



毕马威全球中国业务

KPMG Global China Practice

# CHINA OUTLOOK 2016



2016

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# Foreword



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At the beginning of 2016, the economic landscape in China is undoubtedly more challenging to decipher than when we prepared our 2015 report.

Over the last year, there has been a lot of discussion about China's transition to an era of slowing rates of economic growth. Continuing turmoil in the China stock market and weaker growth in several of the country's most closely followed economic indicators have provided further cause for concern. A string of business climate surveys have all tended to portray the lower competition, higher margin glory days as relics of the past.

These phenomena have led many pundits to argue that China's economy may be in for a hard landing. Scanning global headlines, one is left with the impression that foreign investors' eyes are pivoting towards untapped parts of Asia or India, or to opportunities closer to home. Increased outward investment by Chinese companies is cited as further evidence of structural problems at home.

Yet, we believe these headlines do not tell the complete story. While 6.9 percent gross domestic product (GDP) growth in 2015 represents a 25-year low, it is still one of the highest among the world's largest economies. In addition, the incremental economic output generated by China's 6.9 percent growth today is much higher than in the years when China was experiencing double-digit growth.

A nuanced analysis of economic data confirms our view that China is transitioning from an investment-intensive, export-led model of growth, to one driven by consumption and innovation, a shift that is being reflected in patterns of inward foreign direct investment (FDI) and outward direct investment (ODI). This process has led to the emergence of a two-track economy. One track – in basic manufacturing and traditional industries – is experiencing significant headwinds; while a second track – in services, advanced manufacturing and consumer markets – is exhibiting strong growth potential.

Of the record USD 126.3 billion that was invested into China last year, the services sector accounted for 61.1 percent; and while manufacturing's share of total FDI decreased for the fifth consecutive year, investments into 'high-tech manufacturing' increased by

9.5 percent year-on-year (YoY). Foreign investors are recognising that opportunities are shifting rapidly to new industries, such as e-commerce, healthcare and automation. This shift supports what is perhaps the single constant of China's 30-year economic transformation – the Chinese Government's adept ability to mobilise foreign technology, know-how and capital towards the sectors with the most pressing needs for development assistance.

In overseas markets, Chinese firms have increasingly invested in services, advanced manufacturing, technology and other high value-added and consumption-related sectors, as well as in assets providing high and stable returns. The latest data shows that China's ODI reached a historic high of USD 118.02 billion in 2015, and though sector-specific data for 2015 had not yet been released at the time of publication, figures on outbound merger and acquisition (M&A) deals show that high value-added sectors such as electronics, financial services and healthcare present attractive investment opportunities for Chinese firms.

Going forward, we expect the 'two-track' economy to continue characterising China's growth, which will have a corresponding impact on inward and outward investment trends. While GDP is likely to continue on its slower growth trajectory, we see this as a positive development, as it is a necessary condition for China's transition to a high value-added economy. Along the way, the demands of Chinese citizens and the priorities of the Chinese Government will become more complex, impacting the motivations and strategies of foreign firms investing in China, and Chinese firms investing abroad.

As a final note, when we consider the outlook for 2016, we must remember that 2016 marks the start of the next Five-Year Plan period, from 2016 to 2020. The final plan is expected to be released in March 2016, but based on the 'Proposal' for the 13th Five-Year Plan released in late 2015, we expect that the plan will contain additional encouragement for Chinese companies to expand overseas in key sectors critical to the national priorities laid out in the plan. Similarly, we expect it to emphasise stepped-up FDI in areas such as pollution abatement, and to facilitate the introduction of foreign capital and innovation to address societal challenges under the 'new normal'.

\* Figures are sourced from the National Bureau of Statistics of China (NBS) and Ministry of Commerce (MOFCOM). Full sources are provided in the document.

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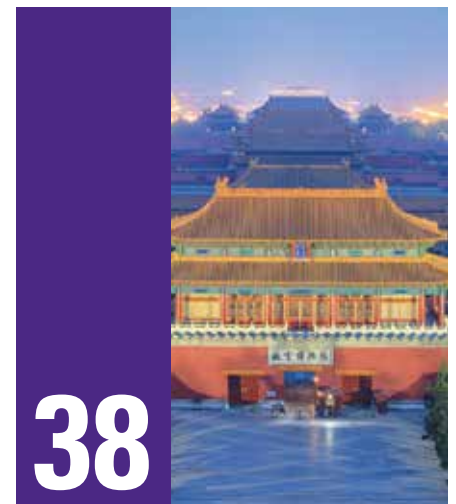
## BUSINESS ENVIRONMENT



## OUTWARD DIRECT INVESTMENT (ODI)



## FOREIGN DIRECT INVESTMENT (FDI)



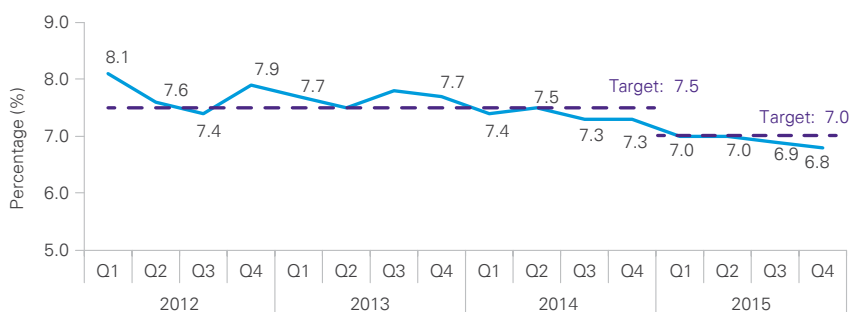
# Business environment

In *China Outlook 2015* – a flagship publication by KPMG’s Global China Practice (GCP) which was released last January – it was predicted that in light of the headwinds facing China’s economy, its GDP growth was “likely to slow down further in 2015, but not dramatically”. During the Third Session of the 12<sup>th</sup> National People’s Congress (NPC) a few months later, Chinese authorities lowered the official GDP target from 7.5 percent to “about” 7.0 percent.

Looking back, the challenges in 2015 were actually more significant than anticipated. Several of the most closely followed economic indicators – such as the Purchasing Managers’ Index (PMI), exports, fixed asset investment (FAI), commodity prices and housing sales – displayed weaker performances. These factors, along with the Chinese stock market turmoil and currency depreciation in the second half of 2015, seemed to support the arguments of China’s bears, who believed the country’s economy was approaching a hard landing.

Come 2016 and this still has not happened, and China’s economic growth has proved to be quite resilient. At 6.9 percent for the whole year, the country’s GDP growth rate for 2015 stayed very much in line with the official target (see chart below). While slower than previous years, this is still among the highest of the world’s major economies, and given the size of China’s economy today, the increase in economic output in 2015 was more than in previous years when the growth rate was higher. In comparison, the US would have to grow at 4 percent in order to produce the same amount of incremental economic output that China generated with 6.9 percent growth. Unsurprisingly, according to forecasts prepared by the International Monetary Fund (IMF), China is expected to continue being the largest contributor to world GDP – in purchasing power parity terms – and is expected to account for nearly 20 percent of world GDP by 2020, compared to 15.5 percent for the European Union and 14.9 percent for the US.<sup>1</sup>

**China’s GDP quarterly growth rate, year-on-year**



Source: 'Preliminary Accounting Results of GDP for the Fourth Quarter and the Whole Year of 2015', National Bureau of Statistics of China (NBS), 21 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160121\\_1307717.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160121_1307717.html); KPMG analysis

<sup>1</sup> 'IMF Data Mapper: World Economic Outlook (October 2015)', IMF, accessed on 19 February 2015, <http://www.imf.org/external/datamapper/index.php>. Importantly, the IMF's most recent data revision to its World Economic Outlook did not modify the projections for China's GDP growth; see 'World Economic Outlook update: Subdued demand, diminished prospects', IMF, 19 January 2016, <http://www.imf.org/external/pubs/ft/weo/2016/update/01/pdf/0116.pdf>



More importantly, because the abovementioned indicators are short term in nature, drawing conclusions and forecasts based solely on these indicators overlooks the government's efforts to facilitate a structural shift in the country's economy. As a result, we are left with an incomplete understanding of China's true growth potential. The country is in the process of transitioning into a high value-added economy, which means that its growth will increasingly (and necessarily) be driven by consumption, innovation and the services sector.

China's growth has already benefited from the contributions of the consumption and service-related sectors. In particular, e-commerce is turning into a pillar of growth: reducing costs and other barriers to entry, increasing competition, driving down prices, and unlocking new demand. These factors have helped offset weak growth in exports and the manufacturing sector.

Below, we highlight some of the key developments in China's economy in 2015 that are relevant to understanding the trends and outlook for Chinese investment overseas, and foreign investment in China.

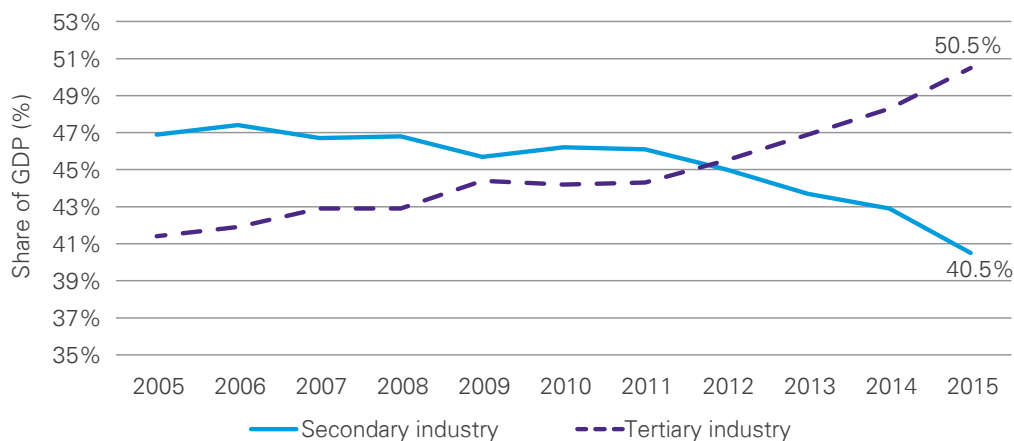
## Further signs of a 'two-track' economy

Looking beyond the overall GDP figures, our analysis shows that a 'two-track economy' has developed in China.

The first track – characterised by slowing growth – comprises the country's traditional sectors, which profited from and drove decades of fast-paced growth, such as the steel, shipbuilding, real estate and industrial products sectors. Companies in these sectors are now facing multiple challenges. Increasing pressure to restructure China's economy has focused attention on overcapacity problems, and the imperative for companies to move up the value chain and comply with stricter international and environmental standards. External shocks such as lacklustre global demand and monetary policy by foreign central banks have exacerbated these problems.

The other, faster growth track primarily consists of sectors and companies focusing on consumers and services, as well as those driven by innovation and technology. The development of these new economic 'engines' in China continued in 2015, including e-commerce, medical devices, services and high-end manufacturing. These sectors have seen impressive growth and are poised to continue this momentum into 2016.

### Share of GDP: Tertiary industry vs secondary industry<sup>2</sup>











Source: 'Preliminary Accounting Results of GDP for the Fourth Quarter and the Whole Year of 2015', NBS, 21 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160121\\_1307717.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160121_1307717.html); 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>

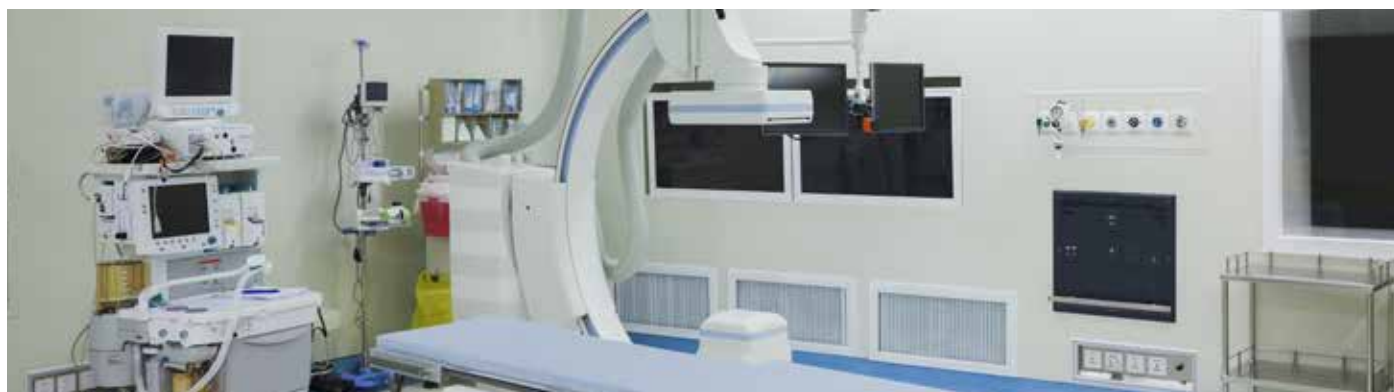


<sup>2</sup> The secondary industry comprises mining; manufacturing; production and supply of electricity, gas and water; as well as construction. The tertiary industry comprises the service sector of the economy.

## Share of GDP per sector in China

	2015	Percentage points change: 2005-2015
<b>Secondary industry</b>	<b>40.5%</b>	<b>-6.4</b>
 Industry (mining, manufacturing, and production and supply of electricity, gas and water)	33.8%	-7.6
 Construction	6.9%	+1.3
<b>Tertiary industry</b>	<b>50.5%</b>	<b>+9.1</b>
 Wholesale and retail	9.8%	+2.3
 Transport, storage and post	4.5%	-1.2
 Hotels and catering services	1.8%	-0.5
 Financial intermediation	8.5%	+4.5
 Real estate	6.1%	+1.5
 Others (e.g. scientific research, services to households and other services, and education)	19.3%	+2.5

Source: 'Preliminary Accounting Results of GDP for the Fourth Quarter and the Whole Year of 2015', NBS, 21 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160121\\_1307717.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160121_1307717.html); 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; the percentages in this table are calculated based on preliminary figures released by the NBS



## China's economic transition showing signs of progress

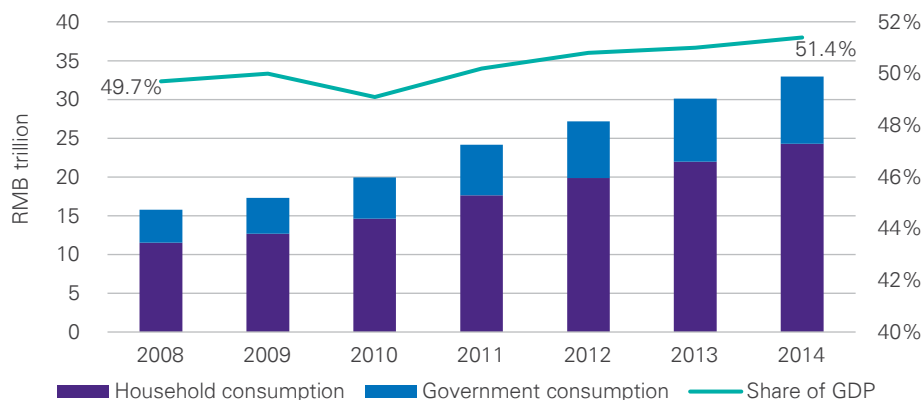
China is in the midst of a fundamental transition, moving from an investment-intensive, export-led model of growth, to a consumption- and innovation-driven one. This is a massive task for the world's second largest economy, and a transition that is proving painful for many industry participants.

