chinese investment in modern service operations such as research and development, design and testing. Those investments complement the acquisition of advanced manufacturing assets and allow Chinese firms to tap into the US talent base and move closer to their US customers. In the last two years, we also saw increasing interest in acquiring core service-sector assets, as Chinese firms gear up to profit from a domestic service-sector boom: for example, Wanda's acquisition of movie theater chain AMC in 2012. The most targeted sectors are software and IT services, financial services, entertainment, and hospitality.

Finally, longer-term direct investment stakes are increasingly becoming part of the asset management strategies of Chinese individuals, firms and institutional investors. Traditionally, those investors had a politically mandated "home bias" and held most of their assets in China. However, given the risks of a concentrated portfolio and the current uncertainties about the growth outlook in China, those investors are looking to diversify their portfolio internationally. Safe-haven economies with sound legal systems and property rights protection, like the US, are naturally attractive for such flows. The drop in prices following the financial crisis has made US residential and commercial real estate an attractive target for these investors. Other industries that traditionally offer stable long-term returns, such as utilities, have also attracted significant Chinese interest.

Lots more investment is on the way

China's outbound investment boom is just beginning. We expect China's ODI stock to grow from the current US$530 bn to US$1-2 trn by 2020. A significant share of this capital will flow to advanced economies as domestic restructuring will increase the commercial logic for outbound investment and the private sector will have more freedom to globalize.

With rising labor and capital costs and a government now ostensibly committed to promoting industrial efficiency, Chinese firms must adjust their business models, moving up into higher value-added products and down the value chain to capture margins closer to consumers. Going abroad is key to this adjustment. Offshoring low-value-added activities to other countries, acquiring brands and technological capabilities, and directly serving customers in overseas markets all require ODI. Another major driver for Chinese companies to go abroad is to acquire technology and know-how that will strengthen their competitiveness at home.

China's ODI stock should grow from its current US$530 bn to US$1-2 trn by 2020

Deregulation of cross-border capital flows will support this movement. Beijing's current rhetoric suggests that the leadership is committed to speeding up the liberalization of outward ODI, by reducing the role of the National Development and Reform Commission in approving investments, and by loosening controls on capital movements. Lowering the current bureaucratic hurdles will particularly benefit outbound ODI by private firms, which now face a burdensome approval process that delays decisions, increases deal risk and puts Chinese firms at a disadvantage in competitive bidding processes.

America's door is open; China's, not so much

One potential obstacle to the flood of Chinese ODI is more restrictive rules in target countries. So far, despite the overheated rhetoric that swirls around a tiny number of headline-grabbing deals, most countries have done little or nothing to restrain inflows of Chinese cash. This could change, however, if China fails to allay lingering concerns about unfair advantages for state-owned and state-supported firms, and improve the environment for foreign investors in China—who still face far more draconian limits on their activities than Chinese firms face abroad.

In the US, investments from China have become a big part of the work of the Committee on Foreign Investment in the United States (CFIUS), which screens FDI proposals for national security threats. China's share in CFIUS-reviewed deals grew from virtually zero before 2008 to 20% in 2012, reflecting both the increase in inbound Chinese deals as well as the recent shift from trade-facilitating investments towards extractive industries and advanced manufacturing. A small number of Chinese deals have been derailed by national security concerns, and some have been politicized outside of the CFIUS process by special interests using national security anxieties. CFIUS, however, has generally worked well in the past and has allowed legitimate investments. The recent surge in inbound FDI and successful transactions in sectors like aviation, food or advanced batteries show that Chinese investors are increasingly capable of navigating the regulatory process with the help of local partners.

