



China Outlook 2015

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Foreword

Thanks in part to economic stimulus and adjustment measures from the Chinese Government, the National Bureau of Statistics of China reported that China's economy grew by 7.4 percent in 2014, close to the government's target of 7.5 percent. By any standard, this is a very strong result – but at the same time, it shows that as China's economy matures, it is unlikely to attain double-digit gross domestic product (GDP) growth: slower GDP growth is now the 'new normal'.

In 2014, Chinese outward direct investment (ODI) entered a new stage, with more Chinese companies investing in more industries in more countries. According to the Ministry of Commerce of the People's Republic of China (MOFCOM), non-financial ODI in 2014 reached US\$102.9 billion, an annual increase of 14.1 percent. To move up the value chain, Chinese companies expanded overseas investment in additional new sectors, notably high technology, agribusiness and food, real estate, manufacturing, and services, and we saw increased investment activity into North America, Europe and Australia.

MOFCOM statistics show that foreign direct investment (FDI) into China also set a record in 2014, narrowly eclipsing the 2013 total. In fact, for the full year 2014, China's FDI increased to a record US\$119.6 billion, up by 1.7 percent year-on-year. The big story was FDI growth in the service sector which grew 7.8 percent in 2014, whereas manufacturing FDI witnessed a double-digit decline, reflecting the extent to which China's economy has been 'rebalancing' towards the service sector.

At the Central Economic Work Conference held in Beijing in December 2014, the Chinese Government laid out its agenda for the economy, as well as for FDI and ODI. The government emphasized stable economic growth policies and a focus on raising people's living standards. With regard to outbound and inbound investment, the conference discussed:

- Measures to promote the efficiency and quality of outbound investment
- The promotion of infrastructure investment and construction along the 'New Silk Road Economic Belt' and the '21st Century Maritime Silk Road'
- The broadening of market access to the service sector and further opening up of the manufacturing sector to foreign investment.

Against this backdrop, this outlook report seeks to highlight the major developments in China's macro-economy, ODI and FDI in 2014, and offers a closer look at the industry sectors where we identified emerging trends and opportunities.

This report from KPMG's Global China Practice (GCP) provides our outlook for 2015, including these predictions:




- GDP growth is likely to slow down further in 2015, but not dramatically
- Having likely overtaken FDI growth in 2014, ODI should see continued double-digit growth in 2015, which will widen the gap further
- FDI is likely to remain at the 2014 level of around US\$120 billion.



Peter Fung

Global Chair, Global China Practice

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Economic Outlook



Emergence of a 'new normal' for China's economy

China's GDP growth stood at 7.4 percent in 2014, averting a hard landing. The growth rate experienced a slowdown from 2013, mainly because of slower fixed asset investment growth and a challenging environment in the manufacturing sector. However, the speed of economic restructuring and upgrading increased. President Xi Jinping described this economic pattern as the 'new normal'.¹

Year-on-year GDP quarterly growth rate, 2011-2014

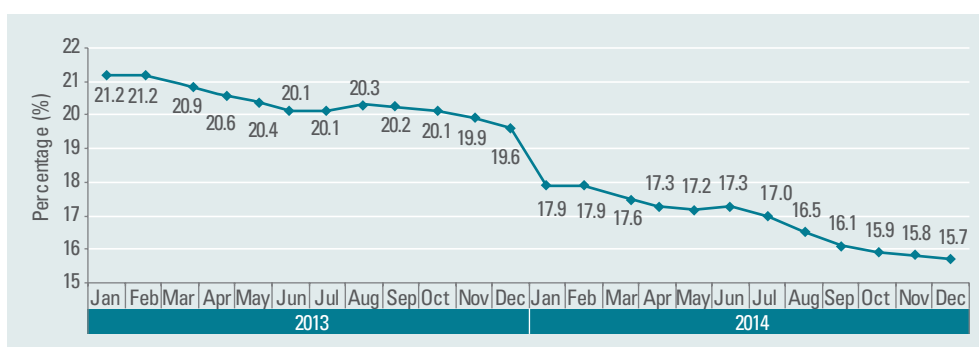


Source: 'China's Economy Realized a New Normal of Stable Growth in 2014', National Bureau of Statistics of China (NBS), 20 January 2015, http://www.stats.gov.cn/english/PressRelease/201501/t20150120_671038.html

The monthly growth rate of accumulated fixed asset investment year-on-year went through a continued decline in 2014, except for a 0.1 percentage point increase in June. This decline was mainly attributed to cooling real estate investment, which accounted for 18.9 percent of the total fixed asset investment in 2014. The downward pressure was partly offset by investment in infrastructure and agriculture, both of which had annual growth rates above 20 percent in 2014.

Investment from the private sector grew by 18.1 percent in 2014, 2.4 percentage points higher than the overall fixed asset investment growth rate. This brought its share of total fixed asset investment up from 63 percent in 2013 to 64.1 percent in 2014, indicating that the private sector is becoming more active than the state-owned sector.

Year-on-year fixed asset investment monthly growth rate, 2013-2014



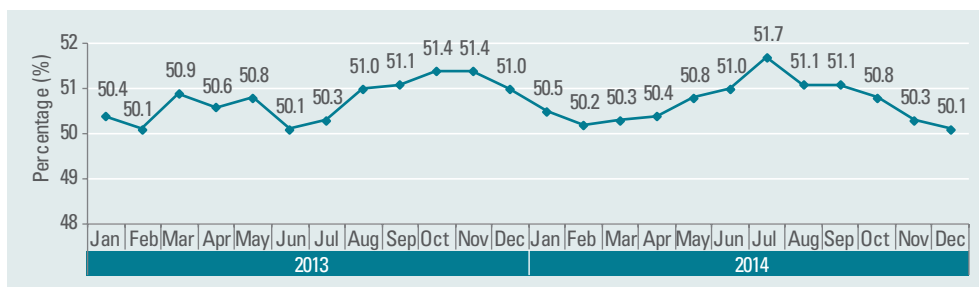
Source: 'China's Economy Realized a New Normal of Stable Growth in 2014', NBS, 20 January 2015, http://www.stats.gov.cn/english/PressRelease/201501/t20150120_671038.html

¹ 'Xi's "new normal" theory', *Xinhuanet.com* (新华网), 9 November 2014, http://news.xinhuanet.com/english/china/2014-11/09/c_133776839.htm

The service sector has become increasingly important as a driver of the economy. It accounted for 48.2 percent of China's economic output in 2014.

The manufacturing sector was still weak, with China's official Purchasing Managers Index (PMI) experiencing a continued decline since August, while industrial value-added growth also fell to 8.3 percent in 2014, 1.4 percentage points lower than in 2013. Although the production of traditional manufacturing such as the steel, cement and automobile sectors grew more slowly, some high-value manufacturing sectors remained active, such as the electronic equipment sector.

Monthly Purchasing Managers Index (PMI), 2013-2014

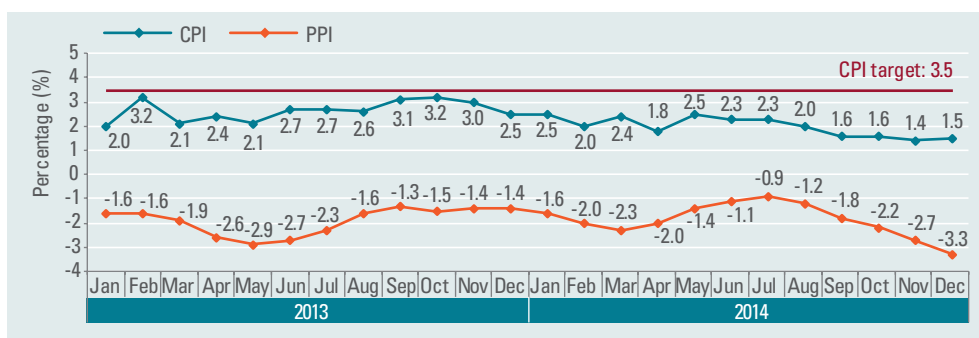


Source: 'China's PMI Was 50.1 Percent in December', NBS, 4 January 2015, http://www.stats.gov.cn/english/PressRelease/201501/t20150104_662879.html

Driven by the steady growth in personal income, demand for services such as tourism and healthcare increased over the past year.² However, consumption of goods did not perform as strongly: retail sales of consumer goods grew more slowly than in 2013. Inflation, as measured by the Consumer Price Index (CPI), which reflects the composite price of consumer goods and services, was held in check in 2014: at the end of 2014, CPI was 2.0 percent, well below the 2013 levels and well under the government's target of 3.5 percent, suggesting that the growth in service consumption was unable to offset the decline in the growth rate of consumer goods consumption. The Producer Price Index (PPI) has remained below zero since March 2012, which reflects the continued sluggish demand for manufactured products.

As we discussed in our 2014 third quarter *China Quarterly Report*, the service sector has become increasingly important as a driver of the economy. It accounted for 48.2 percent of China's economic output in 2014, up by 1.3 percentage points compared with 2013, leading the manufacturing sector by 5.6 percentage points.