However, progress is being made. First, while still low by other major economies' standards, recent economic data shows that the contribution from consumption as a percentage of GDP in China is rising. Based on preliminary data from the NBS, we calculate that final consumption accounted for 52.7 percent of China's GDP in 2015, up from 51.4 percent in 2014. By comparison, consumption expenditure in the US, both personal and from the government, accounted for 68.4 percent of the US GDP in 2015.<sup>3</sup> Over the last few years, household consumption has accounted for over 86.1 percent of China's final

consumption, and although no full-year data is available as at February 2016, we believe this was still the case for 2015. We expect Chinese consumers to become one of the main drivers of China's growth in the future, especially given the country's current rapid urbanisation rate.

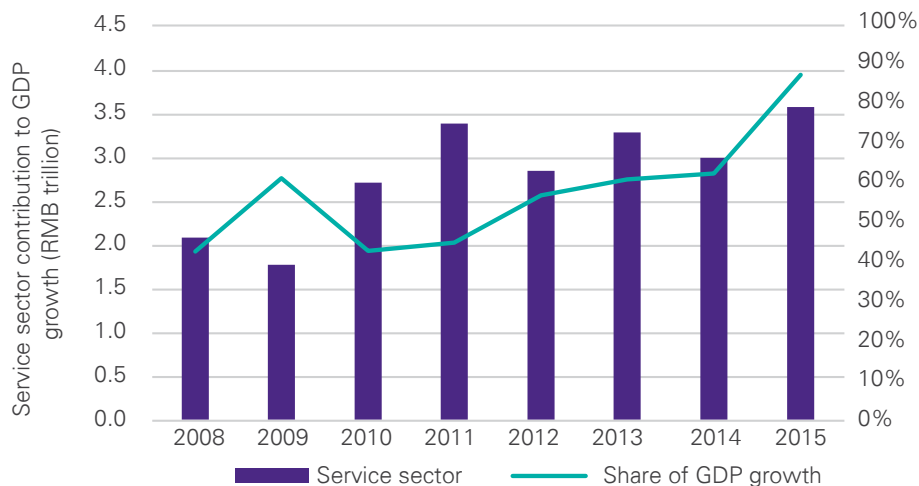
Second, the services element of the economy has presented robust growth, offsetting the impact of the industrial slowdown. Indeed, the service sector had already surpassed industry as the main driver of China's GDP growth in 2012, when it accounted for 56.9 percent of GDP growth that year. This percentage continued to increase over the following years, reaching 87.6 percent in 2015, as shown in the chart below. The resilience that the service sector has shown amid the global and domestic slowdown helps to underline its importance for China's long-term growth, and explains why its development is among the Chinese Government's top policy priorities.

### Consumption and share of GDP in China, 2008-2014



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

### Service sector's contribution to China's GDP growth



Source: 'Preliminary Accounting Results of GDP for the Fourth Quarter and the Whole Year of 2015', NBS, 21 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160121\\_1307717.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160121_1307717.html);  
'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; KPMG analysis

<sup>3</sup> 'National economic accounts', U.S. Department of Commerce, Bureau of Economic Analysis, accessed on 15 February 2016, <http://www.bea.gov/national/index.htm>

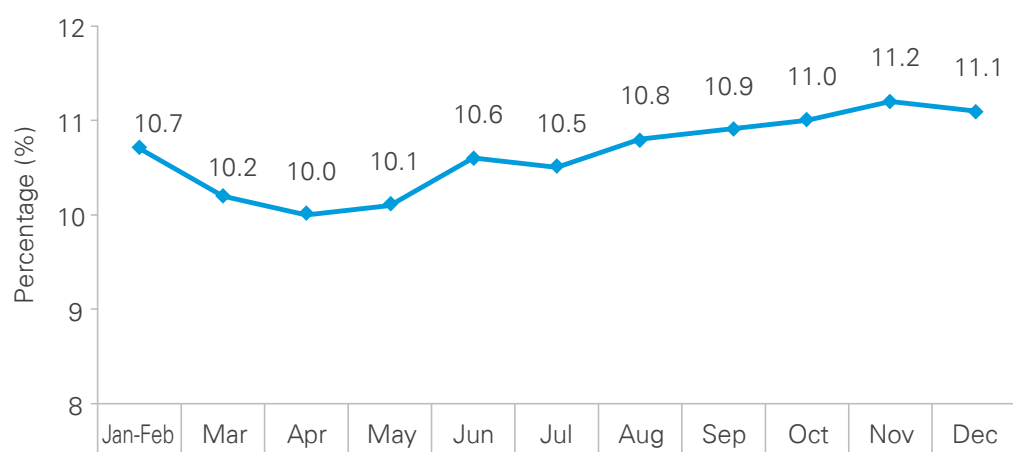
## Chinese consumers getting out their e-wallets

As shown in the following graph, retail sales in 2015 strengthened during the year. Of particular note is the role of e-commerce, which has become a dominant feature in the consumer spending landscape. In 2015, the online retail sales of goods and services totalled RMB 3.8 trillion, an increase of 37.2 percent YoY.<sup>4</sup> During last year's 'Singles Day' – an annual event that takes place in China on 11 November and in which online stores offer heavy discounts – e-commerce giant Alibaba registered RMB 91.2 billion in online sales, an increase of almost 60 percent compared to its sales during Singles Day in 2014.<sup>5</sup>

The e-commerce revolution in China is leading to the rise of industry disruptors and new entrants, and is forcing a rethink

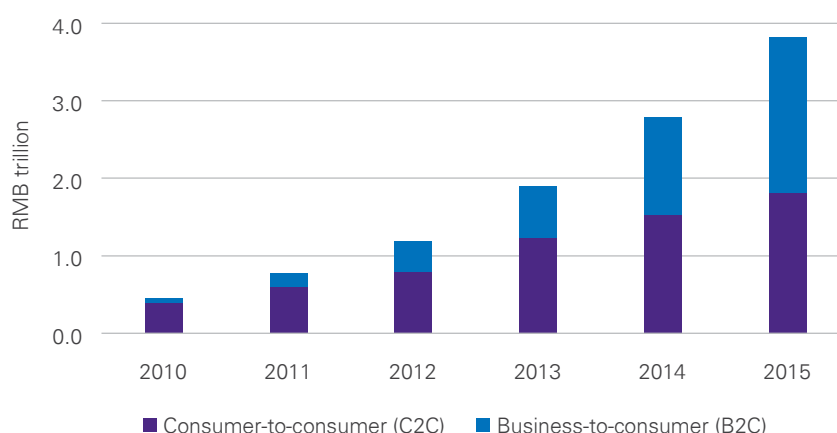
of business models and practices in almost every sector. Retailers and companies in the consumer goods sector no longer have to depend on investing in bricks-and-mortar stores to expand their reach in the China market. At the same time, because e-commerce has made it comparatively less costly and much easier for companies and individuals to market their products, this has led to intense market competition and, consequently, a decrease in prices. This is an area where we expect to see more activity in 2016. In fact, iResearch, a consultancy that focuses on China's internet industry, expects the country's online sales to roughly double in the next three years, reaching RMB 7.5 trillion in 2018.<sup>6</sup>

### 2015 retail sales of consumer goods in China, year-on-year growth rate



Source: 'Total Retail Sales of Consumer Goods in December 2015', NBS, 20 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160120\\_1307123.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160120_1307123.html); KPMG analysis

### Online shopping in China 2010-2015



Source: '2015 China E-commerce & O2O Summary Report', iResearch, 19 January 2016, [http://www.iresearchchina.com/content/details8\\_19531.html](http://www.iresearchchina.com/content/details8_19531.html); KPMG analysis

<sup>4</sup> '2015 China E-commerce & O2O Summary Report', iResearch, 19 January 2016, [http://www.iresearchchina.com/content/details8\\_19531.html](http://www.iresearchchina.com/content/details8_19531.html)

<sup>5</sup> 'Alibaba Group generated USD14.3 billion of GMV on 2015 11.11 global shopping festival', Alibaba Group, 12 November 2015, <http://www.alibabagroup.com/en/news/article?news=p151112>

<sup>6</sup> '2015 China E-commerce & O2O Summary Report', iResearch, 19 January 2016, [http://www.iresearchchina.com/content/details8\\_19531.html](http://www.iresearchchina.com/content/details8_19531.html)

Chinese consumers are also becoming increasingly sophisticated. They are demanding high-quality, customised products – not only to satisfy their basic needs, but also their value-added entertainment and comfort-oriented wants. Indeed, 2015 saw a rise in purchases of communication devices, electronics, and services such as healthcare, entertainment and tourism. Addressing this shift in Chinese consumers' preferences will continue to be a primary focus for all market players, both domestic and foreign. In particular, foreign companies operating in China have to rethink their strategies based on the following premise: it is no longer about marketing to the Chinese consumer, but about manufacturing for the Chinese consumer.

Financial services is another sector which is developing on a fast track, and which is benefiting from the popularity of internet-based services, coupled with the government's monetary policy easing and ongoing financial reforms.

## High-tech is the name of the game

In *China Outlook 2015* we predicted that “[s]ectors along the high-end value chain, such as high-end equipment manufacturing ... are expected to have great development opportunities” in 2015. This proved to be the case, as over the course of the year, the Chinese Government introduced a number of major policy initiatives to stimulate the upgrading of the country's manufacturing capabilities and help companies move up the technology value chain.

The 'Made in China 2025' and 'Internet Plus' plans, both announced in 2015, have jointly promoted the development of specific sectors, including information and communications technology (ICT), research and development (R&D), smart manufacturing, equipment, and 'green' technologies. Although the manufacturing sector saw sluggish overall growth in 2015, some of the targeted sectors within this industry saw robust growth, with the value-added of aerospace vehicles and equipment manufacturing, and high-tech manufacturing up by 26.2 percent and 10.2 percent respectively. Additionally, according to Wan Gang, who heads the Ministry of Science and Technology, China's investment in R&D is estimated to have reached RMB 1.43 trillion in 2015, up 9.9 percent YoY.<sup>7</sup>

## Slower investment growth shows government discipline

China's FAI growth<sup>8</sup> has experienced a continuous slowdown over the past couple of years, mostly driven by weaker economic conditions in the real estate and manufacturing sectors (see charts on the next page), which account for over 50 percent of total FAI. While this is affecting China's economic growth, we see it as a positive development, as

it demonstrates that authorities are committed to pushing forward their ambitious reform programme to facilitate China's transition into a high value-added economy.

As anticipated in *China Outlook 2015*, the authorities have been implementing a series of targeted measures to maintain steady growth. For instance, the People's Bank of China (PBOC) has been making extensive use of its liquidity facility tools, e.g. the Medium-term Lending Facility and Pledged Supplementary Lending, to inject liquidity directly into certain banks, with the understanding that these funds are meant to support lending in specific sectors. The China Development Bank and the Agricultural Development Bank of China, for their part, announced plans to issue RMB 300 billion in bonds to help finance infrastructure projects.<sup>9</sup> Furthermore, Chinese authorities approved a series of infrastructure projects worth over RMB 7 trillion in areas such as transportation, clean energy and water conservation to shore up growth.<sup>10</sup>

We expect this targeted approach to continue in 2016, particularly benefiting infrastructure investment. China's rapid rate of urbanisation will likely lead to a series of challenges, such as city saturation, and could add to current issues such as traffic congestion and the need to increase and improve China's regional interconnectivity. In view of this, we expect government initiatives such as the 'Belt and Road', the 'New-type Urbanization Plan' and the 'Beijing-Tianjin-Hebei coordinated development plan' to take a central role in China's future development plans.