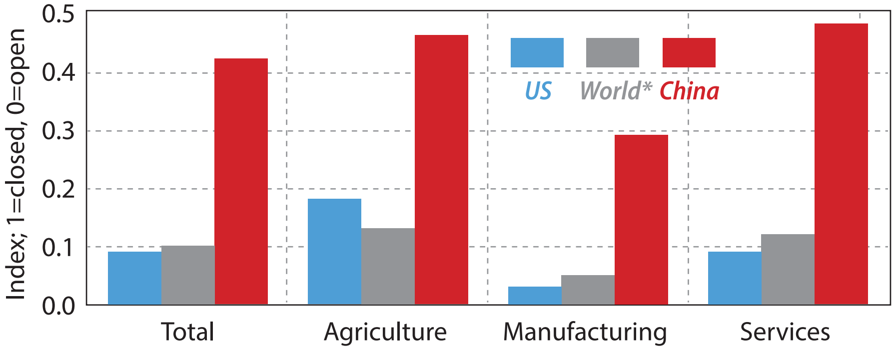
Despite complaints, Chinese firms are proving more adept at navigating investment review boards such as CFIUS

But the situation may change if China's domestic reforms do not keep pace with the growth in its global investment. The most urgent and visible problems are the asymmetry in market access between China and the US, and allegedly unfair advantages for Chinese state-owned and state-supported enterprises. These problems have already triggered tighter reviews of Chinese inbound ODI in other advanced economies such as Australia and Canada. Some in Washington are calling for an expansion of US investment screening from a narrow national security focus to a broader "net benefit" test.

China formally restricts foreign investment in many sectors, including those in which Chinese firms now invest overseas; the OECD finds that China is far more closed to FDI than is typical of major economies. And there is rampant informal discrimination of foreign companies in China as well. As Chinese companies now compete head-to-head with US firms in open, overseas markets, and Chinese FDI in the US now, by some measures, exceeds US direct investment in China, indulgence toward this "developing economy behavior" is fading fast. The US does not need to ask for outright reciprocity, but a substantial reduction in Chinese investment barriers is needed to maintain political support in America for keeping the door open to Chinese companies.

Still behind the Great Wall

Formal restrictiveness to FDI (2013)



*58 major countries

OECD, Rhodium Group

To address these concerns, Beijing is negotiating bilateral investment treaties (BITs) with the US and the European Union. Negotiators hope that China will offer significant cuts to its list of industries that are restricted to foreign investors, following President Xi Jinping's call at the Party Third Plenum in November 2013 to "select the superior and eliminate the inferior" by giving market forces a greater role in the Chinese economy. Given the surge in Chinese ODI, it would be even better if China does not wait until a BIT is ratified, but instead presses ahead and unilaterally announces an early harvest of investment opening in important sectors as early as this year. Such a step would signal that China is aware of the new realities in cross-border investment flows, and that it is committed to addressing existing barriers before they become a major obstacle to its own firms investing overseas and threaten an open global investment environment.

Investment Abroad: The Dragon Steps Out

Whatever Became Of China, Inc.?

By Erica Downs

Some used to worry that "China, Inc."—Chinese resource companies, state-owned banks and government agencies working in concert—would "lock up" energy and mineral resources around the world. Those fears proved misplaced, thanks to miscues by Chinese firms and changing market conditions.

A decade ago, China's state-owned energy and mining companies seemed on the verge of becoming a global juggernaut. Driven by an unexpected surge in the country's commodity demand and fueled by cheap loans from state-owned policy banks, Chinese firms went on a resource buying binge from Afghanistan to Zambia. Many outside observers, especially in the United States, fretted that "China, Inc." would be able to acquire anything, anywhere, and that nobody could stop them.

Today, everyone has calmed down. True, Chinese resource companies are now big international players: their value share of global oil and natural gas mergers and acquisitions grew from less than 3% in 2005 to 15% percent in 2012, according to Bernstein Research. Yet they have learned some very hard lessons along the way, and anxiety in the rest of the world has notably lessened. Looking ahead, there are good reasons to believe that Chinese state firms will become more selective and commercially driven in their outward investments.

In fact, the "China, Inc." stereotype was never as accurate as some outside observers feared and some Chinese desired. China's companies,

Erica Downs is a fellow at the John L. Thornton China Center at the Brookings Institution, focusing on the international expansion of China's companies and Chinese energy policy.

government agencies and financial institutions rarely function as a coherent entity. Instead, the Chinese executives, bureaucrats and financiers involved in cross-border transactions often have competing and uncoordinated agendas. Chinese commentators have lamented a situation of "each soldier fighting his own war."