Monthly inflation indices: CPI & PPI

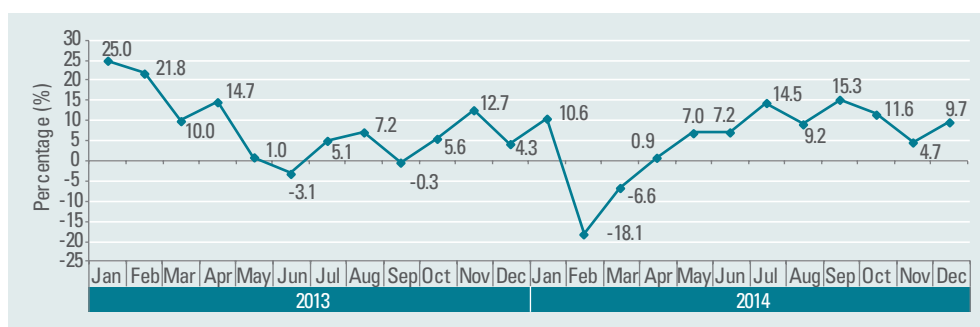


Source: 'Consumer Prices for December 2014', NBS, 14 January 2015, http://www.stats.gov.cn/english/PressRelease/201501/t20150114_668075.html; 'Producer Prices for the Industrial Sector for December 2014', NBS, 14 January 2015, http://www.stats.gov.cn/english/PressRelease/201501/t20150114_668079.html

² 'Regular Press Conference of Ministry of Commerce on October 16, 2014', *Mofcom.gov.cn* (商务部网站), 17 October 2014, <http://english.mofcom.gov.cn/article/newsrelease/press/201410/20141000762774.shtml>

Although exports experienced significant growth in the third quarter of 2014, the yearly growth rate only reached 6.1 percent, 1.8 percentage points lower than in 2013. This was mainly due to seasonal factors and false index effects³ on the growth rate in the first quarter of 2014. As the global market continues to recover and negative effects caused by the false index are eliminated, higher export growth should be expected in 2015, which will likely drive up China's economic performance.

Year-on-year export monthly growth rate, 2013-2014



Source: 'Import and Export of China', General Administration of Customs, <http://english.customs.gov.cn/tabid/47819/Default.aspx>

Third National Economic Census – getting a handle on service industry development

A National Economic Census is conducted once every five years in China. A major objective of the Third Census was to get a comprehensive understanding of China's service sector and secondary industry (mainly manufacturing). The results were released in December 2014:

- The service industry grew faster than the secondary industry. At the end of 2013, the service industry accounted for 74.7 percent of the nearly 11 million legal entities in these two industries, up by 5.7 percentage points over the end of 2008.
- By more accurately measuring the service and secondary industries, the census found that the size of these economic sectors had been understated by 5.2 and 2.9 percentage points respectively. As a result, China's gross domestic product (GDP) for 2013 was adjusted up by 3.4 percentage points over the preliminary accounting to RMB 58.8 trillion – an increase of RMB 1.9 trillion (roughly equivalent to the size of Malaysia's 2013 GDP).
- Services are now calculated to represent a slightly larger slice of the economy: 46.9 percent of total GDP, up by 0.8 percentage points from the initial estimate.

As the global market continues to recover, higher export growth should be expected in 2015.

³ From February to April 2013, some Chinese companies used over-invoicing to circumvent Chinese capital controls, which inflated export figures.

China's economic restructuring is creating more development potential for private capital, especially SMEs.

Characteristics of economic development in 2014

In contrast to the fast-growth environment of past years, China is now pursuing a more sustainable growth pattern, and the country's economic structure, economic growth drivers and industry development have all been subject to considerable change. In 2014, China's economy displayed the effects of this transition in a number of ways:

- The former pillar industry, traditional manufacturing, currently faces overcapacity and environmental issues. The elimination of outdated production capacity and reduced demand for manufactured products (e.g. steel and cement) caused by lower growth in fixed asset investment, put pressure on the manufacturing sector as a whole.
- High-value manufacturing, which was previously on a small scale and mainly dependent on imports, performed noticeably better, mainly due to the government's promotion of the sector. The development of this segment also strengthened China's upstream industry chain and encouraged Chinese companies to improve their technology. In addition, the service sector continued to maintain a relatively high growth rate compared with the manufacturing sector.
- The real estate sector has been in a cyclical period of decline, with the yearly growth rate of floor space sold at 7.6 percentage points below that in 2013. However, there were no dramatic real estate market crashes and the real estate prices remained fairly high, with prices relative to income levels being higher than in some developed countries such as the US and UK,⁴ mainly because of the government's stimulus policies.
- Reforms were launched in many areas, including for state-owned enterprises (SOEs), tax, the financial system and the administrative approval system. These reforms are helping improve the business environment and providing expanded opportunities for companies to develop and grow.
- China's economic restructuring is creating more development potential for private capital, especially small and medium enterprises (SMEs). Private enterprises are accelerating into traditional monopoly industries such as the banking sector.
- The local government debt burden was exacerbated by increased government-funded infrastructure investment and tax deductions for the service sector and SMEs. The economic slowdown also increased the risk of default in the shadow banking system. To mitigate these risks, the central government launched a local government bond pilot program and implemented stronger operational regulations for the shadow banking sector.

⁴ 'Housing affordability in China', *Newgeography.com*, 21 October 2014, <http://www.newgeography.com/content/004576-housing-affordability-china>

Targeted policy measures in 2014

China's economic growth in 2014 was boosted by a number of government support measures. Some of the main measures released in 2014 shared common characteristics:

- 1** They benefited both economic growth and economic restructuring, and targeted specific sectors, such as infrastructure and SMEs.
- 2** They were mainly small-scale measures which were unlikely to result in economic bubbles.
- 3** They were closely related to people's livelihoods.

The measures had significant effects, for example, infrastructure investment experienced noticeable growth in 2014. More targeted stimulus measures are expected to be released in 2015 to further support economic growth.

Many of the key initiatives that came into effect in 2014 are likely to continue having an impact in 2015 and beyond:



INFRASTRUCTURE INVESTMENT

- On 23 September, the Ministry of Finance (MOF) issued a notice to promote public private partnerships (PPP) to encourage more social capital investment in infrastructure.
- On 8 October, the State Council decided to streamline approval reviews for infrastructure investment projects.



SMEs

- On 8 April, the MOF extended the scope of qualified SMEs that can enjoy a 50 percent income tax deduction.
- On 9 June, China's central bank reduced the reserve deposit rate by 0.5 percentage points for commercial banks whose percentage of loans held by SMEs and the agriculture sector had reached a minimum level.



REAL ESTATE

- On 30 September, China's central bank reduced the minimum down payment and discounted mortgage rates,⁵ and scrapped a ban on mortgage loans for people buying a third house. In addition, most local governments have loosened restrictions on residential property purchases.⁶



SERVICE SECTOR

- In 2014, the State Council released a series of 'guiding opinions' aimed at upgrading manufacturing technology and accelerating the growth of the service sector.



FINANCING COST

- On 22 November, China's central bank cut the benchmark rate for one-year deposits by 0.25 percentage points to 2.75 percent, and cut the one-year lending rate by 0.4 percentage points to 5.6 percent.



AGRICULTURE

- On 22 April, China's central bank cut the reserve deposit rate by 0.5 and 2.0 percentage points for rural cooperative banks and rural commercial banks respectively.



EXPORT

- On 15 May, the State Council released measures to stabilize foreign trade growth, including detailed measures promoting trade in services.

⁵ Provided they have paid off the mortgage on their first property, prospective borrowers applying for a loan to buy a second home can enjoy a lower minimum down payment of 30 percent, and a 30 percent discount on mortgage rates as first-time home buyers.

⁶ All local governments, except for Beijing, Shanghai, Guangzhou, Shenzhen and Sanya, have loosened restrictions on housing purchasing.

KPMG's Global China Practice expects that more targeted measures are on the way, including government-funded investment in infrastructure and a looser monetary policy.

Economic growth outlook

The Central Economic Work Conference is held annually in Beijing to discuss and set out the government's agenda for economic development. According to the Central Economic Work Conference held from 9-11 December 2014, we expect the Chinese Government to place more emphasis on economic restructuring and to keep the economic growth rate within the "proper range".⁷ We anticipate that the economic trends in 2015 and beyond in China will include the following:

- The economic restructuring process will likely temporarily exert a negative impact on China's economic growth. KPMG's Global China Practice estimates that the GDP growth rate will be slightly slower in 2015.
- Based on the government's focus on steady economic growth and its promotion of economic restructuring, we expect that more targeted measures are on the way, including government-funded investment in infrastructure and a looser monetary policy. Price controls in the energy, transportation and healthcare sectors are likely to be loosened, while monopoly industries such as telecoms are likely to be opened up further. However, massive stimulus measures are unlikely to be rolled out in the near term, as the economy is less likely to depart significantly from its present trajectory.
- According to the Central Economic Work Conference, the government will focus on a number of important and large-scale regional development strategies. These include the Yangtze River Economic Belt, the Silk Road Economic Belt and the 21st Century Maritime Silk Road ('One Belt and One Road'), and the coordinated development of Beijing, Tianjin and Hebei provinces. We expect these strategies to speed up economic development in the related regions. [See 'The road forward' on p. 8 for details]
- Based on the government's economic restructuring, we anticipate that China's economy will increasingly be driven by innovation, the service sector and private capital. Sectors along the high-end value chain, such as high-end equipment manufacturing, and service sectors including healthcare are expected to have great development opportunities. On the other hand, the overcapacity phase-out and weakened demand in the manufacturing sector will continue to put pressure on future manufacturing growth.
- KPMG's Global China Practice maintains the projection in our 2014 third quarter *China Quarterly Report* that the real estate sector in first-tier cities and less developed regions will continue to suffer from an oversupply, including residential and commercial space. The government is likely to continue taking softer, less direct measures to boost real estate consumption as well as to prevent prices from declining too rapidly.

⁷ 'Li delivers boost for the economy', *China Daily* (中国日报), 9 October 2014, http://www.chinadaily.com.cn/china/2014-10/09/content_18708538.htm

The road forward

- The Yangtze River Economic Belt involves 11 regions (provinces or municipalities),⁸ and the service sector, green energy and modern agriculture will feature prominently in the strategy.
- For 'One Belt and One Road', 'One Belt' involves nine regions⁹ while 'One Road' involves six¹⁰ as at December 2014. The Asian Infrastructure Investment Bank (AIIB) will help supply the capital for infrastructure construction. AIIB's authorized capital is US\$100 billion; in addition, the Chinese Government also pledged US\$40 billion to establish the Silk Road Fund.¹¹ A number of sectors, including infrastructure, oil and gas, transportation, and tourism, are likely to see sizable development opportunities.
- Regarding the coordinated development of Beijing, Tianjin and Hebei provinces, total investment is estimated to reach RMB 250 billion (approximately US\$40.2 billion).¹² Transportation, the environment and high-value manufacturing will be at the forefront of the strategy.