<sup>7</sup> 'The trade volume of scientific and technical services reached RMB 983.5 billion in 2015', Xinhua News, 11 January 2016, [http://news.xinhuanet.com/fortune/2016-01/11/c\\_11117740138.htm](http://news.xinhuanet.com/fortune/2016-01/11/c_11117740138.htm)

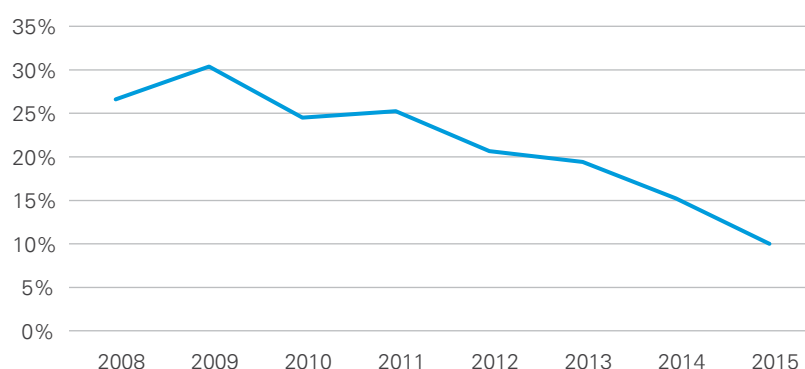
<sup>8</sup> 'China increases investment in scientific and technical area', NBS, 23 November 2015, [http://www.stats.gov.cn/tjsj/sjzd/201511/t20151123\\_1279552.html](http://www.stats.gov.cn/tjsj/sjzd/201511/t20151123_1279552.html)

<sup>9</sup> The NBS definition of FAI includes investments in capital construction projects in urban and rural areas, investments in real estate development, as well as investments in national defence projects and civil defence projects, and rural household investment. See 'China Statistical Yearbook 2014', NBS, <http://www.stats.gov.cn/tjsj/nds/2014/indexeh.htm>

<sup>10</sup> 'Policy banks to issue bonds worth 300 bln yuan this year', Huo Kan, Caixin, 8 October 2015, <http://english.caixin.com/2015-08-10/100838149.html>

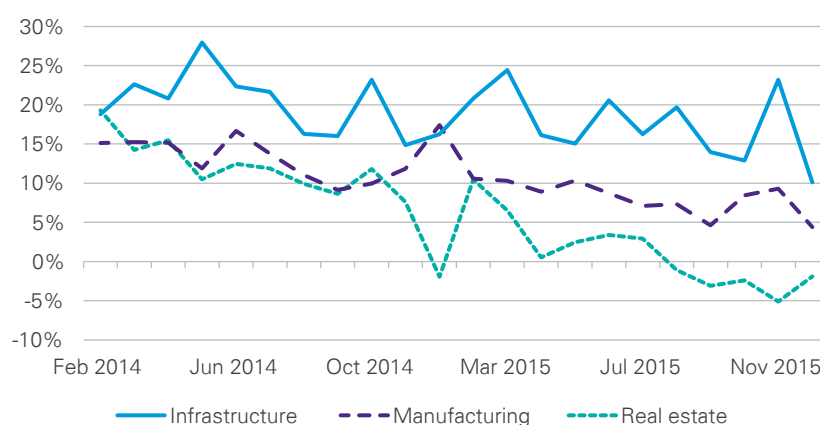
<sup>11</sup> 'China approves \$1.1t in projects', Hu Weiija, Global Times, 6 January 2015, [www.globaltimes.cn/content/900336.shtml](http://www.globaltimes.cn/content/900336.shtml)

### Fixed asset investment growth in China, year-on-year



Source: 'Investment in Fixed Assets for 2015', NBS, 19 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160119\\_1306487.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306487.html); 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>

### Fixed asset investment growth rate in selected sectors in China, year-on-year



Source: 'Investment in Fixed Assets for 2015', NBS, 19 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160119\\_1306487.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306487.html); 'National Real Estate Development and Sales in 2015', NBS, 20 January 2015, [http://www.stats.gov.cn/english/PressRelease/201601/t20160120\\_1307100.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160120_1307100.html); 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>

## Many core manufacturing sectors, and exports, feeling the pinch

Both exports and imports declined in 2015 amid a sluggish global market and slower China economic growth, highlighting the importance of driving up consumption to reduce dependence on foreign trade.

The negative effects of China's economic restructuring on its traditional sectors, particularly manufacturing, were exacerbated by weakening global demand. The manufacturing sector, which by itself accounts for over 30 percent of China's FAI, is highly connected to other sectors of the economy, such as commodities (e.g. steel and iron ore) and construction. Consequently, its weak performance spilled over into these areas.

Mining and energy-intensive industries (including steel and chemicals) were also adversely affected by overcapacity elimination. In 2014, China eliminated antiquated production capacity amounting to 31 million tons of steel and 81 million tons of cement. In addition, industry demand was weak due to slower FAI growth. All of these factors dragged down the industrial value-added growth rate to 6.1 percent, 2.2 percentage points lower than in 2014.<sup>11</sup>

<sup>11</sup> 'China's economy realized a moderate but stable and sound growth in 2015', NBS, 19 January 2015, [http://www.stats.gov.cn/english/PressRelease/201601/t20160119\\_1306072.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306072.html)

China's exports shrank for the first time since 2009, with a drop of 2.8 percent YoY in 2015, mainly due to the weak demand in the global market, as well as RMB appreciation against the Japanese yen and the euro in 2015. The depreciation of the RMB against the USD that occurred in the last months of 2015, following the PBOC's decision in August to modify the way it calculates the RMB's 'central parity rate',<sup>12</sup> may have a positive effect on China's export growth. However, in our view, it is unlikely that this effect will be very large. Without a recovery in external demand, China's export growth will remain weak. Also, Chinese authorities have declared that they do not intend to use currency manipulation to prop up exports.<sup>13</sup>

China's imports experienced a large decrease of 14.1 percent YoY in 2015 driven by weak domestic demand in industrial products and falling commodity prices. The drop in prices of 10 commodities, including crude oil, copper concentrate, plastics and soya beans, led to USD 188 billion in import costs savings, even while imported volume increased at the same time. This greatly reduced production costs for domestic enterprises.<sup>14</sup>

## 2015 saw the launch of several major economic policy initiatives

In recognition of the structural pressures that China's economy is facing, Chinese authorities launched a series of policies and initiatives meant to facilitate the country's transition into a high value-added economy. Support was provided to accelerate the upgrading and development of traditional manufacturing sectors, while other programmes were aimed at developing 'fast-track' activities such as internet-based businesses, green industries and R&D. The key policies, including their implications for FDI and ODI, will be explained in the following chapters.

Importantly, rather than focusing on the speed of growth, these initiatives place importance on the quality of growth, in order to achieve a more balanced level of development that is conducive to long-term prosperity. We expect this to continue being a feature of China's policies in the next few years, especially following the release of the 13<sup>th</sup> Five-Year Plan in March 2016.

### *The 13<sup>th</sup> Five-Year Plan: Achieving a "moderately well-off" society*

On 29 October 2015, at the Fifth Plenary Session of the 18th Communist Party of China (CPC) Central Committee, the leadership of the Party adopted the *CPC Central Committee's Proposal on Formulating the Thirteenth Five-Year Plan (2016-2020) on National Economic and Social Development* ("the Proposal").<sup>15</sup>

While the full and final version of the 13<sup>th</sup> Five-Year Plan is expected to be released in March 2016, the Proposal suggests that the focus will be squarely on improving the quality and efficiency of development by accelerating the establishment of institutional frameworks and mechanisms, as well as appropriate development paradigms to guide economic growth under the 'new normal'.

The Proposal identifies five underlying concepts for the country's development over the period from 2016 to 2020, with the ultimate objective of achieving a "moderately well-off society":

1. **Innovation**, which will be necessary for China to transition into a high value-added economy and, consequently, achieve a higher quality of growth
2. **Regional development**, which aims to address China's development disparity among regions and between urban and rural areas through infrastructure investment and the stimulation of regional markets
3. **Green development**, which places importance on developing China's green economy by tackling pollution and energy efficiency issues through market initiatives
4. **Opening up**, which looks to increase the efficiency of China's market by further integrating it with the global market
5. **Inclusive development**, which aims to ensure that China's development process benefits all individuals at all levels of society.

We believe that the implementation of the 13<sup>th</sup> Five-Year Plan will have a positive impact on China's business environment, leading to the emergence of numerous opportunities for both Chinese and foreign companies operating in China, and especially in those sectors that will contribute towards the country's economic transformation. KPMG's Global China Practice will be releasing a series of analyses on the business implications of the 13<sup>th</sup> Five-Year Plan following its release.

<sup>12</sup> This refers to the midpoint for the RMB, which is calculated on a daily basis, around which the RMB is allowed to trade within a 2 percent band.

'China increases investment in scientific and technical areas', NBS, 23 November 2015, [http://www.stats.gov.cn/tjsj/sj/d/201511/t20151123\\_1279552.html](http://www.stats.gov.cn/tjsj/sj/d/201511/t20151123_1279552.html)

<sup>13</sup> 'China has "no plan" to devalue yuan to help exports – or start a trade war, Premier Li Keqiang tells IMF', Zhou Xin, SCMP, 28 January 2016, <http://www.scmp.com/news/china/economy/article/1906533/china-has-no-plan-devalue-yuan-help-exports-or-start-trade-war>

<sup>14</sup> 'The Regular Press Conference of the Ministry of Commerce (January 20, 2016)', MOFCOM, 22 January 2016, <http://english.mofcom.gov.cn/article/newsrelease/press/201601/20160101244116.shtml>

<sup>15</sup> 'The CPC Central Committee's Proposal on Formulating the Thirteenth Five-Year Plan (2016-2020) on National Economic and Social Development', Xinhua News, 3 November 2015, [http://news.xinhuanet.com/fortune/2015-11/03/c\\_1117027676.htm](http://news.xinhuanet.com/fortune/2015-11/03/c_1117027676.htm)

## Free trade agreements

In 2015, China ratified and started implementing free trade agreements (FTAs) with Australia and South Korea, and China is the largest trade partner for both countries. These FTAs will boost trade and investment between China and the other two countries: lower tariffs will help Chinese exporters' competitiveness, as well as reduce costs for consumers in China purchasing products imported from Australia and South Korea.

Official declarations suggest that while Chinese authorities remain cautious about the Trans-Pacific Partnership (TPP),<sup>16</sup> implementation of the agreement is not expected to have an immediate negative effect on China's trade and investment flows. Indeed, according to China's Ministry of Commerce (MOFCOM), more time is required to assess the impact of the TPP on China as well as on the global trade system, while the National Development and Reform Commission (NDRC) believes that the effects of the TPP on China will be diluted thanks to the fact that China has signed FTAs with two-thirds of the current TPP members.<sup>17</sup>

## 2016 may be a good time to launch your start-up

Another clear government focus in 2015 was on building up China's entrepreneurial and innovation capabilities. In his *Report on the Work of the Government* at the Third Session of the 12<sup>th</sup> NPC in March 2015, Premier Li Keqiang emphasised that China needs to develop the "twin engines" of "mass entrepreneurship and innovation". Three months later, the State Council issued an 'Opinion' to put more detailed policies in place to achieve this goal.<sup>18</sup>

The Opinion lays out specific measures to support entrepreneurial activity and innovation, including streamlining administrative processes, setting up an innovation fund and implementing preferential tax policies. These initiatives appear to be bearing fruit, with 4.38 million new registered companies in China in 2015,<sup>19</sup> 20 percent higher than in 2014.

There have also been a number of academic and private sector initiatives to support start-ups and entrepreneurs. In October 2015, KPMG China launched the KPMG Innovative Start-up Centre in Beijing's Zhongguancun (also known as 'China's Silicon Valley'), to help accelerate the growth of start-up companies.<sup>20</sup>



<sup>16</sup> The TPP was signed on 4 February 2016 in Auckland, New Zealand by 12 countries including the US, Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

<sup>17</sup> 'TPP negotiations conclude, experts believe the impact on China is limited', NDRC, 30 October 2015, [http://www.ndrc.gov.cn/fzgggz/jjmy/dwjmhzh/201510/t20151030\\_756863.html](http://www.ndrc.gov.cn/fzgggz/jjmy/dwjmhzh/201510/t20151030_756863.html)

<sup>18</sup> 'Opinions of the State Council on Several Policies and Measures for Vigorously Advancing Popular Entrepreneurship and Innovation', State Council, 16 June 2015, [http://www.gov.cn/zhengce/content/2015-06/16/content\\_9855.htm](http://www.gov.cn/zhengce/content/2015-06/16/content_9855.htm)

<sup>19</sup> '12,000 new companies registered per day in 2015', Ifeng.com, 17 January 2016, [http://news.ifeng.com/a/20160117/47103540\\_0.shtml](http://news.ifeng.com/a/20160117/47103540_0.shtml)

<sup>20</sup> 'Strategy in action: Opening of the KPMG Innovative Start-up Centre in "China's Silicon Valley"', KPMG China, 11 October 2015, <http://www.kpmg.com/CN/zh/PressRoom/PressReleases/Pages/press-20151011-KPMG-signs-agreement-with-haidian-estate-of-zhongguancun.aspx>

## Business response to the 'new normal'

### More challenges, but still plenty of opportunities to be found

Businesses have been quick to adapt to the new environment. Slower GDP growth, the effects of the continued anti-corruption campaign, a more sophisticated and demanding consumer market, rising costs, a more uncertain RMB exchange rate environment, and other challenges are impacting both domestic and foreign companies. These are driving companies operating in the China market to undertake new initiatives to improve their efficiency, enhance their R&D capabilities, and deal with rising compliance costs to meet enhanced environmental and food safety requirements.

More importantly, we see an increasing number of companies looking to revisit and rethink their fundamental business models in light of new (or potential) industry disruptors such as e-commerce, and government initiatives to tackle the issues of overcapacity and industrial transformation, to meet China's evolving consumption trends and/or expand their business scope to cover new services or markets.

In addition, companies should not underestimate the business opportunities arising from the 'new normal'. China's transition to an innovation-driven, service-oriented and consumption-led economy will drive development in sectors as diverse as high-tech manufacturing, environmental and healthcare services, e-commerce and logistics, maternal and child care, eldercare, and agribusiness.

In 2016, we expect the government to continue creating platforms to spur innovation and entrepreneurial activity nationwide, and to streamline administrative procedures and remove barriers to business creation and expansion. These initiatives, together with the opening up of sectors previously off limits to private sector investment, should create new business opportunities for start-ups and other investors.



**Thomas Stanley**

Chief Operating Officer,  
KPMG Global China Practice

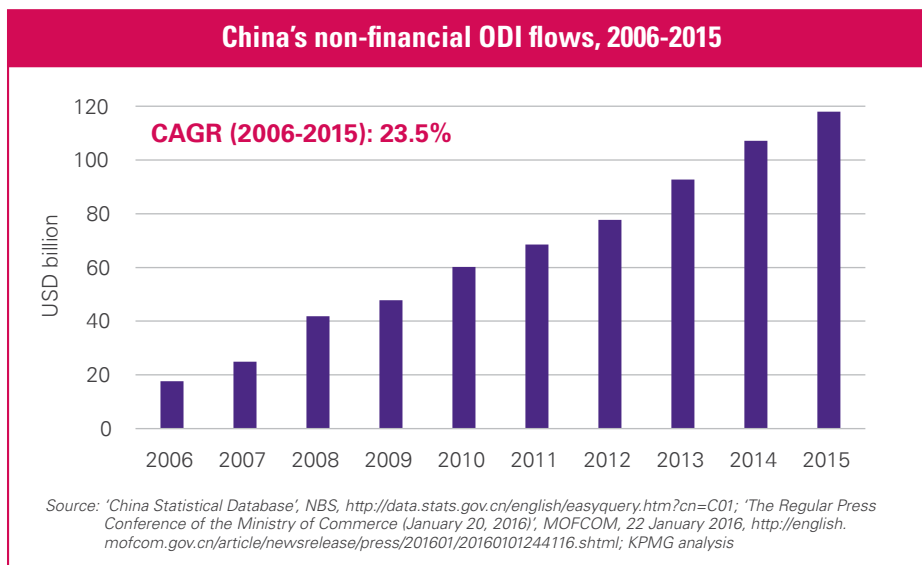
*“ Few would argue with the need for China to fundamentally re-engineer its economy to put it on a sound footing for the long term. This adjustment is taking place in a slower-growth environment, which, taken together with other competitive and market factors, is presenting significant challenges for business. At the same time, we see new growth opportunities in sectors whose development will assist in China's economic transformation, and the government is channelling investment into these areas. ”*



# Outward Direct Investment (ODI)

## 2015 Highlights

Consistent with our predictions in *China Outlook 2015*, Chinese overseas investment continued its upward trajectory, with non-financial ODI flows increasing by 14.7 percent to reach a historic high of USD 118.02 billion in 2015, as shown in the chart below.