Each soldier fighting his own war

Chinese firms have competed against each other for overseas projects since they began venturing abroad in large numbers in the mid-2000s. Once one Chinese company identified an overseas target, other firms would join the pursuit in lemming-like fashion, prompting one Chinese manager to joke that the biggest fear of Chinese firms expanding abroad is not competition from foreign companies but rather poaching by domestic "brother" enterprises. Chinese officials decry such fraternal rivalry because it can lead to bidding wars, pushing up the price paid by the winning Chinese firm.

In two early iconic—and significantly, failed—"China, Inc." deals, the separate agendas of Chinese companies, government agencies and financiers were not well aligned. In the case of Minmetals' attempted acquisition of the Canadian miner Noranda in 2004, the Chinese government effectively scuttled the transaction by failing to approve it before the exclusive negotiating period expired. Minmetals, which sought to transform itself from a trading company to a diversified natural resources firm, had lined up debt financing from China Development Bank (CDB). The bank regarded the transaction as a way to promote the national interests in accessing raw materials and creating Chinese global champions, as well as bolstering its own expertise in financing cross-border M&A. Chinese officials, however, reportedly were worried about the cost of the acquisition and whether Minmetalswould be able to successfully manage an international mining company.

In two early "China, Inc." deals, the separate agendas of Chinese companies, government agencies and financiers were not well aligned, leading to failure

In the case of China National Offshore Oil Corp.'s (CNOOC) attempt to acquire the US oil company Unocal in 2005, the Chinese oil major appeared to have had the acquiescence but not the support of the Chinese government. Soon after CNOOC withdrew its bid in the face of strong political opposition in the US, the company's CEO, Fu Chengyu (who now runs the country's biggest oil refiner, Sinopec), publicly lamented the lack of effective government backing for Chinese companies investing abroad. He noted that it would have been helpful if the Chinese government agencies involved in the negotiations over North Korea's nuclear program, the purchase of Boeing aircraft and adjusting the renminbi exchange rate had considered CNOOC's bid for Unocal in the context of these three issues in US-China relations. Putting aside the question of whether such linkages would have helped sway US policymakers and pundits in CNOOC's favor, the point is that Fu felt his government had let him down.

Chinalco-Rio: the exception that proves the rule

The deal that crystallized the China, Inc. image proved to be an exception, not the rule. This was Chinalco's stealth acquisition of a 9% stake in the Anglo-Australian mining giant Rio Tinto in 2008. Chinalco, CDB and the National Development and Reform Commission (NDRC) worked closely together to undertake the transaction and undermine the proposed takeover of Rio Tinto by BHP Billiton, the world's largest mining company.

Chinalco's raid on Rio Tinto seemed proof positive of the existence of China, Inc. The government feared that the merger of BHP Billiton and Rio Tinto—two of the three companies that dominated the global iron ore trade, and suppliers of 40% of China's ore needs—would drive up prices. So it put out a call to stop the marriage. Chinalco and CDB responded to this call for national service and worked hand in glove with China's leaders to flawlessly execute the largest share raid in history.

> Chinalco's 2008 raid on Rio Tinto showed a level of concerted action that China has subsequently never been able to match

In fact the coordination in this case was entirely exceptional. First, the circumstances were unusual. The contract iron ore price increased fourfold between 2004 and 2008, including a 66% increase in 2008 alone, to US$61 a ton. Chinese officials, who did not understand global commodities markets as well as they do today, assumed that a tighter oligopoly would lead automatically to an even greater rise in prices. (Ironically, the iron ore price climbed even more dramatically after Chinalco's investment in Rio, thanks to the abandonment of the contract-price system. The spot price peaked at over US$180 a ton in early 2011).

Second, Chinalco's talented CEO, Xiao Yaqing, saw the share raid as a way of transforming Chinalco into a global multi-metal company and serving his personal ambition to climb higher in the Party-state bureaucracy (after the Rio deal, he was rewarded with a promotion to deputy secretary-general of the State Council) At any rate, no large Chinese resource deal before or since has exhibited anywhere near the level of concerted action shown in this instance.