⁸ The regions include Shanghai, Jiangsu, Zhejiang, Anhui, Jiangxi, Hubei, Hunan, Sichuan, Chongqing, Yunnan and Guizhou.

⁹ The regions include Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, Chongqing, Sichuan, Yunnan and Guangxi.

¹⁰ The regions include Guangdong, Fujian, Zhejiang, Jiangsu, Guangxi and Hainan.

¹¹ 'Cambodian PM hails China for initiatives on AIIB, Silk Road Fund', *Xinhua*, 13 January 2015, http://africa.chinadaily.com.cn/world/2015-01/13/content_19302382.htm

¹² 'The Beijing-Tianjin Cooperation Demonstration Zone of the Future Technology City Launched', Tianjin Binhai New Area, 22 December 2014, <http://english.tjbhnews.com/node/47891>

Outward Direct Investment



Overview of ODI

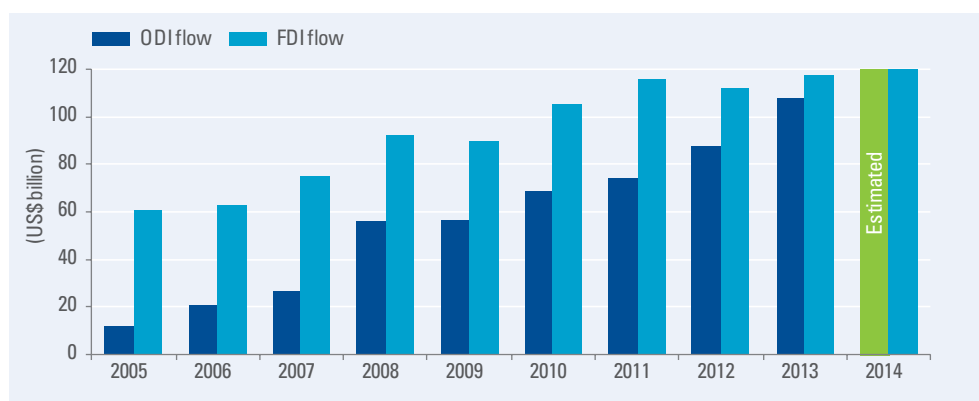
It appears that China's outward direct investment (ODI) overtook inward foreign direct investment (FDI) in 2014, by a narrow margin, making the country a net capital exporter for the first time. China's Ministry of Commerce estimates that the total ODI volume for 2014 stands at around US\$120 billion, a 10 percent rise from US\$108 billion in 2013.

This steady growth trend is expected to continue as Chinese companies increasingly realize that overseas investment is an effective strategy for them to upgrade, transform and become more competitive.

	2013	2014	% change
Total ODI (US\$ billion)	107.8	120.0 (estimated)	11.3%
Non-financial ODI (US\$ billion)	90.2	102.9	14.1%
Revenue from China's overseas contracting projects (US\$ billion)	137.1	142.4	3.8%

Source: Ministry of Commerce, 21 January 2015, <http://www.mofcom.gov.cn/xwfbh/20150121.shtml>, 27 October 2014, <http://www.mofcom.gov.cn/article/i/dxfw/gzdz/201410/20141000773143.shtml>

Value of China's ODI and FDI, 2005-2014



Source: '2013 Statistical Bulletin of China's Outward Foreign Direct Investment', Ministry of Commerce, 21 January 2015, <http://www.mofcom.gov.cn/xwfbh/20150121.shtml>, 27 October 2014, <http://www.mofcom.gov.cn/article/i/dxfw/gzdz/201410/20141000773143.shtml>; '2014 China Statistical Yearbook', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; KPMG Analysis



Vaughn Barber

Partner, Head of Outbound, KPMG in China

"With US\$1.25 trillion in ODI expected over the next decade, China seems set to enter the fast lane as a 'global investor'. Overseas investments are helping more Chinese companies from more sectors access new markets, and acquire the experience, technology, brands and human capital necessary to become more competitive. Recipient countries are also benefiting from the capital, experience, cost-competitive inputs to the production process and expanded market opportunities that Chinese investors bring. There is an increasing recognition that Chinese companies can achieve success in areas like infrastructure and agribusiness by 'partnering' with incumbent players in key target markets."

Outbound M&A











	2013	2014	% change
Deal value (US\$ billion)	64.8	62.9	- 3.0%
Number of deals	357	388	8.7%

Source: Dealogic, accessed 4 January 2015, KPMG analysis

As China shifts the emphasis of its economic growth model from 'quantity growth' to 'quality development', Chinese companies are investing in 'new' sectors beyond resource extraction. These sectors include high technology, agriculture and food, real estate, and services. Of the top 10 outbound merger and acquisition (M&A) deals, there was only one large mining deal in 2014, while five years ago in 2010, there were six oil and gas deals and one mining deal.

TOP industry sectors attracting Chinese overseas M&A investment, by deal value

2014

	COMPUTERS & ELECTRONICS
	MINING
	REAL ESTATE
	UTILITIES & ENERGY
	AGRIBUSINESS & FOOD
	OIL & GAS
	FINANCE
	INSURANCE
	DINING & LODGING
	AUTOMOTIVE

2010

	OIL & GAS
	MINING
	AUTOMOTIVE
	FINANCE
	CHEMICALS
	UTILITIES & ENERGY
	COMPUTERS & ELECTRONICS
	TRANSPORTATION
	HEALTHCARE
	CONSTRUCTION

Source: Dealogic, accessed 4 January 2015, KPMG analysis

Chinese companies' investment destinations are also changing: from resource-rich developing countries to developed countries that provide access to advanced technologies, established brands, extensive industry experience and worldwide distribution networks.

With deals being done in more sectors, it is not surprising to see that Chinese companies' investment destinations are also changing: from resource-rich developing countries to developed countries that provide access to advanced technologies, established brands, extensive industry experience and worldwide distribution networks. The 2014 data shows that more deals are being struck in developed markets such as the US, Europe and Australia. Nine out of the top ten outbound M&A deals (by value) in 2014 all took place in developed economies, while looking back to 2010, only four were conducted in developed countries, including one in the US and one in Canada, both of which targeted oil and gas assets. In addition, in the table below we show changes in the top countries for Chinese overseas M&A by value in 2010 and 2014.

TOP countries attracting Chinese overseas M&A investment, by deal value

2014



US



PERU



UK



AUSTRALIA



FRANCE



ITALY



SINGAPORE



PORTUGAL



CANADA



NETHERLANDS

2010



BRAZIL



CANADA



ARGENTINA



US



AUSTRALIA



ISRAEL



NETHERLANDS



SWEDEN



GUINEA



UK

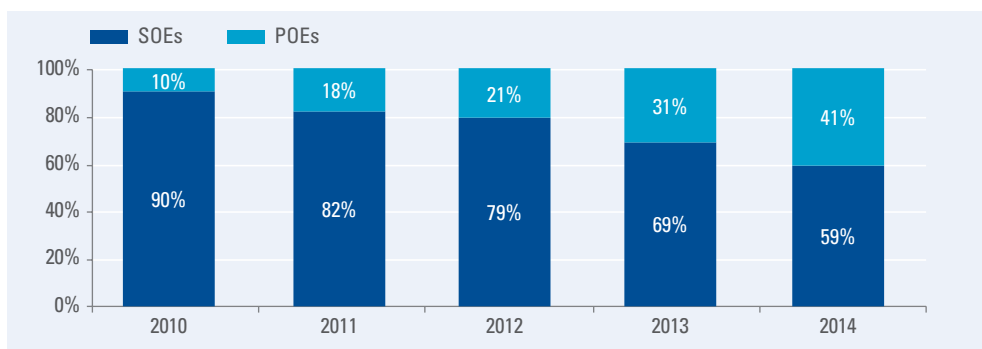
Source: Dealogic, accessed 4 January 2015, KPMG analysis

Chinese POEs are getting more ambitious and completing larger transactions.

In the past, China's large state-owned enterprises (SOEs) dominated ODI activities with their massive deals in resource extraction. What KPMG member firms are currently seeing is that in addition to seeking access to natural resources, Chinese companies' ODI activities are now increasingly driven by the need to upgrade and transform themselves for sustainable growth.

These investors include a large number of privately owned enterprises (POEs), which are struggling with challenging and competitive domestic markets. What is more, a notable trend is that Chinese POEs are getting more ambitious and completing larger transactions. POEs accounted for 41 percent of Chinese outbound M&A in 2014 (by value), up from 31 percent in 2013 and only 10 percent in 2010. Of the top 10 outbound M&A deals in 2014, POEs accounted for five, compared to only one in 2010.