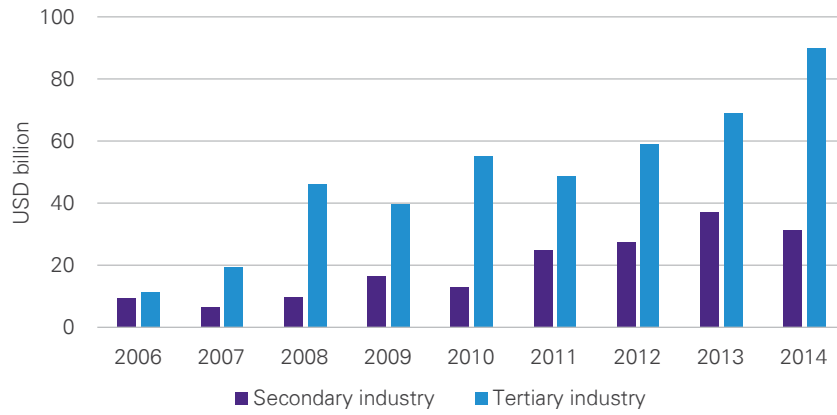
## Sectors

The tertiary industry, which comprises services and consumer-related sectors, started accounting for the majority of China's overseas investment from 2005. Since then, this trend has only become more apparent, with the last available data showing that ODI flows and stock in the tertiary industry increased by 30.2 and 38.9 percent respectively in 2014. On the other hand, ODI flows in the secondary industry fell by 15.5 percent YoY, and growth in ODI stock slowed down to 19.5 percent from 36.7 percent in 2013. This was driven by a drop in Chinese overseas investment into mining and construction. Overall, Chinese ODI into high value-added and consumer-related sectors has shown strong growth over the last few years, with investment into healthcare, entertainment and high-tech sectors all achieving a compound annual growth rate (CAGR) above 50 percent for the 2011-2014 period (see the table on p. 17).



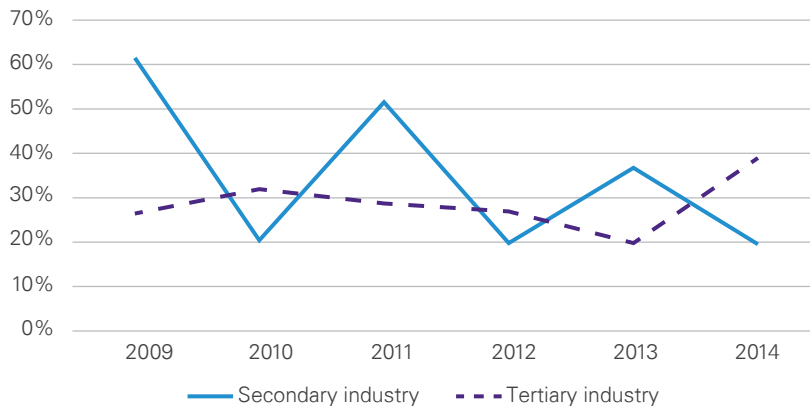


### China's ODI flows: Secondary vs tertiary industry, 2006-2014



Source: 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; KPMG analysis

















### China's ODI stock YoY growth in secondary and tertiary industries, 2009-2014



Source: 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; KPMG analysis



## Growth in China's ODI flows by sector

	2014 YoY	CAGR (2011-2014)
<b>Secondary industry</b>		
 Mining	- 33.3%	4.6%
 Manufacturing	33.2%	10.8%
 Construction	-22.2%	27.2%
 Supply of electricity, gas and water	159.3%	-2.0%
<b>Tertiary industry</b>		
 Wholesale and retail	24.9%	21.0%
 Transport, storage and post	26.2%	17.6%
 Hotels and catering services	197.9%	27.9%
 Financial intermediation	5.4%	37.9%
 Real estate	67.1%	49.6%
 Leasing and business	36.1%	12.9%
 Health, social security and social welfare	800.6%	188.5%
 Culture, sports and entertainment	67.0%	70.4%
 Information transmission, computer services and software	126.3%	59.8%
 Scientific research, technical service and geologic prospecting	-6.9%	33.2%
 Management of water conservancy, environment public facilities	280.6%	29.3%
 Other services	68.4%	43.0%

Source: 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=C01>; KPMG analysis

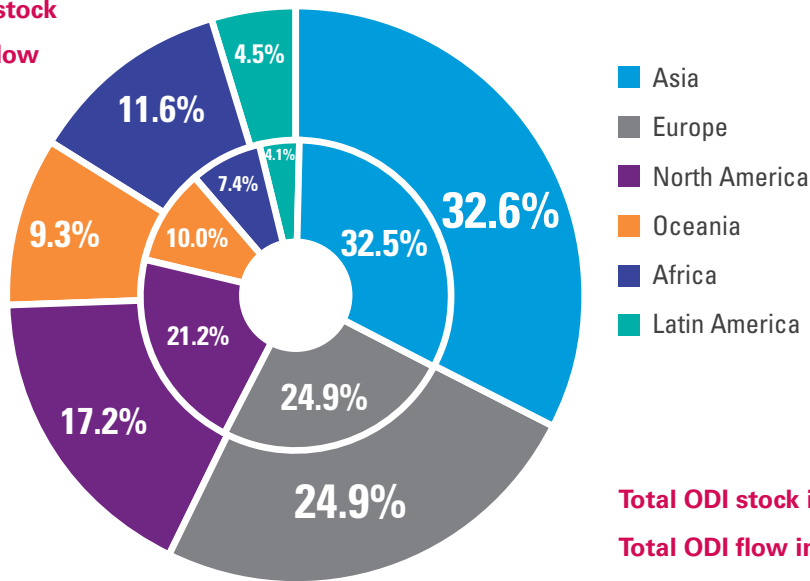
### Geographies

After excluding the ODI figures for Hong Kong, the British Virgin Islands and the Cayman Islands,<sup>21</sup> the top 10 destinations for China's overseas investment in 2014 include a combination of both developed economies and emerging markets, as shown in the table alongside. The US, Luxembourg, Australia, Singapore and the UK ranked

as the top five destinations for China's overseas investment in 2014, both in terms of flows and stock. Within the top 10 destinations for Chinese ODI stock in 2014 (shown in the table on p.19), the five countries with the highest CAGRs over the period from 2011 to 2014 were the UK, the US, Indonesia, Kazakhstan and Russia.

### China's ODI flows and stock by region in 2014

**Outer circle: ODI stock**  
**Inner circle: ODI flow**























**Total ODI stock in 2014: USD 279.2 billion**  
**Total ODI flow in 2014: USD 43.5 billion**

Source: '2014 Statistical Bulletin of China's outward foreign direct investment', MOFCOM, NBS and State Administration of Foreign Exchange, China Statistics Press, Beijing, September 2015



<sup>21</sup> As much of the inward FDI from China into these three jurisdictions is reinvested as outward FDI either into mainland China or other countries, the figures potentially distort the picture when it comes to understanding where Chinese ODI is destined.

## Top 10 countries attracting Chinese overseas investment in 2014

ODI Flow				ODI Stock			
		YoY	CAGR 2011-2014			YoY	CAGR 2011-2014
1	 US	96.1%	61.3%	 US	US	73.6%	61.7%
2	 Luxembourg	259.0%	53.5%	 Australia	Australia	36.9%	29.3%
3	 Australia	17.1%	8.6%	 Singapore	Singapore	39.9%	24.9%
4	 Singapore	38.4%	-4.9%	 Luxembourg	Luxembourg	50.3%	30.3%
5	 UK	5.6%	1.8%	 UK	UK	8.5%	71.7%
6	 Germany	58.0%	41.1%	 Russia	Russia	14.7%	32.2%
7	 Indonesia	-18.6%	29.0%	 France	France	89.9%	31.4%
8	 Netherlands	332.0%	83.1%	 Canada	Canada	25.7%	27.8%
9	 Laos	31.4%	30.8%	 Kazakhstan	Kazakhstan	8.4%	38.2%
10	 Pakistan	520.1%	44.9%	 Indonesia	Indonesia	45.9%	59.1%

Source: '2014 Statistical Bulletin of China's outward foreign direct investment', MOFCOM, NBS and State Administration of Foreign Exchange, China Statistics Press, Beijing, September 2015

### Outbound M&A transactions

Chinese companies conducted 502 deals in 2015, up from 325 the previous year.<sup>22</sup> The value of announced deals went up by 40 percent YoY to reach USD 87.7 billion. Given this rapid growth, Chinese outbound M&A may be on track to surpass the USD 100 billion mark this year.<sup>23</sup> Indeed, the first few weeks of 2016 showed no signs of this trend abating, with a staggering USD 74.8 billion of deals being announced in the period up to 18 February,<sup>24</sup> including the mega-deals listed below.

- In what would be China's largest outbound transaction ever, on 3 February, China National Chemical Corporation (ChemChina) announced a USD 43 billion agreement to acquire the Swiss agrochemical and seeds company Syngenta. This comes hot on the heels of ChemChina's acquisition of a 12 percent strategic stake in Mercuria, one of the five biggest independent oil traders, and their USD 1.0 billion acquisition of Germany's KraussMaffei Group, a global leader in the manufacture of machinery for

the production and processing of plastics and rubber, all in January 2016. Last year, ChemChina acquired the world's fifth largest tyre maker, Pirelli, for USD 8.9 billion in what was the largest outbound deal for 2015.

- HNA Group announced the USD 6 billion acquisition of Ingram Micro, a US-based company specialising in the provision of global supply chain and technology solutions. Ingram Micro distributes products from some of the most renowned technology firms; it has operations in 38 countries and serves customers in about 160 countries. This deal will complement both companies' logistics capabilities to further expand their overseas reach and could enable HNA Group to transform into a supply chain operator.
- Haier announced the acquisition of General Electric's Appliances business for USD 5.4 billion, which will not only allow Haier to expand its presence in the US market, but also provide Haier with "great products, state-of-the-art manufacturing facilities and a talented team."<sup>25</sup>

<sup>22</sup> All M&A data in this report was obtained from Dealogic, unless otherwise indicated. Outbound transactions of targets in Hong Kong, the British Virgin Islands and the Cayman Islands are excluded from all the statistics in this section, unless otherwise stated.

<sup>23</sup> These figures should be considered as approximate, as there are 11 deals from 2014 and 110 from 2015 that have still not been completed.

<sup>24</sup> Based on our calculations using Dealogic data, accessed on 18 February 2016. We exclude deals targeting Hong Kong, the Cayman Islands and the British Virgin Islands.

<sup>25</sup> GE agrees to sell appliances business to Haier for \$5.4B, GE Appliances, 15 January 2016, <http://pressroom.geappliances.com/news/ge-agrees-to-sell-appliances-business-to-haier-for-5-4b>

- Wanda announced the acquisition of US film studio Legendary Entertainment for USD 3.5 billion, which will help Wanda grow its film business and take advantage of Chinese consumers' increasing demand for entertainment-related products and services.
- In what would be the largest outbound deal to date in the automotive components sector, Ningbo Joyson Electronic Corporation announced the USD 920 million acquisition of US-based Key Safety Systems, a leading global supplier of advanced engineered safety products for automotive and non-automotive markets.

Consistent with our predictions, three trends characterised China's outbound M&A in 2015:

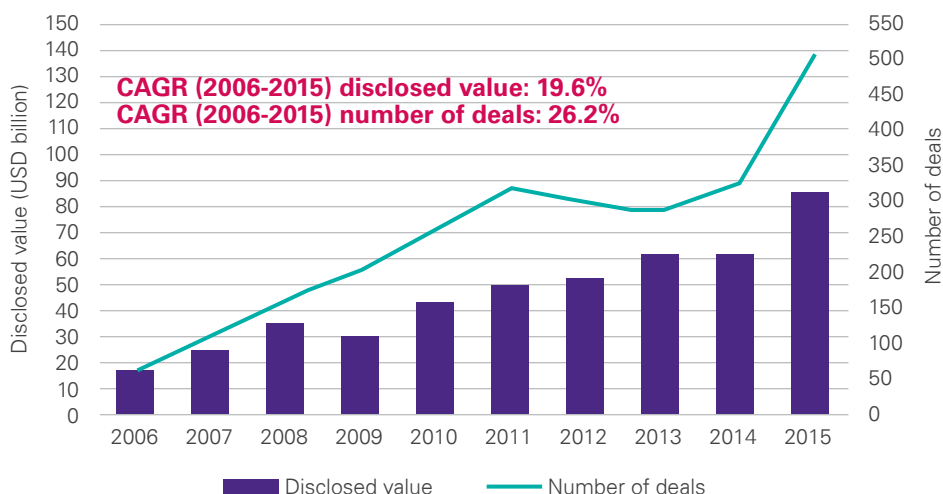
- First, China's outbound M&A activity continued to be focused on 'quality growth', with not only more, but also larger deals being announced in high value-added and

consumption-related sectors. For instance, 2015 saw 99 deals in the computers and electronics sector, up from 57 in 2014, with their total disclosed value increasing from USD 9.0 billion to USD 11.8 billion.

- Second, and consistent with the first trend, Chinese companies did more deals in developed markets in 2015 compared with prior years.<sup>26</sup> This translated into 408 deals or 81.3 percent of the total, with a value of USD 67.8 billion in 2015, up from 277 deals with a value of USD 52.3 billion in 2014, and 225 deals with a value of USD 33.3 billion in 2013.