A second reason people have stopped worrying about China's energy and mining companies taking over the world is the fact that, as latecomers to the global commodity markets, Chinese firms have mainly been stuck bidding for relatively low-quality, high-risk projects. As Fu Chengyu observed in late 2004, "It's actually not easy for us to find good projects. The world oil industry has a one hundred year history. The good projects are already taken."

That said, the shale gas and tight oil boom in the US has created some good opportunities for China's oil companies. Not only have they invested in unconventional oil and natural gas projects in the US, but they have also purchased assets in third countries sold by US oil companies that want to focus their investments at home. Moreover, China's oil companies probably face less competition for assets in Canada's oil sands and Brazil's offshore fields than they would have had the American unconventional energy revolution not occurred.

> The main reason for reduced anxiety abroad is that many of China's overseas energy and mining projects have fared poorly

Perhaps the most important reason for reduced anxiety abroad is simply that many of China's overseas mining projects have not fared very well. Chinese companies have struggled to deliver natural resource development projects on time and on budget and to be good corporate citizens, damaging their reputations in the process. Many of the problems Chinese firms have encountered overseas stem from their failure to do adequate due diligence.

The poster child for overseas investments gone awry is the Sino Iron project being developed by Citic Pacific and Metallurgical Corporation of China (MCC) in Western Australia. The project is US$6 bn over budget and four years behind schedule. Some industry experts think it may never be economically viable. The basic problem was that the Chinese developers, who had never before mined iron ore, failed to do their homework. Citici Pacific and MCC were unaware of the specific environmental challenges at the project site, which are vastly different from those in China. They were also in the dark about Australia's immigration and labor laws, which thwarted MCC's plan to use low-cost Chinese workers to develop the project.

Other mining mishaps span the globe. In Ghana, illegal Chinese gold miners have been a diplomatic headache for Beijing. Accused of looting resources, taking jobs from Ghanaians, flouting local laws and damaging the environment, hundreds of Chinese gold diggers have been deported while others have been attacked by angry Ghanaians. In Zambia, protests by workers over low wages and poor working conditions have turned violent, with Chinese managers shooting the protestors and tarring the reputation of Chinese companies as foreign investors.

New commandments for going out

China's companies and government have learned from these setbacks abroad. CEOs and officials are now focused on ensuring that overseas investments do not lose money or damage the China brand. The new thinking about China's "going out" strategy can be summed up in four commandments:

Thou shalt not overpay. Chinese energy and mining companies, which had developed a reputationfor paying top dollar, are getting more cautious about the premiums they offer. In 2011, for example, Minmetals subsidiary MMG walked away from a bidding war with Barrick Gold for Equinox Minerals on the grounds that topping Barrick's offer would be value destructive. Similarly, NDRC, tired of watching China's companies throw good money after bad, has made its approval of proposed overseas acquisitions conditional upon the Chinese buyer obtaining a "reasonable" acquisition price. This requirement prompted Hanlong Mining to revise its offer for a stake in Australia's Sundance Resources from A$0.57 to A$0.42 a share before the deal collapsed with the arrest of Hanlong's CEO Liu Han in 2013.

Thou shalt thoroughly vet potential acquisitions. The endorsement of the chief engineer of the Chinese acquirer is no longer enough to get the green light from NDRC and debt financing from CDB. Chinese executives, officials and financiers want independent, professional assessments of potential targets to help separate the good projects from the bad ones. Indeed, the State-owned Assets Supervision and Administration Commission (Sasac) now requires state-owned companies seeking to invest abroad to procure feasibility studies and due diligence reports, including a third-party appraisal of the value of the target.

Thou shalt be held responsible for deals gone south. Unlike their counterparts at companies like Rio Tinto and Exxon Mobil, the CEOs of China's state-owned mining companies appear to have suffered few consequences for spectacular losses that have occurred during their tenures. Former Rio

Tinto CEO Tom Albanese lost his job in connection with a US$3 bn write-down on coal assets acquired in Mozambique. But no heads have rolled at Citic Pacific, where Chairman Chang Zhenming has seen the costs of the Sino-Iron project balloon on his watch. Similarly, Shen Heting remains the boss of MCC despite a series of overseas investments that have lost money or harmed MCC's reputation (or both). However, the times may be a-changing. In 2011, Sasac unveiled new rules stipulating that state-owned enterprises (SOEs) and related persons will be held responsible for major losses on overseas investments if the company did not provide Sasac with an investment plan and information on financial sources before undertaking the transaction.