Chinese overseas M&A deals by deal value, 2010-2014



Source: Dealogic, accessed 4 January 2015, KPMG analysis



Top 10 outbound M&A deals by deal value in 2014

No.	Date	Acquirer	Acquirer entity type	Target	Target country (region)	Deal value (US\$ billion)	Shares acquired (%)	Target sector
1	April 2014	<ul style="list-style-type: none"> China Minmetals Guoxin Int'l Investment Corp. CITIC Group 	SOE	Xstrata Las Bambas SA	Peru	7.01	99.99	Mining
2	January 2014	<ul style="list-style-type: none"> Lenovo Group 	POE	Motorola Mobility Holdings Inc	US	3.14	100	Computers & Electronics
3	July 2014	<ul style="list-style-type: none"> State Grid Corporation of China 	SOE	CDP RETI S.r.l	Italy	2.81	35	Utilities & Energy
4	February & April 2014	<ul style="list-style-type: none"> COFCO Corp. Hopu Investment Management Co. 	SOE	Nidera Handelscompagnie B.V.; Noble Agri Ltd	Netherlands Hong Kong	2.80	51	Agribusiness
5	January 2014	<ul style="list-style-type: none"> Lenovo Group 	POE	IBM's x86 Server Business	US	2.07	100	Computers & Electronics
6	October 2014	<ul style="list-style-type: none"> Anbang Insurance Group 	POE	Waldorf Astoria hotel New York	US	1.95	100	Real Estate
7	August 2014	<ul style="list-style-type: none"> Hua Capital Management Ltd Shanghai Pudong Science and Technology Investment Co., Ltd. 	SOE	OmniVision Technologies Inc.	US	1.68	100	Computers & Electronics
8	July 2014	<ul style="list-style-type: none"> Hony Capital 	POE	PizzaExpress Ltd	UK	1.54	100	Dining & Lodging
9	January 2014	<ul style="list-style-type: none"> Fosun International Ltd 	POE	Caixa Geral de Depósitos SA's insurance unit	Portugal	1.49	80	Insurance
10	November 2014	<ul style="list-style-type: none"> Jin Jiang International Holdings Co Ltd 	SOE	Groupe du Louvre	France	1.49	100	Real Estate

Source: Dealogic, accessed 4 January 2015, KPMG analysis

Looking forward

Chinese ODI to see steady growth – even off the high base in 2014

KPMG's Global China Practice expects China's ODI growth to stay above 10 percent for the next couple of years. China's pursuit of 'quality development' and its stable macro-economic development should underpin continued growth in ODI. In the meantime, the economic rebound in the US and Europe, and the potential for higher investment returns, should continue to provide good investment opportunities for Chinese companies.

China's ODI activities have entered a new stage, shifting focus from 'quantity and speed' to 'quality and efficiency'. We will likely see more companies – especially POEs – invest in more value-added industry sectors such as agribusiness and food, technology, high-end manufacturing, and real estate in more countries and regions, including developed markets.

More partnerships to be established in new markets

Both ODI and M&A data show that developed markets are key investment destinations for Chinese companies, as they offer them markets, technologies, experience, brands and access to talented people. However, some Chinese investors have stumbled when entering mature markets: the deal structure, regulatory requirements and stakeholder relationships are far more complex than for previous investments in developing markets.

Compounding this situation, most Chinese companies are relatively unknown in the international business community. For those companies without a proven reputation and track record in developed markets, it can be very effective to partner with reputable companies which have relevant experience in the local market to bridge the trust and experience 'gap'.

The objective of such cooperation is to help both parties achieve a win-win outcome. Foreign parties are typically looking for Chinese capital, access to the huge China market, and to leverage other competitive advantages brought by the Chinese partner. In turn, Chinese companies may be able to rely on a foreign partner's knowledge and business connections in the local market to identify market opportunities and mitigate operational risks. In addition, by working with experienced management teams and local employees, Chinese companies can better adapt their business concepts and culture to the local environment, and build a positive image in overseas markets.

2014 saw a number of milestone cases involving Sino-foreign partnerships. We will continue to see more, as this investment model is becoming a new trend for Chinese companies investing overseas, particularly in new markets.

'High-speed rail diplomacy' is also emerging as an economic and diplomatic tool to promote China's technology expertise.

Government initiatives lead to new opportunities

The Chinese Government's role in ODI has gradually been changing from that of a regulator to a facilitator, as it focuses its efforts on improving the investment environment. These efforts can be seen in the regulatory changes that the National Development and Reform Commission and the Ministry of Commerce put in place in 2014 to relax the approval requirements for Chinese outbound investments.

Also in 2014, the Chinese Government announced several national strategic initiatives that may lead to significant new ODI opportunities in the infrastructure space. The 'One Belt and One Road'¹³ strategy, and the establishment of the Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund should promote large-scale infrastructure investment in the countries and regions along the 'belt' and 'road' for at least the next 5-10 years. 'High-speed rail diplomacy' is also emerging as an economic and diplomatic tool to promote China's technology expertise. We expect to see Chinese companies participating in more high-speed rail projects around the world – including as providers of debt and equity capital, suppliers of highly competitive and advanced equipment, and providers of construction services, in both developing and developed countries.

Banking on infrastructure

Twenty-one Asian countries signed the memorandum of understanding (MOU) on establishing the Asian Infrastructure Investment Bank (AIIB) in Beijing in October 2014. The 21 countries are Bangladesh, Brunei, Cambodia, China, India, Kazakhstan, Kuwait, Laos, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, the Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan and Vietnam. As at 13 January 2015, five more countries had joined the AIIB – Indonesia, Maldives, New Zealand, Saudi Arabia and Tajikistan.

The AIIB will be an inter-governmental regional development institution in Asia. As agreed, Beijing will be the host city for AIIB's headquarters. The MOU specifies that the authorized capital of AIIB is US\$100 billion and the initial subscribed capital is expected to be around US\$50 billion.

¹³ This refers to the New Silk Road Economic Belt, which will link China with Europe through Central and Western Asia, and the 21st Century Maritime Silk Road, which will connect China with Southeast Asian countries, Africa and Europe.

ChAFTA is expected to stimulate Chinese investment in a number of strategic industries.

FTAs to further open up investment opportunities with Australia and South Korea

China and Australia have built a remarkable trade and investment partnership on the basis of economic cooperation and mutual benefit. The conclusion of negotiations for the China–Australia Free Trade Agreement (ChAFTA) was announced in November 2014. ChAFTA is expected to stimulate Chinese investment in a number of strategic industries, including agriculture, animal husbandry, food processing and infrastructure. These are pillar Australian industries that are eager for Chinese capital; in return they have high-quality resources, technologies and experience that can help Chinese companies move up the value chain.

ChAFTA will promote further growth of Chinese investment into Australia, in particular investment from Chinese POEs. Although Australia's Foreign Investment Review Board (FIRB) will continue to screen all investment by Chinese SOEs and retain the ability to screen Chinese investments at lower thresholds for sensitive sectors, the FIRB will significantly raise the screening threshold for Chinese investments in non-sensitive sectors by private sector entities from AUD 248 million to AUD 1,078 million. ChAFTA will also reduce barriers to labor mobility and improve temporary entry access for Chinese investors, particularly for large infrastructure projects above AUD 150 million.

Once ChAFTA comes into force, Chinese companies that invest in Australia will also benefit from agreed tariff reductions when their Australian operations export products to China, including agriculture and processed food, resources, and engineering and manufactured products covered by the agreement.

Similarly, China and South Korea completed substantive negotiations on a free trade agreement (FTA) in the same month as ChAFTA, which marks a big step forward in the bilateral economic and diplomatic ties between these neighboring countries. By strengthening the economic partnership, the FTA should help the two countries enhance their strong security ties. Cultural and tourism resources in South Korea have aroused Chinese investors' interest and are likely to continue to attract more Chinese investment in related sectors, including real estate, tourism, hospitality, entertainment, fashion and medical services. Following the conclusion of the China–South Korea FTA, negotiations are currently underway for the China–South Korea–Japan FTA, which may be concluded in 2015. Once this has been completed, we will likely see further expansion and deepening of trade and investments among these three influential East Asian countries.

Chinese financial investors will play a bigger role in Chinese overseas investment

While Chinese strategic investment still represents the lion's share of Chinese overseas investment, financial investors have been making their mark. In 2014, financial investors accounted for 22 percent of the total value of completed Chinese outbound M&A.¹⁴ In addition to China's leading investment arm, China Investment Corporation, more Chinese financial investors have entered the global stage, including private equity firms, insurance companies, banks, government financial investment arms and private investment companies. They are motivated by the potential of relatively higher, stable returns in overseas markets in sectors such as agriculture and food, energy and utilities, real estate, infrastructure, finance, and consumer products.

¹⁴ 'China's Global Outbound M&A in 2014', Thilo Hanemann and Cassie Gao, Rhodium Group, 5 January 2015, <http://rhg.com/notes/chinas-global-outbound-ma-2014-recap>

Privatisation programs in many Western countries will continue to provide both strategic and financial investors with investment opportunities. At the same time, policy initiatives by Chinese regulators are also acting as a catalyst for some overseas financial investment.

There were many deals from Chinese financial investors in 2014 and more are expected in 2015. Ongoing privatisation programs in many Western countries will continue to provide both strategic and financial investors with investment opportunities. At the same time, policy initiatives by Chinese regulators are also acting as a catalyst for some overseas financial investment. For example, Chinese insurers are being encouraged by the China Insurance Regulatory Commission (CIRC) to increase their overseas investment.

SOEs likely to seek safer and more flexible investments abroad

SOE reform is seen as a potential new economic driver for China. A successful reform program may improve the operational efficiency, transparency and competitiveness of China's large state-owned giants. The commitment of these companies to market-oriented reforms may also positively influence their decision-making on overseas investment.

The details of the reforms still need to be further clarified by government policies, however, the financial results will certainly become one of the key indicators in assessing SOE senior executives' performance. Consequently, management will pay greater attention to investment returns, instead of focusing on the accumulation of assets, which was previously the main evaluation criterion and led, in some cases, to resource misallocation. We anticipate that SOEs will be proactive in mitigating overseas investment risk, including by hiring experienced advisors, working with established local businesses through joint venture or alliance structures, and partnering with financial investors. It is also likely that SOEs will become more flexible than in the past, including in terms of taking minority stakes in overseas investments, demonstrating a greater degree of market-orientation and pragmatism.



Industry highlights



AGRICULTURE AND FOOD

China's large population – and limited arable land and water resources – mean that grain and edible oil reserves have long been one of China's top concerns. To secure grain and oil supplies, Chinese companies have been encouraged by the government to extend their upstream agribusiness value chain overseas, and to strengthen their position in international commodities trading. The joint ventures which the China National Cereals, Oils and Foodstuffs Corporation (COFCO) concluded with the Dutch commodities trader Nidera and Hong Kong-based Noble Agri Limited in 2014 exemplify this. With a combined investment of US\$2.8 billion, these deals are the biggest overseas acquisitions in China's grain and oil sector to date.