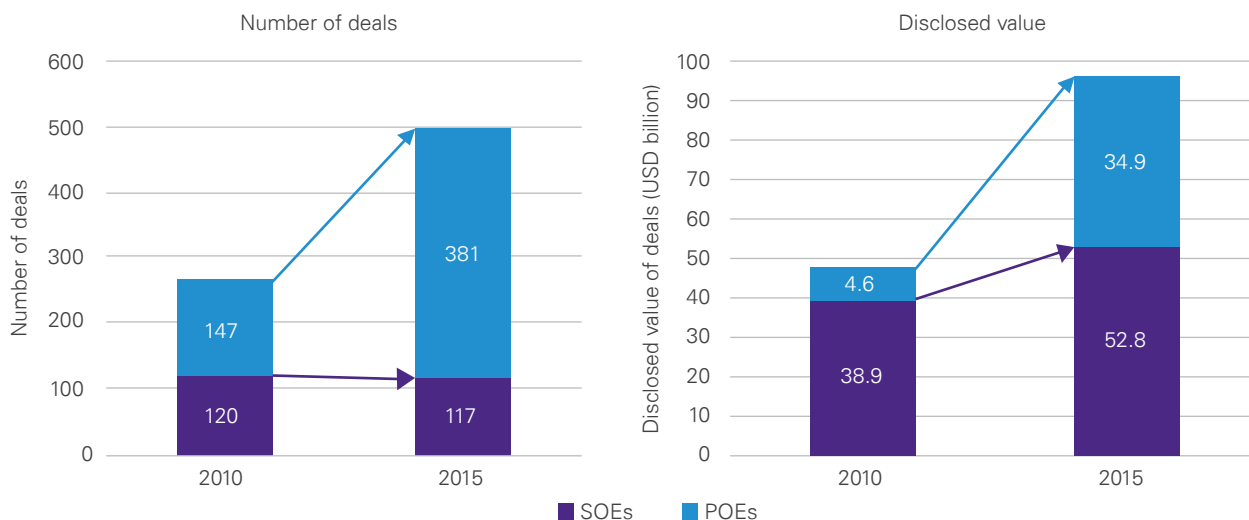
- Third, more deals were announced by privately owned enterprises (POEs), accounting for 75.9 percent of the total number of deals in 2015, which was up from 68.0 percent in 2014 and 55.1 percent in 2010. State-owned enterprises (SOEs) are still doing the majority of the largest deals.

### China's outbound M&A deals, 2006-2015



Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies

### China's outbound M&A deals in 2015: SOEs vs POEs



Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies











<sup>26</sup> The report classifies economies as 'developed' and 'developing' based on the International Monetary Fund's index of advanced economies. See: 'World Economic Outlook: Adjusting to Lower Commodity Prices', IMF, October 2015, <https://www.imf.org/external/pubs/ft/weo/2015/02/pdf/text.pdf>

## Top countries and regions for Chinese outbound M&A transactions in 2015, by number of deals

Rank	Country/region	No. of deals	Investment targets
1	 US	113	Computers and electronics, healthcare, real estate, machinery, telecoms, insurance, utility and energy
2	 Australia	42	Mining, utility and energy, real estate, agribusiness and food, healthcare
3	 South Korea	38	Computers and electronics, consumer products, leisure and recreation, telecoms
4	 Germany	26	Automotive, machinery, healthcare
5	 Taiwan	24	Chemicals, computers and electronics, consumer products, financial services, healthcare
5	 UK	24	Computers and electronics, professional services, real estate, transportation
6	 Singapore	21	Computers and electronics, transportation, consumer products
7	 Canada	19	Mining, oil and gas, healthcare
8	 Italy	14	Automotive, financial services
9	 Japan	13	Agribusiness and food, computers and electronics, healthcare
10	 France	11	Healthcare, real estate, professional services
10	 Israel	11	Computers and electronics, real estate





















Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies

## Top countries for Chinese outbound M&A transactions in 2015, by disclosed deal value

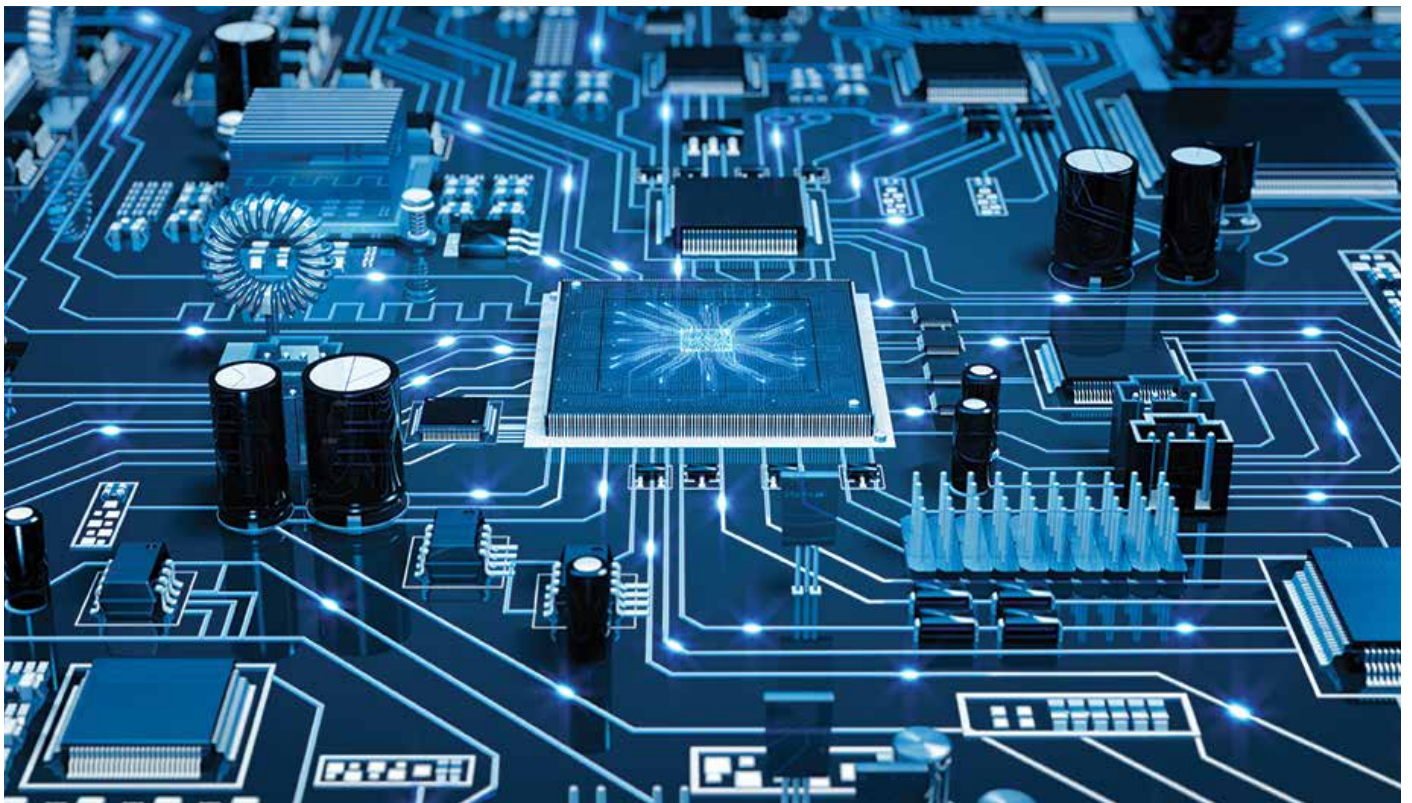
Rank	Country/region	Disclosed deal value (USD billion)	Investment targets
1	 US	14.4	Computers and electronics, healthcare, real estate, machinery, telecoms, insurance, utility and energy
2	 Italy	10.6	Automotive, financial services
3	 Australia	8.4	Mining, utility and energy, real estate, agribusiness and food, healthcare
4	 Ireland	7.5	Transportation, financial services
5	 Taiwan	5.9	Chemicals, computers and electronics, consumer products, financial services, healthcare
6	 Brazil	5.0	Automotive, financial services, machinery, transportation, utility and energy
7	 Switzerland	4.1	Computers and electronics, financial services, healthcare, leisure and recreation, transportation
8	 Netherlands	3.5	Chemicals, computers and electronics, consumer products, financial services, agribusiness and food
9	 Malaysia	3.2	Chemicals, computers and electronics, consumer products, real estate, utility and energy
10	 Singapore	2.6	Computers and electronics, transportation, consumer products

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies

## Top 10 sectors for Chinese outbound M&A deals in 2015, by value and number of deals

Rank	Sector	Disclosed value (USD billion)	Sector	Number of deals
1	 Financial services (including insurance)	18.1	 Computers and electronics	99
2	 Computers and electronics	11.8	 Healthcare	54
3	 Utility and energy	10.2	 Real estate (including hotels and restaurants)	35
4	 Automobile	9.6	 Mining	33
5	 Real estate (including hotels and restaurants)	7.4	 Financial services (including insurance)	27
6	 Transportation	7.0	 Transportation	26
7	 Oil and gas	6.8	 Utility and energy	23
8	 Mining	4.5	 Professional services	24
9	 Healthcare	3.3	 Consumer products	23
10	 Leisure and recreation	2.2	 Oil and gas	21

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies



## Top 10 announced outbound M&A deals in countries and regions in 2015, by deal value<sup>27</sup>

No.	Deal value (USD billion)	Announced month	Acquirer	Acquirer entity type	Target	Target's origin	Shares acquired (%)	Target sector
1	8.98	March	ChemChina; Silk Road Fund	SOE	Pirelli & C. SpA	Italy	100	Automotive
2	7.5	July	Bohai Leasing	SOE	Avolon Holdings	Ireland	100	Financial services (aircraft leasing)
3	3.71	November	China Three Gorges Corporation	SOE	Power stations	Brazil	100	Utility and energy
4	2.80	July	HNA Group	SOE	Swissport International	Switzerland	100	Transportation and logistics
5	2.28	November	China General Nuclear Power Corporation	SOE	Edra Global Energy	Malaysia	100	Utility and energy
6	2.24	July	China Minsheng Investment Corporation	POE	Sirius International Group	US	100	Insurance
7	2.17	December	State Power Investment Corporation	SOE	Pacific Hydro	Australia	100	Utility and energy
8	1.93	May	Zhongrun Resources Investment Corporation	POE	Boldtumur Eruu Gol LLC; Erlian Longming Railway Maintenance Development	Mongolia	100	Mining
9	1.89	June	Haocan (Shanghai) Equity Share Investment Fund Corporation	POE	Tatung	Taiwan	100	Computers and electronics
10	1.84	May	Fosun International	POE	Ironshore	US	80	Financial services

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by Chinese companies

Chinese contractors were also very active in the international market, having signed new contracts worth USD 210.1 billion during 2015, which represents a YoY increase of 9.5 percent. Their international revenue in 2015 totalled USD 154.1 billion, up 8.2 percent on a YoY basis.<sup>28</sup> To date, Chinese international contractors have mainly been active in developing countries. Data from the China

International Contractors Association, for instance, shows that in 2014, Chinese contractors signed USD 176.2 billion worth of new contracts in Asia, Africa and Latin America, whereas in Europe, North America (US and Canada) and Oceania, they only signed USD 15.5 billion worth of new contracts.<sup>29</sup>

<sup>27</sup> We exclude the attempted acquisition of Fairchild Semiconductor by Hua Capital Management and China Resources Microelectronics, which was rejected by the target company on 16 February 2016, citing concerns about the possibility that the Committee on Foreign Investment in the United States (CFIUS) would not approve the transaction. See: 'Amendment to a previous filed SC 14D9', SEC filings, Fairchild Semiconductor, 16 February 2016, <https://www.fairchildsemi.com/about/investors/sec-filings/>. We also exclude Unisplendour Corporation's proposed acquisition of Western Digital, as Unisplendour decided to terminate the transaction on 23 February 2016 following the decision by CFIUS to investigate the investment. See: 'Western Digital committed to creating significant value through ScanDisk acquisition', Western Digital, 23 February 2016, <http://www.wdc.com/en/company/pressroom/releases/?release=4e964652-0f24-4987-9d5a-97e5379eba81>

<sup>28</sup> 'Concise Statistics of China's Overseas Contracted Projects in 2015', MOFCOM, 21 January 2016, <http://fec.mofcom.gov.cn/article/tjsj/ydjm/gccb/201601/20160101239834.shtml>

<sup>29</sup> Annual Report on China International Project Contracting 2014-2015' CHINCA. KPMG analysis.

## Looking forward

Under the 'new normal' we expect that Chinese ODI will continue to grow at more than 10 percent per annum, exhibiting healthy diversification across all metrics.

### Sectors:

We expect that Chinese ODI will continue to be undertaken across more sectors. Key drivers of Chinese ODI activity at a macro level include:

- Acquiring experience, technology, brands and human capital to become more competitive, and support China's transition towards an advanced economy, which will benefit countries which are strong in sectors such as advanced manufacturing and information communication technology
- Accessing high-quality products and services that can be deployed in China to meet its evolving consumption needs, which will benefit sectors such as agriculture and food production, healthcare and eldercare services
- Creating new sources of demand for products and services affected by overcapacity issues in the domestic market
- Sourcing investments which allow Chinese companies to diversify their portfolio risk and earn more stable returns
- Building a credible track record that facilitates expansion into new markets, particularly in developed economies.

To understand and anticipate trends in Chinese ODI, it is necessary to look at the drivers for investment activity at a sector level. We have done this in the 'Industry highlights' section on pp. 30-36.

### Types of investors:

More Chinese companies will make investments overseas, and POEs will feature increasingly in this trend. This is because POEs are active in many of the new sectors where Chinese companies are investing, and because from the perspective of many overseas countries, there is typically less sensitivity around investments by POEs compared to SOEs. This is reflected, for example, in the higher approval thresholds for POEs under the China-Australia Free Trade Agreement (ChAFTA).

Financial investors will continue to be a feature of the Chinese ODI landscape, including:

- Insurance companies which, thanks to measures by the China Insurance Regulatory Commission to relax regulatory restrictions on overseas investment activities, and given China's economic slowdown and stock market volatility, will step up efforts to diversify their overseas investments, especially into real estate, to improve their overall risk/return profile

- Financial investors – including state-owned financial institutions and funds and multilateral development banks – which will co-invest in, and in some cases, provide advice and support to the Chinese companies undertaking 'Belt and Road' projects and investments
- Chinese private equity (PE) funds which source and aggregate Chinese and international capital to co-invest in outbound deals by Chinese strategic investors
- Chinese-backed venture capital firms looking for opportunities outside China to strengthen their offerings in the domestic market.