Thou shalt be good corporate citizens. Numerous Chinese companies have learned the hard way that good corporate citizenship is good for business. Indeed, CEOs increasingly recognize that winning the hearts and minds of their hosts is critical to successfully running multi-billion dollar, multi-decade operations. Consequently, China's energy and mining firms are building schools and health clinics, creating jobs for locals, protecting rare species of flora and fauna, and supporting sports teams around the globe as part of their efforts to reduce above-ground risks and burnish their reputations.

A fading phantom

Looking down the road, other factors are conspiring to constrain the might of the mythical China Inc. These include a diminishing capital-cost advantage, increased environmental consciousness, and a state-enterprise reform agenda that will increasingly force big firms to justify acquisitions on purely commercial terms.

China's SOEs have traditionally enjoyed a low cost of capital, in part because of access to three cheap funding sources: low-interest bank loans, low-interest bonds, and (especially for overseas deals) attractively-priced loans from the CDB. All three sources are at risk. As financial liberalization progresses, bond rates could rise—threatening SOEs' own direct funding costs and also putting pressure on CDB, which funds itself on the bond market. Bank loan rates have not yet moved up but could well do so within a couple of years, if Beijing makes good on its pledge to liberalize deposit interest rates. Moreover, very low inflation (and outright deflation in many materials prices) means that the real cost of capital for SOEs is rising faster than nominal rates imply.

Second, China's companies may become more environmentally conscious thanks to Premier Li Keqiang's "declaration of war on pollution" at the last meeting of the National People's Congress. Sinopec, for example, has committed to spending billions of dollars to upgrade its refineries to produce cleaner fuels after years of foot-dragging in response to dangerous levels of air pollution. Greener behavior at home could translate into greener, and more cautious, behavior abroad.

Third, as China shifts from a growth model that relied heavily on investment and exports to one that is more dependent on productivity growth and consumption, the energy and metals intensity of China's economy will diminish, tamping down the demand for commodities. More modest import growth, combined with greater understanding in China about how commodity markets operate, are likely to result in more deliberate overseas natural-resource acquisitions by Chinese companies—a shift from the panic buying of the mid-2000s.

Finally, Chinese companies can no longer count on getting permission to "go out" and generous debt financing simply because they are investing in natural resources in short supply in China. The call in last November's Third Plenum decision for SOEs to maintain and increase the value of state assets, raise production efficiency, and compete on an equal footing means that government and policy bank support for resource investments abroad will be more likely to be conditional than it was in the past. Companies are more likely to receive approval and financing for their acquisitions if they have proven overseas track records and experience producing the commodities they seek to acquire, and if the proposed investment is unlikely to create diplomatic challenges for China or damage its reputation. In other words, individual Chinese resource companies should mature into more savvy competitors. Nevertheless, the threat of unfair competition from a vague and monstrous "China, Inc." with unlimited access to cheap capital and unconditional government backing appears to be fading fast.

Aid To Africa: Helpful Or Harmful?

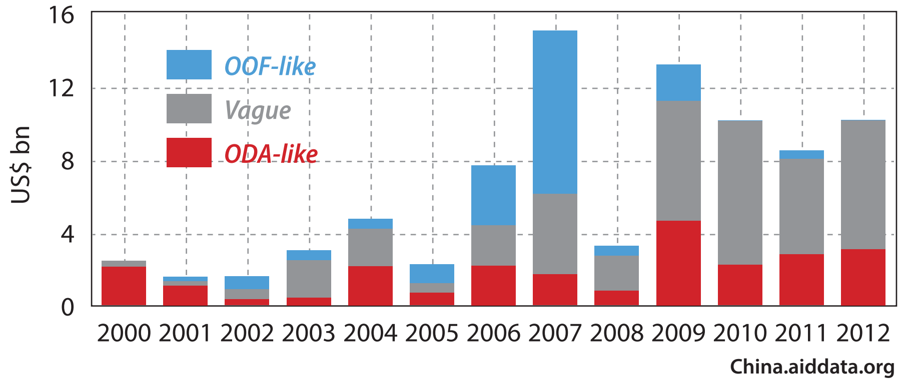
By Bradley C. Parks and Austin M. Strange

Critics have long argued that Chinese aid to Africa is self-interested and perhaps even harmful for African states. A close study of the data suggests the truth is much more complicated.