Food safety is another concern for China. Following a number of high-profile food safety scandals, Chinese customers have lost confidence in 'home-grown' foods, driving demand for imported foods, especially meat and dairy products. Concerns about food safety have also motivated Chinese investors to acquire premium agricultural assets, including dairy farms, animal husbandry pastures and food processing plants, in countries like Australia, New Zealand and the US. In 2014, Heilongjiang Grand Farm Group and Xinjiang Tianshan Animal Husbandry Bio-engineering invested in Australian pastures and cattle farming businesses; in New Zealand, examples include China's dairy giant

Yili Group investing in developing four dairy projects, and Evergrande Group acquiring infant formula company Cowala Dairy. Yili also entered into an agreement with the Dairy Farmers of America to build a plant in the US to produce powdered milk, while in 2013, we also saw Shuanghui International acquire the US pork producer Smithfield Foods.

One further factor driving Chinese ODI in the food sector is that middle-class consumers in China have become interested in Western cuisines. This trend has spurred domestic food companies to acquire well-known Western food brands and bring their products back to the domestic market. In 2014, Bright Food bought a majority stake in Italy-based Salov, which owns a popular olive oil brand in the US and UK. Fosun International invested in Osborne Group, a Spanish company which is a market leader in Europe for Iberian ham.

Facing the twin issues of rising market demand and industry limitations in China, Chinese companies considering overseas investment in the agriculture and food sectors will likely increasingly realize the importance of fully leveraging domestic and overseas resources and exploring the potential of both domestic and overseas markets. We may see more companies investing outside of China to seek synergies in the overseas agriculture and food sectors. By securing overseas

sources of supply, Chinese agribusiness companies can have greater potential influence on global markets, and therefore prices, in addition to better safeguarding and improving China's food supplies.

Chinese companies have been encouraged by the government to extend their upstream agribusiness value chain overseas.



INFRASTRUCTURE

Chinese companies will likely play an important role in financing, building and operating infrastructure projects around the world.

In addition to funding that can be sourced from Chinese strategic and financial investors, and financing that can be obtained from Chinese financial institutions, Chinese construction companies have significant capital and balance sheet support that can be brought to bear on projects. With the experience Chinese companies have gained from a 30-year infrastructure boom, they now have significant economies of scale which, when combined with lower labor costs, enable them to supply construction materials at globally competitive prices. At the same time, this massive infrastructure development at home has made Chinese firms more competitive in the market for infrastructure-related services such as civil engineering and construction.

Governments in developed economies are increasingly aware of the competitive advantages that China offers.

For example, China has – in record time – built the world's most extensive high-speed rail network at home and is now keen to take its know-how overseas by providing other countries with railway tracks, rolling stock, automated signal equipment and modern stations. Major Chinese rail contractors are actively pursuing opportunities in

a number of countries including the US, the UK, Russia, Mexico, India and ASEAN countries. At the end of 2014, China's two largest rolling stock producers agreed to a merger to create a united strategy for overseas expansion and to gain a scale advantage over international competitors, and in October 2014 Chinese company China CNR Corporation Limited (China CNR) was awarded a major contract for subway cars worth over US\$550 million from the Massachusetts Department of Transportation (MassDOT) in the US. Additionally, 'high-speed rail diplomacy' has become a new feature of the Chinese Government's foreign policy, with China's leaders actively promoting the country's high-speed rail technology and equipment on state visits.

Similar to the case of high-speed rail, China is also making efforts to export nuclear power technology and equipment in addition to providing financing. Major Chinese nuclear companies are currently involved in nuclear power plant projects in the UK and Romania as investors, and are reportedly exploring opportunities to supply components and participate in the construction of the projects. In addition, Chinese companies are also reportedly positioning themselves for nuclear projects in other markets, including Turkey, Russia, South Africa, Argentina and Brazil.

2014 closed strongly with China Communications Construction Company Limited (CCCC) announcing that its subsidiary will purchase John Holland, one of Australia's leading engineering, contracting and services providers, and a business unit of Australian headquartered Leighton Holdings, for AUD 1.15 billion. This will help CCCC enter Australia's dynamic market, as part of its aim to be a global transportation infrastructure business.¹⁵ Companies are also sizing up China's 'One Belt and One Road' strategic initiative: a new impetus and platform for China to enhance cooperation with neighboring economies. These are long-term and large-scale plans that may result in massive cross-border infrastructure investment in countries along the 'belt' and the 'road'.

According to a plan released by the Ministry of Commerce in December 2014, Chinese companies are encouraged to invest in transport, energy and telecommunication infrastructure projects in relevant countries to enhance regional connectivity.

Companies are also sizing up China's 'One Belt and One Road' strategic initiative: a new impetus and platform for China to enhance cooperation with neighboring economies.

¹⁵ 'John Holland to be acquired by China Communications Construction Company', John Holland, 12 December 2014, <http://www.johnholland.com.au/Documents.asp?ID=15611>

Industry highlights



REAL ESTATE

China's real estate market has not yet emerged from its slowdown due to tight credit conditions, stringent regulations and short-term oversupply pressures.

In contrast, many markets in Europe and North America are seeing real estate gaining ground as their economies stabilize. As a result, Chinese real estate developers are eager to capture potentially higher and more stable returns overseas, and the interest in outbound real estate investment has risen steadily. Wanda Commercial Properties (Group) Co., Ltd (Wanda), Greenland Group (Greenland) and Vanke Group (Vanke) are among the major Chinese developers that have been actively engaged in overseas projects in 2014:

- Wanda established overseas subsidiaries in Spain, the US and Australia, through which it has bought a landmark estate in Madrid, partnered with an American company to develop a hotel and apartment building in Chicago, and agreed to acquire an office block in downtown Sydney.
- Greenland has invested in developing two residential projects in London and a commercial and residential project in Toronto. It is in the process of bidding for an entertainment complex project in Brisbane with Australian partners.

- Vanke started the development of a residential building in Manhattan, New York.

The overseas real estate market has also generated interest from Chinese companies in other industries, particularly insurance companies. Chinese insurers have been allowed to make direct real estate investments since late 2012. Their direct investment is restricted by the CIRC to mature commercial properties and office buildings with stable income, which are located in the central areas of main cities of developed countries and regions (as specified by the CIRC).

After Ping An Insurance acquired the Lloyd's building in London in 2013 – seen as a watershed investment by a Chinese insurance company in an overseas real estate market – more such cases followed in 2014:

- China Life Insurance purchased a 70 percent stake in a London office building in June.
- Anbang Insurance agreed to buy the Waldorf Astoria hotel in New York in October.
- Sunshine Insurance acquired the Sheraton on the Park hotel in Sydney in November.
- Taikang Life Insurance bid for a London office building in November.

In his speech in October 2014, the Vice Chairman of the CIRC pointed out that Chinese insurers currently invest just 1 percent of their assets overseas, even though the CIRC allows a ceiling of 15 percent, suggesting there is still huge potential for Chinese insurers to increase their overseas investments. He added that by 2020, the Chinese insurance sector would accumulate around RMB 20 trillion (US\$3.23 trillion) worth of premiums which would need to find safe investment channels. For this reason, we expect that Chinese insurance companies are likely to emerge as a major new buying force overseas, particularly in real estate markets that offer stable and attractive returns.

Chinese insurance companies are likely to emerge as a major new buying force overseas.



HIGH-END MANUFACTURING

China is restructuring its industrial growth model by transforming from focusing on labor-intensive sectors to a model driven by advanced technologies. This transformation is forcing Chinese manufacturers to move up their industry value chain by investing more in technology and innovation. Overseas investment is often an effective way to achieve this objective.

As the costs of labor and other factors of production have risen significantly in China in recent years, the era of low-end manufacturing in the country has come to an end. Chinese companies are making strategic overseas investments to acquire technologies, R&D capability, talent, brands and access to international markets.

In Europe, Chinese companies are particularly looking for acquisition targets in the automotive, rail transit equipment, aerospace and aviation, and high-precision machinery sectors. Prominent acquisitions in 2014 included Dongfeng Motor's investment in PSA Peugeot Citroën; Aviation Industry Corporation of China's (AVIC) acquisition of the German auto parts supplier Hilite International through an AVIC subsidiary; Shanghai Electric's investment in Italian power engineering manufacturer AEN; Geely's acquisition of the UK electric car maker Emerald Automotive; and Zoomlion's investment in the Dutch hoist maker RAXTAR.

In the US, Chinese investors are interested in the IT, telecoms, pharmaceutical and advanced materials industries. Significant deals with values in the billions of dollars included Lenovo's acquisitions of Motorola Mobility and IBM's server unit, and a Chinese private equity consortium's acquisition of the US digital imaging product developer OmniVision Technologies.

Greenfield investment is another common strategy for Chinese manufacturers investing overseas. This often involves setting up manufacturing bases to expand overseas production capacity, increase market share and avoid heavy import tariffs. Automobile manufacturing represents a good example. Most Chinese automakers have built assembly plants in their major export markets, and this trend continued in 2014. Additionally, strong engineering and innovation strengths in Europe and the US also attract Chinese companies to set up overseas R&D centers there, such as Wuhan Zall Aviation's investment in June 2014 to establish an R&D base in the US.

China is currently battling industrial overcapacity and coping with environmental challenges. To the extent that overseas investment transfers some excess capacity to foreign countries where demand is high, this could potentially mitigate these problems. For example, the infrastructure construction resulting

from the 'One Belt and One Road' initiative should allow Chinese manufacturers, such as construction equipment manufacturers, and steel and cement producers, to shift some of their surplus production lines to countries along the 'belt' and the 'road'.

Chinese companies are making strategic overseas investments to acquire technologies, R&D capability, talent, brands and access to international markets.