### Countries:

- More investments will be made in North America, Europe and other developed economies, where there are more high-quality targets which can help Chinese companies upgrade, transform and improve their competitiveness.
- More projects and investments will be undertaken along the 'Belt and Road', as the objectives come to be better understood and the mode of implementing this initiative continues to evolve over the coming years.

### Partnerships:

- We will continue to see more win-win cooperation between Chinese and foreign companies, with partnership and building trust lying at the heart of these collaborations.
- Deals will often be struck on the basis of the Chinese partner providing one or more of the following advantages: access to China market demand, funding, a strong balance sheet, cost competitive inputs to the production process, and/or unique expertise that can help the foreign company expand its business locally and/or in third countries.

The impact of the following three drivers will likely increase in 2016 and beyond.



## 1. Government initiatives

China is advancing a new paradigm of international cooperation through its 'Belt and Road', 'International Production Capacity Cooperation' and 'Third-country Market Cooperation' flagship initiatives. Indeed, China is looking to bring together the comparative advantages of its industries and companies, with those of foreign countries and companies, in order to complement each other. In this way, it is hoped that Chinese and foreign companies will be able to expand to and operate in new markets more easily, and that global productivity will be increased by better matching the supply and demand for investment, products and services in these markets.

### The 'Belt and Road' initiative

Much has already been written about the 'Belt and Road' initiative. This attention is set to continue as discussion progresses on multiple fronts about how China can cooperate with governments, institutions and corporates outside China to unlock bottlenecks in global infrastructure development, which will help boost trade and investment, and make a real contribution to sustainable, inclusive growth for dozens of emerging economies.

To date, according to information released by the Chinese Government, the country's trade volume with 'Belt and Road' countries already accounts for about a quarter of its total exports and imports, and China's investment in 49 of these countries has gone up by 18.2 percent YoY to USD 14.8 billion. During 2015, contracting projects along the 'Belt and Road' accounted for 45 percent of Chinese contractors' international revenue and 44 percent of the value of China's newly signed contracts.<sup>30</sup> This activity is set to continue and increase.

KPMG's Global China Practice has identified five business opportunities from the 'Belt and Road' initiative for Chinese and foreign companies:

1. The initiative will initially be focused on improving infrastructure connectivity, as this is necessary to support and stimulate trade and investment flows. This will drive Chinese overseas infrastructure investment in Greenfield projects and secondary assets. The main sectors will be transportation (roads, ports and railway), logistics, energy and utilities.

2. Chinese contractors will increasingly 'go out' into 'Belt and Road' countries to undertake infrastructure development projects, in cooperation with companies from local markets and third countries. Early engagement and progress has focused along three important corridors: China-ASEAN, China-Europe and China-Russia. Within China, there will be a drive to address the infrastructure deficit in landlocked Western provinces, which will also present opportunities for foreign companies.
3. Projects under this initiative will also drive demand for commodities, industrial equipment, construction materials and services including financing, insurance and other professional services.
4. With time, the initiative is expected to lead to the emergence of new markets for Chinese and foreign companies, as positive economic spillover from 'Belt and Road' projects stimulates growth both along the 'Belt and Road' and within China.
5. Going one step further, as China moves up the value chain, we foresee that both Chinese and foreign companies operating in China will increasingly seek to locate parts of their supply chains in countries along the 'Belt and Road' to leverage their comparative advantages and produce higher-quality products at lower cost. These same trends may see foreign companies establishing regional headquarters in China to manage an integrated supply chain covering China and other 'Belt and Road' countries, to sell to consumers in these markets.



**Vaughn Barber**

Global Chair,  
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“Key features of the 'new normal' for China's relations with the rest of the world are 'cooperation' and 'collaboration', both in China and in markets outside China, to the mutual benefit of China, the partnering countries and the third-country markets.”

<sup>30</sup> 'Economic and trade cooperation between China and countries along the "Belt and Road" in 2015', MOFCOM, 21 January 2016, <http://fec.mofcom.gov.cn/article/fwydyd/tjsj/201601/20160101239838.shtml>

## International Production Capacity Cooperation

On 16 May 2015, the Chinese Government released *Guiding Opinions of the State Council on Promoting International Cooperation in Industrial Capacity and Equipment Manufacturing* (the "Opinions"), establishing the framework for and main objectives of China's 'International Production Capacity Cooperation' initiative.<sup>31</sup>

As its name suggests, the initiative aims to match the production capacity of China's industries with existing global demand. Unsurprisingly, this gives priority to China's cooperation with emerging countries whose economic structures have turned or are turning more capital-intensive as opposed to labour-intensive, and as a result require large amounts of money to spur growth. These countries are in their initial stages of industrialisation, setting an attractive investment target for Chinese companies from traditional sectors, which are facing challenges at home due to China's own economic restructuring.

The Opinions identifies 11 main tasks, each pertaining to different sectors:

1. Encourage international cooperation in steel and non-ferrous metals
2. Promote the supply of building materials to meet local markets' demands
3. Accelerate the overseas expansion of Chinese railway companies
4. Strengthen international cooperation for the development of power generation projects
5. Expand the overseas development of energy resources, and promote investment in chemical-related industries
6. Improve international cooperation in light industry and textiles
7. Increase the overseas expansion of domestic automobile brands by establishing manufacturing plants in other countries
8. Stimulate cooperation in the ICT industry in order to increase its international competitiveness
9. Promote construction machinery and other equipment manufacturing enterprises to expand overseas
10. Increase the exports of domestically developed aerospace equipment
11. Promote cooperation in order to develop shipbuilding and high-end ocean engineering equipment markets.

Given the importance of these tasks to China's economic restructuring, we expect this initiative to continue gaining traction. In fact, the NDRC has already identified 45 priority

countries to cooperate with.<sup>32</sup> As at the end of 2015, China had already engaged in production capacity cooperation with 17 countries, including Egypt, Kazakhstan and Zimbabwe, covering sectors such as steel, cement, plate glass, chemicals, and machinery manufacturing.<sup>33</sup>

## Third-country Market Cooperation

This initiative was mentioned by Premier Li Keqiang during his five-day trip to Europe in June-July 2015, where he attended the 17th China-EU Leaders' Meeting and visited Belgium and France. The 'Third-country Market Cooperation' initiative aims to combine China's production capacity with developed countries' advanced technology and equipment to jointly develop markets in developing countries. This would benefit:

- China, by facilitating the export of its production capacity and industrial products to the international market
- Developed countries, by creating new sources of economic growth
- Developing countries, by promoting their industrialisation and economic development.

As Premier Li said in his speech in September 2015 at the World Economic Forum, countries' "[t]hree-party cooperation could combine [their] comparative strengths, and provide quality equipment and products with relatively low prices to bring down construction costs and better meet the needs of different countries. It will also help countries overcome the difficulties in industrial development, upgrade their industries and integrate the high-, mid- and low-ends of the global industrial chain. This will help businesses increase their presence in both the international and Chinese markets."<sup>34</sup>

Given the uncertain outlook of the global economy, third-country cooperation will become an increasingly important driver and feature of cooperation between Chinese and foreign companies, in countries along the 'Belt and Road' and in other markets where their foreign partners have experience and other comparative advantages.

Already, Chinese and French authorities have issued a joint statement to advance third-country cooperation between both countries, while China and South Korea signed a memorandum of understanding (MoU) to explore cooperation opportunities in third-market countries. Also, Chinese authorities and their Japanese, German and Singaporean counterparts are analysing the feasibility of cooperating in third-country markets.

2015 saw a number of agreements in which Chinese and foreign companies cooperated or agreed to cooperate in third-country markets:

31 'Guiding Opinions of the State Council on Promoting International Cooperation in Industrial Capacity and Equipment Manufacturing', Ministry of Commerce, 27 July 2015, <http://www.mofcom.gov.cn/article/b/g/201507/20150701061179.shtml>

32 'NDRC identifies 45 countries to implement production capacity cooperation', MOFCOM, 16 December 2015, <http://fec.mofcom.gov.cn/article/tjgcnzh/xgzxhj/201512/20151201211540.shtml>

33 'A year of forging cooperation through deals', The State Council, 14 December 2015, [http://english.gov.cn/premier/news/2015/12/14/content\\_281475253917394.htm](http://english.gov.cn/premier/news/2015/12/14/content_281475253917394.htm); 'China, Iraq sign memo to promote energy partnership', Xinhua News, 22 December 2015, [http://news.xinhuanet.com/english/2015-12/22/c\\_134942270.htm](http://news.xinhuanet.com/english/2015-12/22/c_134942270.htm); 'China, Egypt agree to boost cooperation under Belt and Road Initiative', Xinhua News, 22 January 2016, [http://news.xinhuanet.com/english/2016-01/22/c\\_135033384.htm](http://news.xinhuanet.com/english/2016-01/22/c_135033384.htm); 'China, Zimbabwe agree to boost cooperation for common development', China Daily, 2 December 2015, [http://m.chinadaily.com.cn/en/2015-12/02/content\\_22598597.htm](http://m.chinadaily.com.cn/en/2015-12/02/content_22598597.htm)

34 'A new blueprint for global growth', HE Li Keqiang, State Council, 11 September 2015, [http://english.gov.cn/premier/news/2015/09/11/content\\_281475187661153.htm](http://english.gov.cn/premier/news/2015/09/11/content_281475187661153.htm)

- As part of a partnership which is being watched as a model for further Chinese energy and infrastructure investment abroad, in June 2015, Portugal's Energias de Portugal (EDP) and its shareholder China Three Gorges Corporation set up a 50-50 joint venture to develop hydroelectric projects in Latin American countries outside Brazil, and in Portuguese-speaking Africa, notably Mozambique. This is in addition to the EUR 2 billion (about USD 2.8 billion)<sup>35</sup> that China Three Gorges committed in 2011 to co-invest in EDP-led projects as part of a deal for China Three Gorges to acquire a minority (21.35 percent) interest in the Portuguese company. The alliance has apparently become an effective way for China Three Gorges to enter the US, Europe and Latin America.
- In September 2015, China National Machinery Industry Corporation and General Electric signed an MoU to jointly build clean energy projects in Africa, particularly in Kenya, valued at USD 2 billion.
- In December, China and the United Arab Emirates (UAE) established a USD 10 billion investment fund which will invest in China, the UAE and third-country markets, particularly in energy, infrastructure and high-end sectors.

***The 'International Production Cooperation' and 'Third-country Market Cooperation' initiatives will be implemented in 'Belt and Road' projects, as well as more broadly, in landmark projects in developed countries.***

## 2. New funding sources

As mentioned, we expect the pool of financial investors participating in and supporting Chinese ODI to increase. As at February 2016, Chinese financial institutions and companies have already announced over USD 1.1 trillion of funding for 'Belt and Road' projects. This is in addition to the USD 100 billion authorised capital for the Asian Infrastructure Investment Bank (AIIB) and the USD 100 billion of authorised capital for the BRICS New Development Bank. It is yet to be seen how this capital will be deployed to solve the infrastructure funding gap in 'Belt and Road' countries.

In January 2016, China became a member of the European Bank for Reconstruction and Development (EBRD) which opens the way for the EBRD to support 'Belt and Road' projects in member countries. In a speech outlining the benefits of China's membership at the 4<sup>th</sup> China-CEE summit in 2015, Jean-Marc Peterschmitt, Managing Director, Countries of Operations and Chief Operating Officer for Banking at the EBRD said: "[o]ne key area where we see huge potential for cooperation is in the infrastructure sector, where China has taken the lead with its important ['Belt and Road'] initiative. We welcome this plan, since it holds the promise of deepening and strengthening China's integration into the global economy through creating a network of transport links between Asia and Europe, crossing many of the countries where the EBRD invests."<sup>36</sup>



<sup>35</sup> Based on the 2011 yearly average midpoint exchange rate for euro to US dollars (1.3925)

<sup>36</sup> "One belt, One Road" and the EBRD', Jean-Marc Peterschmitt, EBRD Press Office, 24 November 2015, <http://www.ebrd.com/news/2015/one-belt-one-road-and-the-ebrd.html>

China has also announced its intention to create financing platforms to support international cooperation in production capacity, for example the '16+1' finance company to support production capacity cooperation between China and various Central Eastern and European countries. As a further example, in September 2015, the PBOC announced that, along with the China Development Bank and State Administration of Foreign Exchange, it had established a USD 10 billion 'Sino-Latin American Production Capacity Cooperation Investment Fund' to promote industrial cooperation between China and Latin America by providing

medium- to long-term financing for projects in the manufacturing, technology, agriculture, energy, infrastructure and finance sectors.<sup>37</sup>

### 3. Free trade agreements

China's FTAs with Australia (ChAFTA) and South Korea both came into force in December 2015. We expect these FTAs to add impetus to the already dynamic investment and trade relationship that China has with these countries.



<sup>37</sup> 'China launches fund for LatAm industrial cooperation', Xinhua News, 1 September 2015, [http://news.xinhuanet.com/english/2015-09/01/c\\_134577360.htm](http://news.xinhuanet.com/english/2015-09/01/c_134577360.htm)



## Australia

As Australia's largest trading partner, China buys almost one-third of all Australian exports and is Australia's top overseas market for agriculture, resources and services exports. China also became Australia's seventh largest source of foreign investment in 2014, with its total investment stock in the country amounting to AUD 64.5 billion (about USD 58.2 billion),<sup>38</sup> which was up 23.7 percent from 2013.<sup>39</sup>

In addition to stimulating trade flows between both countries, we expect that ChAFTA will continue to prompt Chinese companies to invest in Australia for three main reasons:

1. Lower export costs brought by the reduction of tariffs will further incentivise Chinese companies to invest in Australia in order to secure the supply of high-quality products that allows them to tap into China's evolving consumption trends. Various Chinese companies invested in Australia's healthcare, and agricultural and food products sectors in 2015. Even before ChAFTA came into effect, Chinese companies were already partnering with Australian companies to increase local agricultural production and processing capacity, and provide China market access. This type of win-win cooperation will continue and increase.