Over the last 15 years, Beijing has rapidly expanded its overseas development activities across Africa. Critics have leveled various charges at China's activities there. Some argue that Beijing is using its largesse to secure natural resources. Others claim that China is at best providing assistance without any regard for domestic political conditions in recipient countries, and at worst propping up despots and unraveling hard-won governance reforms. Still others propose that China is saddling African governments with large amounts of debt that will prove difficult to repay, and promoting development projects that involve inhumane labor practices and environmental degradation.

Unfortunately, the debate over the impact of Chinese aid is hamstrung by a lack of reliable and consistent data. China does not participate in the global aid reporting systems that most developed countries use. China also defines and measures aid in ways that depart from internationally accepted norms. The OECD's formal term for aid is "official development assistance" (ODA), defined as financial flows with developmental intent and a grant element of at least 25%. Most other financing from foreign governments that does not meet these criteria is classified as "other official flows" (OOF). OOF flows primarily consist of loans whose terms range from somewhat concessional to essentially commercial. The US

Bradley C. Parks is the Co-Executive Director of AidData at the College of William and Mary. Austin M. Strange is an AidData Research Associate and a graduate student at Zhejiang University.



Lots of money, not so much clarity

China's official finance to Africa

and most Western countries give Africa quite a lot of ODA and relatively little OOF.

The bulk of China's overseas development finance takes the form of loans that should probably be classified as OOF, because their terms and purpose are partly or wholly commercial. The confusion between aid in the strict sense of ODA, and the much broader range of concessional and non-concessional financing encompassed by OOF, has led to wildly different estimates of Chinese "aid," and has muddied the discussion of China's impact in Africa.

A new way to study Chinese "aid"

In order to address these data challenges, the development research and innovation lab AidData has launched an effort to track China's overseas development activities. This initiative starts by using open-source information—including English-language and Chinese-language news reports, case studies by academics and non-governmental organizations, company reports, project inventories from Chinese embassy websites, and grant and loan data published by recipient governments—to generate a database of China's foreign aid projects by country and by project type. To ensure that we get an accurate count of projects that are actually implemented, rather than simply announced on paper, we supplement this database with on-site inspections of development projects, analysis of satellite imagery provided by Google Earth, and crowd-sourcing via our website china.aiddata.org, where users (including journalists, NGOs and academic researchers) can flag potential errors in AidData's existing records, or point out previously unidentified development projects.

As of May 2014 our database contains more than 1,900 Chinese official finance projects worth over US$83 bn in financial commitments to Africa

Pure aid is a modest part of the picture
China official financing in Africa, by type (cumulative 2000-12)

	Number of projects	% of total	Value US$bn	% of total	Average project size US$ m
ODA-like	1,113	68%	24.1	29%	22
Vague	418	26%	41.0	49%	98
OOF-like	108	7%	18.4	22%	170

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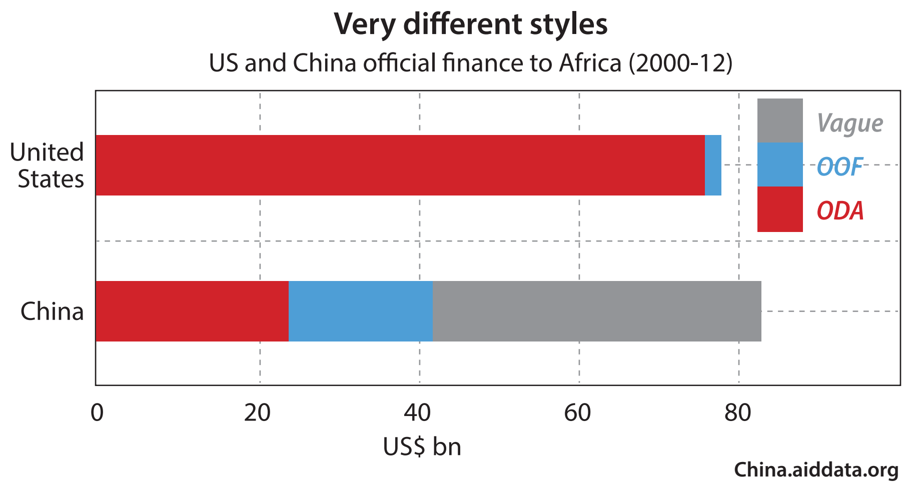
between 2000-2013. We divide these projects into three categories: ODA (traditional "aid"), OOF (mainly concessional lending), and "vague flows," for projects where we lack enough information to define them clearly either as ODA or OOF.