Foreign Direct Investment



Overview of FDI

FDI levels were stable in 2014

	2013	2014	% change
Foreign direct investment (US\$ billion)	117.6	119.6	1.7%

Source: Ministry of Commerce, 15 January 2015, <http://www.mofcom.gov.cn/article/ae/ai/201501/20150100868311.shtml>, KPMG analysis

In 2014, China recorded an FDI inflow of US\$119.6 billion, up 1.7 percent from 2013. The stable FDI level shows that the country is still an attractive destination for foreign investments. KPMG China pointed out in its September 2014 report, *MNCs in China – Making the Right Moves*, that although the Chinese economy may be slowing down, in absolute terms it is still a significant market (ranked as the second largest destination country for FDI in 2013), and new opportunities are arising from increased consumer consumption, industrial restructuring and urbanization.

Value of China's FDI, 2007-2014



Source: '2014 China Statistical Yearbook', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>

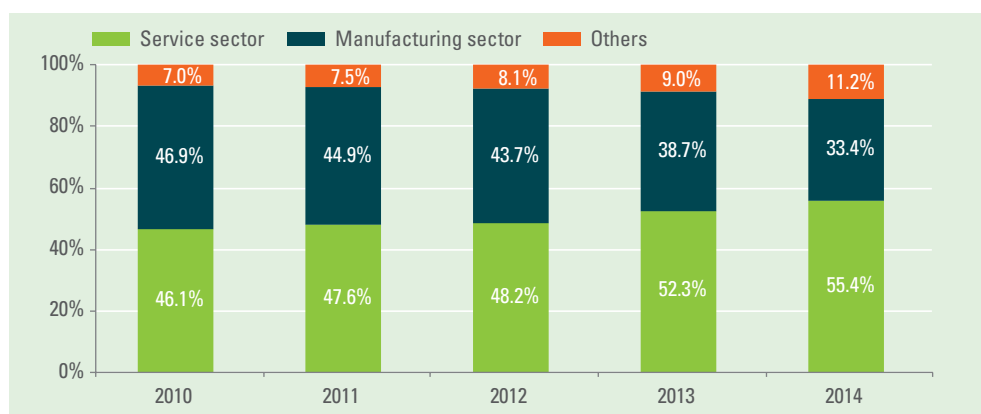
Services now take up a greater share of FDI than the manufacturing sector.

In 2014, the service sector in China continued to grow as a share of China's overall GDP, and FDI patterns exhibited a similar shift.

Service and manufacturing FDI moving in opposite directions

Perhaps the most significant development in the FDI arena in the past few years is the growth in FDI in the service sector. In 2014, services attracted US\$66.2 billion in FDI, up 7.8 percent year-on-year. As shown in the following chart, services now take up a greater share of FDI than the manufacturing sector.

China's FDI breakdown by industry, 2010-2014



Source: Ministry of Commerce, 15 January 2015, <http://www.mofcom.gov.cn/article/ae/ai/201501/20150100868311.shtml>, KPMG analysis

Note: 'Others' includes the sectors of agriculture, forestry, animal husbandry, fishery, etc.

The growth of service sector FDI reflects an underlying shift in China's economy. For much of the past 30 years, China's economic policies have tended to emphasize investment activities and export-led manufacturing over domestic consumption. This economic model generated high rates of growth, but also led to an economy in which consumption accounted for a relatively small part. In many developed nations, services represent over 60 percent of GDP; in China, the service (tertiary) sector is still less than half of GDP.

However, the emergence of a sizable middle class has helped to spur the development of the service sector. China's consumers today have increased disposable income and higher demand for quality services – from healthcare and education, to financial services. At the same time, China's government has in recent years been actively encouraging the shift towards a consumption-led economy and the development of a vibrant services sector. In 2014, the service sector in China continued to grow as a share of China's overall GDP, and FDI patterns exhibited a similar shift.

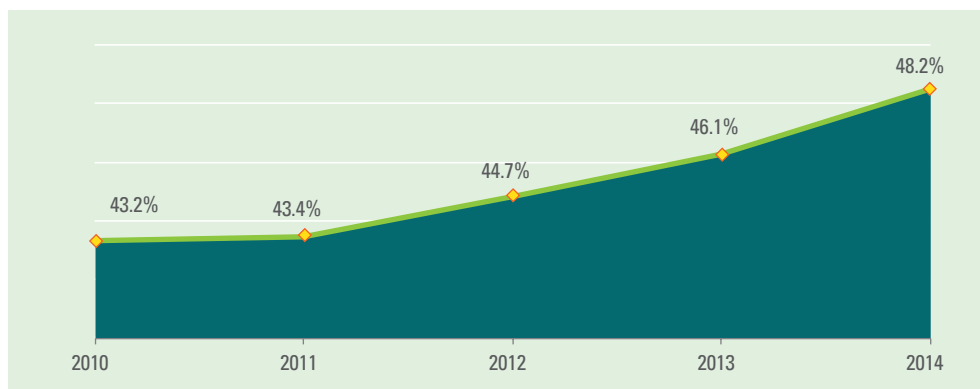




Tom Stanley,
COO, KPMG Global China Practice

“While China is still clearly a magnet for foreign investment, the shift towards more services-related and high-tech investment is becoming ever more pronounced. This trend is likely to continue as China’s overall economy rebalances away from the traditional labor-intensive manufacturing activities.”

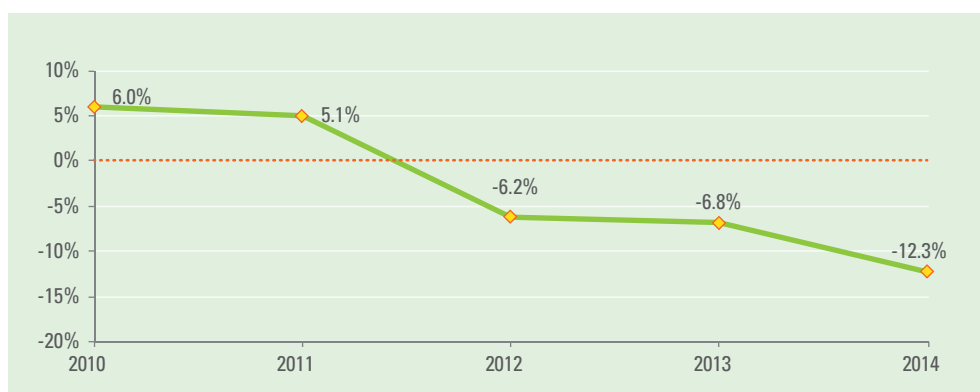
Share of tertiary industry in China's GDP, 2010-2014



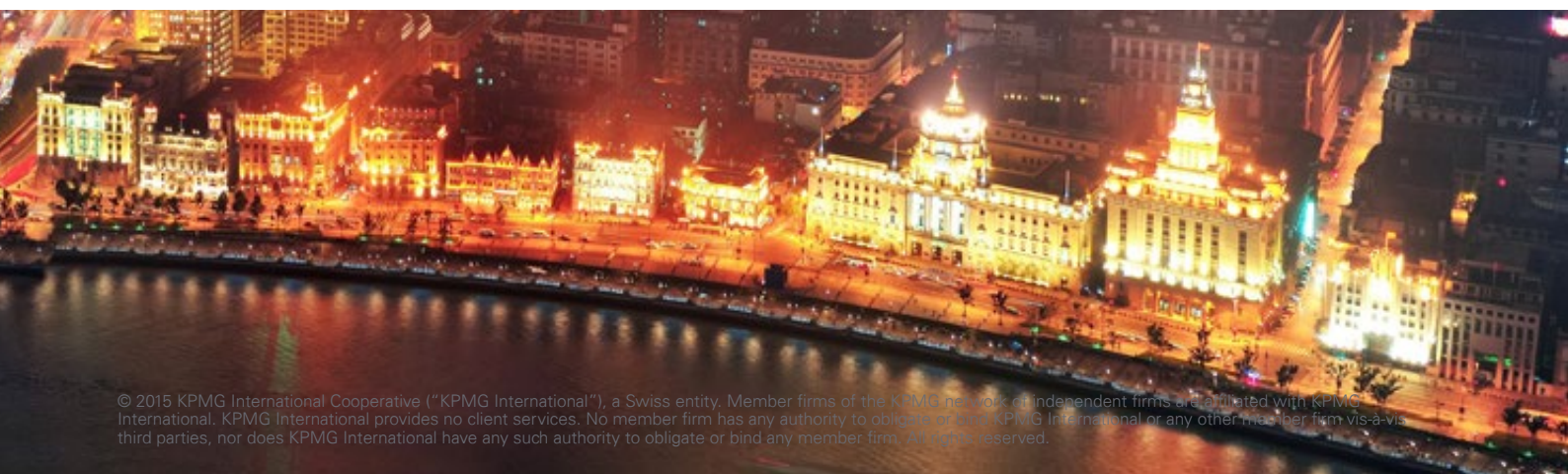
Source: NBS, 20 January 2015, http://www.stats.gov.cn/tjsj/zxfb/201501/t20150120_671037.html, KPMG analysis

In marked contrast, the manufacturing sector in 2014 showed a downward trend. In 2010, manufacturing FDI grew 6.0 percent; the figure for 2014 was -12.3 percent. China is taking measures to tackle industrial overcapacity, and apply more rigid environmental protection standards, at the same time that rising costs and a tightening labor market have greatly impacted many manufacturing activities.

FDI growth in China's manufacturing sector, 2010-2014



Source: Ministry of Commerce, 15 January 2015, <http://www.mofcom.gov.cn/article/ae/ai/201501/20150100868311.shtml>, KPMG analysis

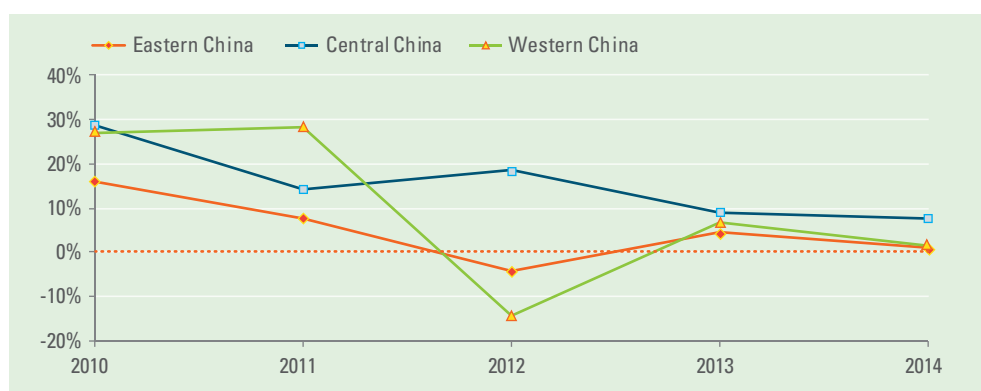


Central China is clearly becoming a more popular investment destination in China.