2. The increase in the investment review threshold from AUD 252 million to AUD 1.094 billion (about USD 180 million to USD 781.3 million)<sup>40</sup> will encourage more investments by Chinese POEs in non-sensitive sectors (excluding agribusiness and farmland). In addition to consumer-related sectors, we expect to see more Chinese companies investing in Australia's real estate in order to benefit from high and steady returns. For instance, in what became the largest direct property sale in Australia's history, China Investment Corporation (CIC) acquired Investa Property Group's portfolio of building assets AUD 2.45 billion (about USD 1.8 billion)<sup>41</sup> in July 2015.

3. ChAFTA includes an Investment Facilitation Arrangement (IFA) under which skilled Chinese workers will be able to enter Australia temporarily to participate in Chinese companies' infrastructure projects as long as the projects are valued at above AUD 150 million (about USD 107.1 million).<sup>42</sup> This is likely to incentivise more Chinese contractors to search for investment opportunities in Australia, which in 2014 was the fourth largest developed market for Chinese Greenfield investments according to the value of new contracts.<sup>43</sup>



## South Korea

China is South Korea's largest trading partner and its biggest export market, while South Korea is already China's second largest trading partner behind the US. As in the case of Australia, Chinese investment deals in South Korea increased rapidly in 2015, driven by Chinese companies' desire to take advantage of lower tariffs on South Korean products. Indeed, prior to the implementation of the FTA, these tariffs ranged from 10 to 20 percent.

While 2014 saw Chinese firms undertake 11 outbound M&A deals in South Korea, this number rose to 36 deals in 2015. Disclosed value also went up, from USD 662.1 million to USD 1.6 billion, though it is important to note that the increase in 2015 was driven by Anbang Insurance's acquisition of a 63.01 percent stake in Tong Yang Life Insurance for USD 1.06 billion. The vast majority of these investments were conducted by privately owned firms, and focused on consumption and high-tech-related sectors.

South Korea's innovation capabilities have become one of the main attractions for Chinese companies, which conducted 14 outbound M&A deals targeting companies in the telecommunications, and computers and electronics sectors in 2015. In fact, South Korea is ranked first in the 2015 Bloomberg Innovation Index, thanks, among other things, to its spending on research and patents.<sup>44</sup>

The FTA will also likely prompt more Chinese companies to invest in South Korea's tourism sector and hotels, as the country, especially Jeju Island, is one of the preferred destinations for Chinese outbound tourists. Indeed, Jeju Island received 2.9 million Chinese visitors in 2014, up from less than 500,000 in 2010. In addition, the total area of land on Jeju owned by Chinese investors leapt to 8.34 million square metres in 2014 from 1.42 million square metres in 2011.<sup>45</sup> In fact, according to news reports, plans have already been announced to build a second airport on the island to accommodate an expected rise in volume of Chinese tourists.<sup>46</sup>

<sup>38</sup> Based on the 2014 yearly average midpoint exchange rate for Australian dollars to US dollars (0.9024)

<sup>39</sup> 'International investment Australia 2014', Australian Government Department of Foreign Affairs and Trade, 14 September 2015, <http://dfat.gov.au/about-us/publications/Pages/international-investment-australia.aspx>

<sup>40</sup> Based on the daily average midpoint exchange rate of 15 February 2016 for Australian dollars to US dollars (0.7142)

<sup>41</sup> Based on the monthly average midpoint exchange rate in July 2015 for Australian dollars to US dollars (0.7414)

<sup>42</sup> Based on the daily average midpoint exchange rate as at 15 February 2016 for Australian dollars to US dollars (0.7142)

<sup>43</sup> Based on data from the China International Contractors Association, as well as the China Global Investment Tracker. See, 'Annual Report on China International Project Contracting 2014-2015' CHINCA; 'Global China Investment Tracker', American Enterprise Institute and Heritage Foundation, <http://www.aei.org/china-global-investment-tracker/>

<sup>44</sup> 'The Bloomberg Innovation Index', Peter Coy, <http://www.bloomberg.com/graphics/2015-innovative-countries/>

<sup>45</sup> 'Chinese wealth transforms South Korea's Jeju Island', In-Soo Nam, The Wall Street Journal, 25 February 2015, [www.wsj.com/articles/chinese-tourists-take-south-koreas-jeju-island-by-storm-1424842046](http://www.wsj.com/articles/chinese-tourists-take-south-koreas-jeju-island-by-storm-1424842046)

<sup>46</sup> 'South Korea's Jeju Island to get new airport as Chinese visitors surge', 10 November 2015, China Aviation Daily, <http://www.chinaaviationdaily.com/news/48/48730.html>



## Industry highlights: Agriculture and food

We saw a decline in the value of outbound M&A transactions in the agriculture and food sector, mainly due to a lack of large deals such as China National Cereals, Oils and Foodstuffs Corporation's (COFCO) acquisitions of majority stakes in Nidera and Noble Agri in 2014. Having said this, 2015 did see a number of smaller deals being undertaken in developed countries, especially in Australia, where Chinese investors acquired stakes in some of the largest and most famous farms to secure the supply of high-quality meat and dairy products for Chinese consumers. The following factors will continue to drive Chinese overseas investment in the agriculture and food sector in the coming years:

- Shortfall in domestic food supply – Forecasts by China's Ministry of Agriculture show that China will need 700 billion kg of grain by 2020 in order to satisfy its domestic demand, which places current domestic supply at a shortfall of approximately 100 billion kg.<sup>47</sup>
- Changing dietary preferences – Chinese consumers are increasingly demanding more protein-rich food. In fact, the World Bank expects China to account for 38 percent of the global consumption of fish by 2030.<sup>48</sup>
- Demand for high-quality products, and food safety concerns – Thanks to the growth of China's middle class and the country's increased market openness, Chinese consumers have become more sophisticated and are also increasingly aware of food safety issues. This is driving demand for high-quality products from foreign suppliers.
- Demographic trends – Chinese authorities recently reformed the country's 'One Child' policy, allowing all couples to have two children starting from 1 January 2016. This will likely lead to increased demand for baby products such as infant formula and baby food
- Push for modernisation – China's 13<sup>th</sup> Five-Year Plan calls for agricultural modernisation, implying that innovation and new technologies will be applied throughout the agriculture and food industry value chain to increase productivity and crop yields.
- ChAFTA – Thanks to the reduction and ultimate elimination of tariffs on certain agriculture and processed food products, ChAFTA will likely stimulate Chinese ODI into Australia's agriculture and food sector to gain access to supplies of high-quality food and agricultural products.

We expect to see more Chinese companies 'going out' into the overseas agricultural and food sector in order to secure the supply of high-quality meat, dairy, seafood and agricultural products. To guarantee the freshness and safety of perishable products, especially when imported from overseas, we also expect Chinese firms to make more investments or reach partnerships with foreign companies that allow them to increase their cold chain

logistics and food processing capabilities. Finally, Chinese companies will make outbound investments to obtain advanced technologies that can be deployed domestically to improve crop productivity, such as crop sensors, agricultural robots, advanced irrigation systems, and genetically modified seeds. ChemChina's acquisition of Syngenta is an important example of this driver.

A number of deals that are representative of these trends were seen in 2015, such as:

- In November, Shanghai Kaichuang Marine International announced it had raised up to USD 137.76 million in order to fund its acquisition of 100 percent and 70 percent stakes in seafood companies Hijos de Carlos Albo (Spain) and French Creek Seafood (Canada) respectively. According to the company, these acquisitions will allow it to increase its presence in the international market, improve its international seafood production chain, expand its business portfolio into canned seafood, and secure the supply of high-quality seafood for sale both in the Chinese and overseas markets.
- China's New Hope Group and Australia's Freedom Foods Group purchased Australia's Moxey Farms for about USD 74.2 million. This deal gives New Hope Dairy Group access to a consistent and long-term supply of high-quality milk and dairy products for the China market, as Moxey Farms has the capacity to produce 50 million litres of milk per year.
- Dashang Group announced the acquisition of Australian cattle grazing properties Glenrock Station in June and Clear Hills in August, for USD 45 million and USD 3 million respectively. With a combined size of almost 32,000 hectares, Dashang aims to use these properties to raise between 10,000 and 15,000 Angus cattle, with the purpose of supplying high-quality beef to the Chinese market.
- China's Fulida Group Holding and Australia's Wellard Group Holdings entered into a joint venture in August to supply and market Australian beef in the Chinese market, as well as to build a series of feedlots and a slaughterhouse in China to process beef from Australian cattle. This project was announced after the feeder and slaughter cattle health protocol, which allows for the trade of live cattle between China and Australia, was signed in July 2015.
- In September, Bright Food announced its acquisition of a 50 percent stake in New Zealand's meat processor and exporter, Silver Fern Farms Ltd, for USD 196.75 million. In an official announcement, Bright Food stated that this deal would help the company become China's largest beef and lamb industrial group.

<sup>47</sup> 'Accelerating the transformation of agricultural development', People's Daily, 25 November 2015, <http://politics.people.com.cn/n/2015/1125/c1001-27852038.html>

<sup>48</sup> 'Fish to 2030: Prospects for fisheries and aquaculture', The World Bank, December 2013, <http://documents.worldbank.org/curated/en/2013/12/18882045/fish-2030-prospects-fisheries-aquaculture>



## Industry highlights: Infrastructure

As predicted in last year's report, 2015 saw a surge in Chinese overseas investment activity in the high-speed rail (HSR) and nuclear power sectors. Some milestone investments in these sectors last year included:

- A Chinese rail consortium announced it would join with US partner XpressWest to build an HSR link between Los Angeles and Las Vegas for an estimated cost of USD 5 billion.
- A Chinese rail consortium won the tender to construct the HSR link between Jakarta and Bandung, in Indonesia, for an estimated cost of USD 5.5 billion.
- China General Nuclear Power Corporation (CGN) acquired a 33.5 percent interest in Électricité de France's nuclear power project that is being built at Hinkley Point in the UK for USD 9 billion.
- China National Nuclear Corporation agreed to invest USD 6 billion in the construction of Argentina's fourth nuclear power plant, as well as concluded a framework agreement to provide 'HPR1000' technology for a fifth power plant.

Our research shows that China's overseas investment in Greenfield infrastructure projects is still mostly directed towards developing countries. In 2014, for instance, Asia, Africa and Latin America together accounted for almost 92 percent of the value of China's newly signed contracts. We believe this trend will continue thanks to the implementation of the 'Belt and Road' initiative, which in 2015 already accounted for about 44 percent of the value of newly signed contracts by Chinese contractors, according to MOFCOM.<sup>49</sup>

Recent examples of Chinese investment in Greenfield infrastructure projects in developing countries include the following:

- During President Xi Jinping's state visit to Pakistan in April 2015, China and Pakistan signed a total of 51 cooperation agreements and MOUs under which China will invest approximately USD 37 billion in Pakistan's energy sector and provide nearly USD 10 billion worth of concessional loans for infrastructure construction in the country.
- In October 2015, China signed an MoU with the government of São Tomé and Príncipe to build a deep-sea port (worth USD 800 million) for the African island country. China Harbour Engineering Company will invest approximately USD 120 million in the project and will be responsible for its engineering, design and construction.
- A consortium comprising China Southern Power Grid Company, China Power International Development and Vietnam National Coal and Mineral Industries Group began the construction of a 1,200-MW coal-fired power plant in Vietnam's Binh Thuan province, with a total project value of more than USD 1.75 billion.

With respect to secondary infrastructure assets, we believe Chinese companies will continue to look for opportunities to invest in developed countries. Investments will also happen in countries that have strategic locations, including in emerging markets along the 'Belt and Road'. Importantly, we also expect to see Chinese construction companies continue

to make acquisitions of construction services companies or consulting companies which have experience and technology that can be used to enhance their competitiveness and/or enter new markets.

2015 saw several overseas investment deals in secondary infrastructure assets by Chinese companies, among which these are some of the most representative:

- Chinese companies are said to be participating in the auction process for the acquisition of EEW Energy from Waste, a Germany-based waste management company. The company is expected to be valued at between USD 1.6 billion and USD 2.1 billion, which would make it China's biggest outbound deal in the waste management sector in about 16 years.
- State Power Investment Corporation won the bid to acquire Australia-based renewable energy company Pacific Hydro, which manages 900 MW of generation capacity across 19 power plants (wind and hydropower) in Australia, Chile and Brazil. At an estimated USD 2.2 billion, this is one of the largest Chinese acquisitions in the Australian energy sector to date.
- In December, China Three Gorges Corporation acquired a 49 percent stake in a 598 MW portfolio of wind projects owned by EDP, in Poland and Italy, for EUR 392 million (about USD 427.1 million).<sup>50</sup>
- In November, CGN signed a deal with 1Malaysia Development Berhad to acquire the energy assets of the latter's power unit, Edra Global Energy, for USD 2.27 billion. The assets include 13 gas-powered energy plants along the 'Belt and Road', and in Malaysia, Egypt, Bangladesh, Pakistan and the UAE. This will not only allow CGN to diversify its energy assets, but also to improve its technological capabilities in the development of gas resources, a priority for Chinese authorities as gas is less contaminating than oil and coal.
- In October, China-based Shandong Landbridge Group purchased a 99-year lease to operate Australia's Port of Darwin and its East Arm Wharf for USD 370 million. Through this deal, Shandong Landbridge Group will be able to benefit from China's increasing demand for Australian products, especially now that ChAFTA has come into force.
- In September, China Merchants Holdings, COSCO Pacific and CIC Capital consortium announced that they had agreed to invest USD 940 million to buy a 65 percent stake in Kumpport Terminal, Turkey's third-largest container port. Through this investment, the Chinese consortium has positioned itself in a strategic location along the 'Belt and Road'. Indeed, as one of the main 'bridges' between Europe and Asia, Turkey is likely to experience an increase in investment and trade flows in the coming years.
- Similar to the above deal, in May 2015, Shanghai International Port (Group) (SIPG) was awarded a 25-year lease for the operation of the Port of Haifa in Israel, a country which also holds a strategic location along the 'Belt and Road'.