More than just bridges and roads

What does this data tell us? Two main conclusions stand out. First, if we consider only aid in the strict sense (ODA), China's reach extends well beyond natural resource extraction, infrastructure building and other "hardware" areas of economic development. Between 2000-2012 Chinese aid projects were most numerous in sectors such as government and civil society (235), health (199) and education (167). This diversity belies the caricature that aid from Beijing is motivated purely by its insatiable appetite for natural resources and a desire to open up international markets for its domestic firms.

Second, however, ODA represents only a minority of China's official finance activities in Africa, in contrast to the US and other Western countries, whose official financial involvement in the continent is pretty much limited to aid. For China, ODA accounted for two-thirds of official financing *projects* in Africa from 2000 through 2012, but less than 30% of the *value* of total flows. The average value of clearly identifiable Chinese ODA projects was US$22 mn. By contrast, clearly identifiable OOF projects averaged US$170 mn each, and in aggregate these accounted for nearly a quarter of flows. About a quarter of projects, and half of total financing flows, fall in our "Vague" category. It is probable that the majority of these projects are of an OOF nature.

About 70% of the combined OOF and Vague flows came in three sectors: energy generation and supply, transport and supply, and multi-sector, each of which accounted for about US$14 bn in flows over the 12-year period. These figures do lend some credence to the argument that



Chinese official financial involvement in Africa is driven by natural-resource extraction and related infrastructure concerns. And to the extent that most of these flows are in the form of loans, the worry that African countries may be incurring excessive debt burdens cannot be dismissed. But it is also true that Chinese OOF is enabling African states to extend the reach and improve the quality of state-run electricity grids, strengthen water and sanitation systems, and build the highways, railroads, bridges and ports necessary for domestic and international commerce. China's willingness to support these activities is significant because the under-provision of infrastructure has long constrained the productivity of African economies. Many countries have struggled to mobilize sufficient public and private capital to meet pressing infrastructure needs.

The contrast between the Chinese and the Western official profile in Africa is illustrated by a comparison of the combined official flows from China and the US in 2000-12. Over that period, the US provided about three times as much ODA to Africa as did China. But when you include OOF and Vague flows, the total commitments were almost identical, at around US$80 bn.

Villain, hero, or neither?

The best available data thus suggest that Western governments and China are taking very different tacks in Africa. In terms of official government financing, China provides considerably more support than do Western counterparts for the "hardware" of economic development. But Beijing is also actively expanding a portfolio of agricultural, educational, health and other socially oriented development projects across Africa, and much of this support is provided on concessional terms. The range of its true aid or ODA activities appears to be quite similar to that of Western aid programs.

The high proportion of Beijing's assistance that takes the form of OOF-like flows does open China to the critique that its interest in the continent is driven more by commercial than by altruistic motives, and that negative unintended consequences may follow. But one could argue with equal plausibility that Chinese official financing is helping to fill major infrastructural gaps, a legitimate economic development need which many Western states have proven reluctant to address.

Of course, official financing is only one component of China's footprint in Africa. AidData does not yet systematically track other financial flows from China, such as state-sponsored and private foreign direct investment and joint venture projects, which may very well be an important part of the overall story of how China is shaping development outcomes in Africa. Additional data collection and analysis will be needed to draw firmer general conclusions about China's development impact in Africa.