Fast FDI growth in Central China continues

In 2014, Central China registered an FDI growth of 7.5 percent, while Eastern and Western China¹⁶ saw FDI increases of 1.1 percent and 1.6 percent respectively. As shown in the graph below, it is the third consecutive year that Central China outperformed Eastern and Western China in FDI growth.

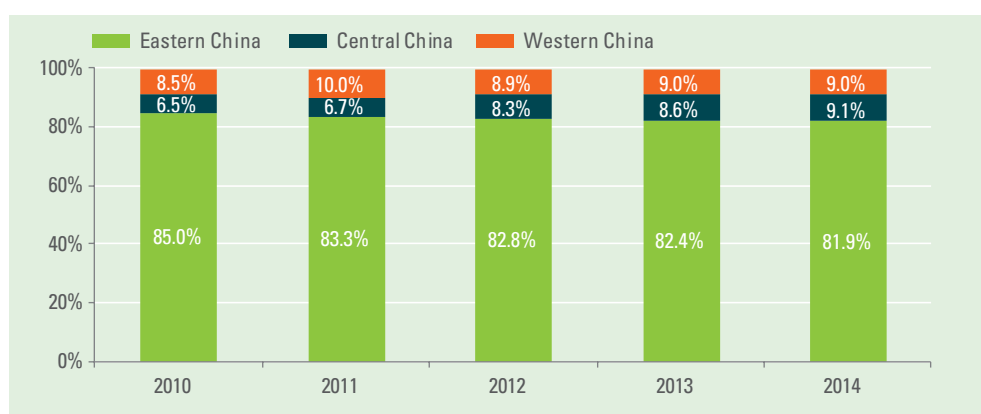
China's FDI growth by region, 2010-2014



Source: Ministry of Commerce, 15 January 2015, <http://www.mofcom.gov.cn/article/ae/ai/201501/20150100868311.shtml>, KPMG analysis

Central China is clearly becoming a more popular investment destination in China, though the eastern provinces still receive a much larger share of FDI in terms of absolute value. Companies are relocating or expanding operations in Central China due, in large part, to relatively lower labor and land costs and improved infrastructure.

Eastern, Central and Western China's share of total FDI, 2010-2014



Source: Ministry of Commerce, 15 January 2015, <http://www.mofcom.gov.cn/article/ae/ai/201501/20150100868311.shtml>, KPMG analysis

¹⁶ We have followed China's National Bureau of Statistics' regional definitions, whereby Eastern China includes the municipalities of Beijing, Tianjin and Shanghai, and the provinces of Liaoning, Hebei, Shandong, Jiangsu, Zhejiang, Fujian, Guangdong and Hainan; Central China includes the provinces of Heilongjiang, Jilin, Shanxi, Anhui, Jiangxi, Henan, Hubei and Hunan; and Western China includes the autonomous regions of Inner Mongolia, Guangxi, Tibet, Ningxia and Xinjiang Uyghur, and the provinces of Sichuan, Guizhou, Yunnan, Shaanxi, Gansu and Qinghai, and Chongqing Municipality.

Inbound M&A

	2013	2014	% change
Deal value (US\$ billion)	37.6	26.7	-29.1%
Number of deals	586	447	-23.7%

Source: Dealogic, accessed 16 January 2015, KPMG analysis

In 2014, inbound M&A activities showed a downward trend, with the total value of inbound M&A deals down 29.1 percent year-on-year to US\$26.7 billion, and the number of deals down 23.7 percent year-on-year to 447. In the fourth quarter alone, the total deal value decreased 17.6 percent year-on-year to US\$8.43 billion, while the number of deals decreased 21.8 percent to 111.

China's inbound M&A deal value and number of deals, 2009-2014

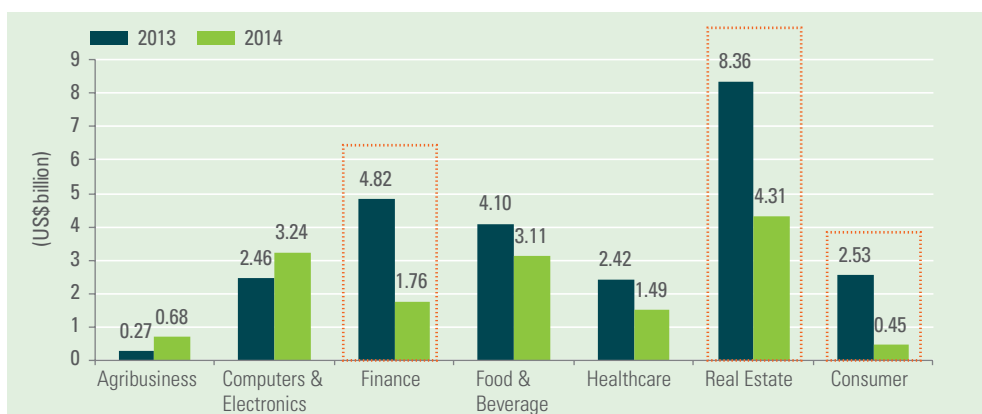


Source: Dealogic, accessed 16 January 2015, KPMG analysis



FDI in the real estate sector was the single most important contributor to the decline in the overall inbound M&A deal value, which fell from US\$8.36 billion in 2013 to US\$4.31 billion in 2014. This was in line with the sluggish property market in China. Finance sector FDI also fell substantially: in 2013, there were three bank-related transactions, each worth over US\$1 billion; while no transactions of a similar scale took place in this sector in 2014. The consumer goods sector is another sector that registered a significant decrease in inbound M&A deal value in 2014.

China's inbound M&A deal value by industry, 2013 vs 2014



Source: Dealogic, accessed 16 January 2015, KPMG analysis

In 2014, there was a notable decrease in the number of large-scale inbound M&A transactions. The average deal value of the top 10 inbound M&A deals in 2014 was only US\$890 million, down 24.3 percent from 2013 levels. There were only two deals over US\$1 billion each on the 2014 top 10 list, the fewest since 2003, the year when SARS (severe acute respiratory syndrome) had such a drastic negative impact on investment activities in China.



Top 10 inbound M&A deals by deal value in 2014

No.	Date	Target	Acquirer	Acquirer Country	Target sector	Shares acquired (%)	Deal value (US\$ million)
1	September 2014	<ul style="list-style-type: none"> Spreadtrum Communications, Inc. RDA Microelectronics, Inc 	Intel Corporation	US	Computers & Electronics	20	1,500
2	May 2014	<ul style="list-style-type: none"> Goleman International Ltd 	Hsin Chong Construction Group	Hong Kong	Real Estate	100	1,395
3	August 2014	<ul style="list-style-type: none"> Yonghui Superstores Co., Ltd 	Dairy Farm International Holdings Ltd	Hong Kong	Retail	19.99	925
4	July 2014	<ul style="list-style-type: none"> C.P. Pokphand Co. Ltd. 	ITOCHU Corporation	Japan	Food & Beverage	25	854
5	May 2014	<ul style="list-style-type: none"> Urumqi Jinshi Huilong Mining Co., Ltd 	Manhattan Resources Ltd	Singapore	Mining	70	799
6	November 2014	<ul style="list-style-type: none"> PayEase, Inc. 	Mozido Inc.	US	Professional Services	100	750
7	January 2014	<ul style="list-style-type: none"> Zhongsheng Group Holdings Ltd 	Jardine Matheson Holdings Ltd	Hong Kong	Auto/Truck	20	731
8	February 2014	<ul style="list-style-type: none"> China Mengniu Dairy Company Limited 	Danone	France	Food & Beverage	6.19	664
9	May 2014	<ul style="list-style-type: none"> Shanghai e-Shang Warehousing Services Co., Ltd. 	Stichting Pensioenfond ABP	Netherlands	Transportation & Logistics	20	650
10	November 2014	<ul style="list-style-type: none"> Hutchison Enterprises (Chongqing) Ltd 	Hui Xian REIT	Hong Kong	Real Estate	100	637

Source: Dealogic, accessed 16 January 2015, KPMG analysis

China plans to open its service sector wider to foreign investment.

Looking forward

Service sector FDI to continue to grow

FDI growth is expected to continue in the service sector, which is growing in size and importance as China rebalances its economy away from a heavy reliance on exports and investment-led growth. China plans to open its service sector wider to foreign investment as a way to further boost growth in services. In November 2013, the current (18th) Central Committee of the Communist Party of China (CPC) held its Third Plenum meeting, and announced new economic reform guidelines for the country. This 'Third Plenum Resolution' has encouraged foreign companies to invest in a broad range of services, including financial services, tourism, entertainment and healthcare.

In 2014, the Chinese Government issued a number of policies to facilitate FDI in service industries. For example, the central government has released new policy guidelines that allow foreign investors better access to the Chinese market for financial services. Foreign banks and other financial institutions are now expected to be able to compete with their Chinese peers in a fairer and more transparent business environment. The healthcare industry is another beneficiary. China began to remove investment barriers for foreign companies in this sector in 2012;¹⁷ new policies announced in 2014 will allow full foreign ownership of private hospitals in seven major Chinese cities and provinces as a pilot program. These new reform measures, as well as the opportunities generated by China's large and ageing population, will likely attract foreign investors to the country's healthcare market, estimated to be worth US\$1 trillion by 2020.¹⁸

Some foreign investors have already carried out pilot projects. For example, in July 2014, German healthcare company Artemed Group signed an agreement to set up a wholly foreign-owned hospital in the China (Shanghai) Pilot Free-Trade Zone. The proposed hospital, expected to start operating in 2016, will cover an area of 10,300 square meters and will focus on diagnostics, medical imaging, research and training.¹⁹

¹⁷ 'China healthcare: taking the private route – "Our view"', KPMG China, Transactions & Restructuring, December 2014

¹⁸ 'China urges more private capital in health insurance sector', *Reuters*, 28 August 2014, <https://uk.news.yahoo.com/china-urges-more-private-capital-health-insurance-sector-032749068-finance.html#MyKP55p>

¹⁹ 'Artemed hospital coming', *ShanghaiDaily.com*, 28 July 2014, <http://shanghaidaily.com/business/finance/Artemed-hospital-coming/shdaily.shtml>; 'Shanghai FTZ to get Artemed hospital', Wang Hongyi, *China Daily*, 23 July 2014, http://www.chinadaily.com.cn/business/2014-07/23/content_17901834.htm

High-tech sector to attract more FDI

Changes in the economic environment are also having a significant impact on China's attractiveness as a destination for foreign investment. Rising labor and resource costs in China have prompted some international (and domestic) companies to relocate their production of low value-added products to other low-cost countries. However, the situation is different for high-tech manufacturing: the chip industry serves as a good example. China has become one of the world's largest markets for cellphones and handheld devices. To gain a firmer local foothold in the market to supply Chinese device manufacturers, Intel cut a deal in September 2014 to pay up to US\$1.5 billion to acquire a 20 percent stake in two Chinese mobile chip manufacturers.

The Chinese Government is committed to shifting from low value-added to high value-added manufacturing, and is keen to encourage foreign participation in this process of industrial upgrading. In 2014, Chinese governments at various levels issued a number of policy guidelines to channel FDI to the high-tech sector. The central government released policies such as *Opinions on accelerating the transformation and innovative development of state-level economic and technological development zones* and *Opinions on accelerating the development of science and technology service*, which encourage foreign investment in advanced manufacturing and high-tech services.

Local governments have also updated their industrial policies. For example, the government of Henan province issued *Opinions on accelerating the development of industrial zones of high and new technologies*, which provides favorable treatment to foreign companies that invest in the construction of high-tech industrial parks, or set up research and development (R&D) centers in the province.

Foreign Investment Law

The Ministry of Commerce released the Draft Foreign Investment Law ("the Draft Law") on 19 January 2015. The new law will replace three existing laws related to foreign investment – the Law of the People's Republic of China (PRC) on Foreign-capital Enterprises, the Law of the PRC on Chinese-foreign Contractual Joint Ventures and the Law of the PRC on Chinese-foreign Equity Joint Ventures.

The new law will likely have a significant impact on China FDI as it will give foreign investors easier access to the Chinese market. Under the current laws, most new foreign investments need approval from Chinese authorities, which can be a complex and time-consuming process. The Draft Law plans to introduce the "negative list" management method that requires projects on the "negative list" to go through the approval procedure; projects that are not on the "negative list" only need to be filed with the Chinese authorities in charge of foreign investment. In addition, foreign companies will receive pre-established national treatment under the new regulations, a measure that can help create a level playing field for foreign investors.

According to the Draft Law, the status of foreign invested companies will not be judged on ownership but on "who is in control". Foreign enterprises in the mainland which are controlled by overseas investors will be considered foreign, while those controlled by Chinese investors will be considered domestic. As a result, it will likely be more difficult for a foreign investor to use a Chinese company as a 'cover' to operate in China and gain benefits if they own a minority stake but exercise *de facto* real control.

Some terms of the Draft Law overlap with certain provisions of the bilateral investment treaties (BITs) which China is currently negotiating with foreign countries, such as the BIT between China and the US. [See the box on p. 33 for details.] It remains to be seen what impact the new Foreign Investment Law will have on these BITs.

The Chinese Government is currently soliciting opinions on the new foreign investment law, the adoption of which will likely impact a variety of interest groups within China and abroad. The proposed law will later be submitted to China's top legislature, the National People's Congress, for final review. Based on past experience, legislation or revisions to legislation involving foreign investment can take a long time (years in some cases).

Investment environment to improve

With new reform initiatives and investment treaties (or free trade agreements) in place, China's investment environment is expected to improve noticeably. In terms of how the Chinese Government is approaching foreign investment, there are a number of initiatives that may benefit foreign investors in the coming years:

- The overall operating environment should improve as highlighted in the recent Third and Fourth Plenum meetings (late 2013 and 2014 respectively). The Third Plenum stressed that the market should play a decisive role in the economy, indicating that there should be less government interference and a fairer competition environment in China in the future. The Fourth Plenum endorsed the principle of rule of law, which will help improve the regulatory environment for foreign companies in China.
- Foreign investors could expect improved access to certain sectors. The Chinese Government's Central Economic Work Conference held in December 2014 announced that the country will enable foreign companies to have broader market access to service and manufacturing sectors in China, in an effort to stabilize the growth of inbound investment and improve investment quality.
- KPMG's Global China Practice anticipates that the recent free trade agreements with South Korea and Australia – substantive negotiations for both of which were concluded in 2014 – and the free trade agreement with Switzerland which came into effect in 2014, will likely lead to increased levels of FDI from those countries.

In addition, China has taken a major step towards streamlining the approval process for inbound investment: investments worth less than US\$300 million (up from US\$100 million previously) in a joint venture controlled by Chinese investors no longer require approval from the National Development and Reform Commission (NDRC) and only need to be registered with the NDRC.

Our view is that the improvement in the investment environment will offset the impact of China's economic slowdown, providing additional support to FDI in the country, and maintaining FDI inflows at around current levels in 2015.

Will 2015 see a bilateral investment treaty with the US?

Bilateral investment treaties (BITs) set out a basic framework that governs investments between two countries. Foreign investments from the other country in the BIT (in this case the US, and China) can enjoy a number of advantages, including greater legal protection, market access and dispute resolution procedures. China and the US are currently negotiating a landmark BIT between the world's two largest economies.

For US companies investing in China, a major benefit would be that US investments would receive so-called "national treatment" – they would receive the same treatment as domestic Chinese companies and would not, for example, be subject to investment restrictions such as foreign ownership caps. These advantages would pertain to investments that had been made prior to the BIT coming into effect, as well as after the BIT has been put in place. BITs also guarantee investors due legal process, provide enhanced dispute settlement procedures, and limit the government's ability to erect discriminatory investment barriers or to expropriate investments.²⁰

On the China side, the country is keen to conclude a BIT with the US, as in addition to facilitating access to the US market for Chinese investors, it would also set a standard for future BITs with other countries – as well as mark a major milestone in US-China economic relations. The two countries have reportedly made good progress in the first phase of talks on a BIT and will kick off more substantive negotiations in 2015.

KPMG's Global China Practice is watching these negotiations closely as the BIT has the potential to have a dramatic impact on Sino-American economic ties. Moreover, there is considerable momentum to conclude the BIT in 2015, before the next US election cycle.

²⁰ 'Bilateral Investment Treaties: What They Are and Why They Matter', Stephanie Henry, *China Business Review*, 29 July 2014, <http://www.chinabusinessreview.com/bilateral-investment-treaties-what-they-are-and-why-they-matter/>

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Over the next few years, China's FDI environment should continue to attract substantial amounts of FDI.

Urbanization to drive long-term FDI growth

Over the past three decades, China's urbanization has developed alongside the country's economy. Now, however, the government plans to actively use urbanization as a tool to promote long-term growth and reshape the country's economic future.

In March 2014, the State Council unveiled the 'National New-Type Urbanization Plan (2014-2020)', which is the country's first official urbanization plan. The central government summarized the lessons learned from China's urbanization since 1978 and promised a "New-Type" urbanization drive going forward, which will focus on the quality of growth and the welfare of urban residents.

The government will pay close attention to the development of technologies and industries that support the achievement of this blueprint, which include energy efficiency and environmental protection, new generation telecommunications, biotechnology, alternative energy, alternative energy vehicles, advanced materials, as well as professional and consumer services. Many international companies have distinct competitive advantages in these industries: they may be well positioned for opportunities created during the course of China's "New-Type" urbanization in the second half of this decade.

Central and Western China will likely be major beneficiaries in the urbanization drive. According to data released by the National Bureau of Statistics, the urbanization rate in those parts of the country is still below 50 percent, compared to over 62 percent in eastern provinces. Many central and western provinces enjoy cost and resource advantages and have the potential to attract investment. In fact, this is already happening on the ground in these areas: for example, in 2014, Samsung's chip factory started operation in Xi'an, Shaanxi Province. This factory was set up with a US\$7 billion investment and is the company's largest project outside Korea.

Over the next few years, China's FDI environment should continue to attract substantial amounts of FDI, as China continues down the road of its economic development and integration with the world economy.

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About KPMG's Global China Practice (GCP)



KPMG's Global China Practice (GCP) was established in September 2010 to assist Chinese businesses that plan to go global, and multinational companies that aim to enter or expand into the China market. The GCP team in Beijing comprises senior management and staff members responsible for business development, market services, and research and insights on foreign investment issues.

There are currently around 60 China Practices in key investment locations around the world, from Canada to Cambodia and from Poland to Peru. These China Practices comprise locally based Chinese-speakers and other professionals with strong cross-border China investment experience. They are familiar with Chinese and local culture and business practices, allowing them to effectively communicate between member firms' Chinese clients and local businesses and government agencies.

The China Practices also assist investors with China entry and expansion plans, and provide assistance on matters across the investment life cycle on both inbound and outbound China investments, including market entry strategy, location studies, investment holding structuring, tax planning and compliance, supply chain management, M&A advisory and post-deal integration.

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