<sup>49</sup> 'Economic and trade cooperation between China and countries along the "Belt and Road" in 2015', MOFCOM, 21 January 2016, <http://fec.mofcom.gov.cn/article/fwtydy/tjsj/201601/20160101239838.shtml>

<sup>50</sup> Based on the monthly average midpoint exchange rate as at December 2015 for euro to US dollars (1.0896)



## Industry highlights: High-end manufacturing

As noted in our *China Outlook 2015* report, rising costs in China (such as wages and land) and a stronger RMB (compared to a decade ago) have put pressure on profit margins and made it harder for Chinese manufacturing companies to compete with international competitors on price. At the same time, Chinese consumers are increasingly demanding more sophisticated and high-end products, while authorities are implementing stricter environmental standards to reduce the impact of pollution and environmental degradation on people's quality of life. The squeeze has created the famous 'burning platform' for Chinese companies to upgrade and innovate, and many are electing to use overseas acquisitions of technology, expertise and R&D capabilities as a way to accomplish this. In addition to the Haier and Joyson deals that were announced in 2016, these are some of the representative deals from 2015:

- The largest Chinese outbound M&A deal in 2015 – ChemChina's acquisition of Italian tyre maker Pirelli – will enable ChemChina to access Pirelli's advanced technology and expertise in the manufacture of premium tyres, which can be sold at higher margins. Furthermore, Pirelli's strong market position in Europe and Latin America will also help ChemChina expand its international footprint.
- In February, Zhuzhou CSR Times Electric announced that it had acquired Specialist Machine Developments Limited, a British deep-sea robot and mechanical equipment manufacturer. This acquisition will make it possible for CSR Times Electric to expand into the high-end sub-sea equipment sector and support its business in offshore wind power and offshore engineering.
- In August, Hunan Yonker Environmental Protection announced that it had acquired a 51 percent stake in US-based Integrated Science & Technology, an industry leader in the provision of environmental remediation and engineering solutions.
- In December, electric vehicle start-up Faraday Future (Faraday), which is backed by China's Leshi Internet Information & Technology (more commonly known as LeTV), announced its plans to build an automotive production plant in the US, with a first phase investment amount of USD 1 billion. This is one of several overseas investments backed by LeTV to become an industry leader in the manufacture of new energy vehicles.

Chinese manufacturers have also been active in establishing overseas R&D centres. For example, in 2015, Beijing Automotive Industry Group set up a technical centre in Silicon Valley to focus on the development of software, electrification and self-driving features in vehicles. CRRC Corporation Limited opened R&D centres in cooperation with local partners in Germany and the UK to research light-weight materials and other new technologies for rail transit.

With the implementation of the 'Made in China 2025' initiative, we expect to see more Chinese overseas investment in the sectors prioritised by the Chinese Government, including new information technology, robotics, aerospace equipment, ocean engineering equipment, rail transport equipment, new energy vehicles, new materials, biological medicine and medical devices.



## Industry highlights: Real estate

Chinese companies continued their buying spree in the overseas real estate sector during 2015, with financial investors stepping up their acquisitions of commercial real estate assets – such as office buildings, hotels and malls – in gateway cities in developed countries. According to Dealogic data, financial investors accounted for almost two-thirds of all the announced deals and for slightly more than 85 percent of their total disclosed value, while real estate companies accounted for the rest. These were some of the most high-profile deals by Chinese investors last year:

- CIC undertook the two largest transactions of the year in this sector, acquiring Investa Property Group's portfolio of office buildings in Australia for USD 1.8 billion, and a portfolio of 10 shopping malls across France and Belgium for USD 1.2 billion.
- Sunshine Insurance Group acquired the newly built New York-based Baccarat Hotel from Starwood Capital Group and Tribeca Associates in February 2015 for more than USD 230 million.
- Ping An Insurance and US-based Blumberg Investment Partners established a USD 600 million fund in October 2015, to make logistics-related real estate investments in the US.

We have also seen Chinese developers undertaking various Greenfield investments, acquiring plots of land in different countries to develop them. Real estate consultancy CBRE notes that purchasing land overseas is becoming an increasingly attractive way to 'go out' for Chinese developers, as the yields on land can be much higher than those of existing real estate assets in primary locations.<sup>51</sup> In addition to this, by undertaking development projects, developers can build their track record and strengthen their position in local markets, putting themselves in a position to capitalise on demand from the local community and from Chinese visitors.

When moving to acquire plots of land overseas, Chinese developers will either target developed countries due to their stronger economic fundamentals, healthier housing markets and clear regulatory framework, or target emerging countries that are close to China's borders. For instance, in 2014, Wanda acquired the Jewel project located in Australia's Gold Coast, with the intention of developing a five-star hotel and two towers of serviced apartments. Construction started in 2015 and the required investment to finalise the project is reported to be about USD 900 million. Meanwhile, in Malaysia, several of China's largest developers, such as Country Garden and Vanke, have been acquiring plots of land and building residential towers, many of which are being bought by mainland Chinese.

Going forward, we expect more Chinese ODI in real estate given the following drivers:

- The weak performance of the domestic real estate market, along with strong competition and stricter government regulations about financing, are having a negative impact on developers' balance sheets, many of which are highly leveraged. This is pushing them to find new demand abroad by expanding into countries with real estate markets that can deliver steady cash flows.
- The commercial real estate sector in developed countries has some of the world's top-quality assets, offering Chinese investors high and steady returns. This is especially the case in cities such as New York, London, Tokyo, Sydney and Paris, whose office buildings have strong rental demand, especially in their central business districts.
- China's ongoing boom in outbound tourism has increased the attractiveness of the overseas hospitality sector as a destination for Chinese investment. China is not only the world's biggest 'exporter' of tourists, but Chinese are also among the world's highest spending tourists.<sup>52</sup>
- There is also an increasing flow of Chinese students attending overseas education institutions. The latest data by the Institute of International Education shows that in 2014 there were approximately 459,800 Chinese studying abroad, up from 339,700 in 2010-2011.<sup>53</sup> More Chinese companies will invest in student accommodation quarters overseas to capitalise on this trend.
- The overseas logistics and warehouse sector is also turning into a preferred target of Chinese investment, as companies look to take advantage of increasing trade flows between China and other countries thanks to the e-commerce boom and new FTAs.
- We expect Chinese insurers to continue investing in the overseas real estate market to sustain expected growth in premiums. While under current regulations Chinese insurers can invest up to 15 percent of their total assets overseas, data released by the China Insurance Regulatory Commission reveals that they are far from reaching this threshold. In 2014, only 0.8 percent of Chinese insurers' total assets, or USD 13.4 billion, were allocated to the real estate sector, and it is estimated that only half of this was invested overseas.<sup>54</sup>

<sup>51</sup> 'Chinese developers are turning to overseas land developing for profits', CBRE, 21 September 2015, <http://www.cbre.com.hk/EN/aboutus/mediacentre/mediaarchives/Pages/Chinese-Developers-Turning-to-Overseas-Land-Developing.aspx?redirect=true>

<sup>52</sup> According to the China National Tourism Administration (CNTA), 2015 saw 120 million Chinese outbound tourists, who spent USD 104.5 billion abroad, representing a YoY increase of 12.0 percent and 16.7 percent, respectively. See: '2016 National Tourism & Travel Market Conference: Add to the appeal of beautiful China', CNTA, 4 February 2016, [http://en.cnta.gov.cn/focus/travelnews/201602/t20160204\\_759847.shtml](http://en.cnta.gov.cn/focus/travelnews/201602/t20160204_759847.shtml); 'International tourist arrivals up 4% reach a record 1.2 billion in 2015', World Tourism Organization UNWTO, 18 January 2016, <http://media.unwto.org/press-release/2016-01-18/international-tourist-arrivals-4-reach-record-12-billion-2015>; 'Which country's tourists spend the most money?', Emma Luxton, World Economic Forum, 30 December 2015, <http://www.weforum.org/agenda/2015/12/which-countrystourists-spend-the-most-money/>

<sup>53</sup> 'China's students overseas', Project Atlas, Institute of International Education, <http://www.iie.org/Services/Project-Atlas/China/Chinas-Students-Overseas>

<sup>54</sup> 'USD73bn investment bonanza by 2019: Chinese Insurance Outbound Capital', Cushman and Wakefield, 24 November 2015, [http://www.cushmanwakefield.com/~media/global-reports/Chinese\\_Insurance\\_Capital.pdf](http://www.cushmanwakefield.com/~media/global-reports/Chinese_Insurance_Capital.pdf)



## Industry highlights: Information communication technology

Consistent with its intention to facilitate and accelerate the country's transition into a high value-added economy, the Chinese Government has been taking measures to promote the development of China's ICT sector, such as through the implementation of the 'Internet Plus' strategy. As it comprises the full spectrum of services and technologies that support information management, ICT is at the core of the country's push for innovation. Advancements in ICT facilitate, and indeed promote, the upgrading and transformation processes of other sectors. Developing an intelligent ecosystem that links industries to consumer preferences through the use of big data, internet technology and the Internet of Things will allow China's products and services to better match its domestic demand, thus reducing companies' operating costs and increasing overall economic productivity.

More Chinese ICT companies have started exploring the overseas market for investment opportunities that give them access to advanced technology and expertise that can contribute to their innovation capabilities, in order to improve the services they provide to individuals and companies in the domestic market. E-commerce companies, for instance, are going out to increase their information management capabilities and enhance their capacity to link the supply and demand of China and foreign markets. Mobile app developers, for their part, are looking to invest in innovative and creative companies whose products can allow them to stay relevant in what is a fast-changing market.

Some representative overseas investments by Chinese companies in the ICT sector during 2015 include the following:

- In July 2015, Alibaba injected USD 1 billion in its subsidiary Aliyun Computing to fund the establishment of overseas cloud data centres, and by September, Aliyun had already opened three of these centres in Hong Kong, the US (Silicon Valley) and Singapore. With direct connections to its existing data network via Beijing, Hangzhou, Qingdao and Shenzhen, the overseas data centres will help Alibaba better serve the information management needs of Chinese companies investing abroad.
- In August 2015, Huawei Technologies inaugurated its ICT training and innovation centre in Sydney, which cost about USD 22.1 million. With a capacity to train 2,000 people per year, the centre's objective is to help develop an Australian community of leading ICT professionals.
- In July, Alibaba invested about USD 206 million to raise its stake in Singapore Post Limited (SPL) to 14.51 percent and to acquire a 34 percent stake in SPL's subsidiary Quantum Solutions, which provides leading end-to-end e-commerce logistics and fulfilment services across the Asia Pacific region.
- In June, Tencent completed the second stage of its USD 128 million investment in US mobile game developer Glu Mobile. This deal was preceded by Tencent's majority stake acquisition in Swiss online game company Miniclip, which was announced in February.



## Industry highlights: Healthcare

China's demand for high-end healthcare services and products, as well as advanced medical devices to treat chronic diseases and take care of their elder population has increased rapidly over the past few years. According to the World Health Organization, 3 million Chinese people die each year of chronic non-communicable diseases (NCDs), such as lung cancer, strokes, heart disease and diabetes. In the case of Chinese people aged 60 years or over, almost 80 percent of deaths are due to NCDs, which is an issue of great concern, given China's rapidly ageing population – Chinese aged 60 years or over are expected to account for about 28 percent of the country's total population by 2040.<sup>55</sup> Unsurprisingly, China is already the world's second largest market for medical equipment, and healthcare spending is expected to constitute 6.5-7 percent of the country's GDP by 2020.<sup>56</sup>

In order to tap into this demand, Chinese companies have been stepping up their overseas investment in the healthcare sector in countries such as Israel, the US and Australia. Their objective is to access technology, expertise and high-quality brands that can be adapted to satisfy the needs of the Chinese market. Some of the deals that were conducted in 2015 include:

- In December 2015, Shandong Luye Medical Group acquired Health Care, Australia's third largest private hospital operator for USD 688 million, which will allow it to leverage Health Care's advanced medical technologies, hospital operation models and management systems.
- In September, Biostime International Holdings, a Chinese nutrition and baby care products provider, announced the acquisition of an 83 percent stake in Australian health supplement maker Swisse Wellness Group for about USD 989.27 million. The acquisition will allow Biostime to leverage its customer base and experience in the infant nutrition and care products sector in China, to expand into the premium family nutritional products segment. In addition to providing Swisse with a unique expansion platform in China, the partnership will also enable the combined group to diversify and expand its geographic presence in Australia and internationally. ChAFTA will remove all tariffs on pharmaceutical products, including vitamins and health products by 2019.<sup>57</sup>
- In August, a consortium of Chinese firms, including HOPU Investment and YuanMing Capital, announced a USD 200 million investment in US-based Mevion Medical Systems, a world leading developer and provider of proton therapy systems for cancer treatment.
- In July, Shanghai Jiuchuan Investment (Group) bought Israel's SHL Telemedicine for about USD 130 million. SHL Telemedicine specialises in the manufacturing of portable monitoring devices that allow individuals to transmit medical data via telephonic and internet communication technologies to medical centres, where it can be processed and analysed.

<sup>55</sup> 'China Country Assessment Report on Ageing and Health', World Health Organization, 2015, [http://apps.who.int/iris/bitstream/10665/194271/1/9789241509312\\_eng.pdf](http://apps.who.int/iris/bitstream/10665/194271/1/9789241509312_eng.pdf)

<sup>56</sup> 'China: Healthcare products and services', Export.gov, accessed on 15 January 2016, <http://export.gov/china/doingbizinchina/industryinfo/healthcare/index.asp>; 'Analysis on "Health China 2020" Strategy Research Report', National Health and Family Planning Commission (former Ministry of Health), 2012, <http://www.moh.gov.cn/wsb/pzcyj/201208/55651.shtml>

<sup>57</sup> 'China-Australia Free Trade Agreement – Fact sheet: Resources, energy and manufacturing', Australian Government Department of Foreign Affairs and Trade, <http://dfat.gov.au/trade/agreements/chafta/fact-sheets/Pages/fact-sheet-resources-energy-and-manufacturing.aspx>



## Industry highlights: Transportation

Though there were not as many transportation deals as other sectors, 2015 also saw some significant overseas investments by Chinese companies in the transportation sector, with most of the high-profile deals targeting aviation companies. HNA Group, in particular, was a significant player in the sector. The following factors will continue to drive outbound activity in this sector:

- The number of China's outbound tourists is expected to increase,<sup>58</sup> which has been facilitated by the liberalisation of visa policies, along with the development of new technologies that have allowed for an increase in aeroplanes' capacity, longer flights, and a reduction in ticket prices and flying times.
- Related to the above, Chinese outbound tourists are travelling to more places and increasingly further away from their homes,<sup>59</sup> thus requiring longer-haul flights. For instance, Boeing's *Current Market Outlook* expects that passenger travel between China and the US will triple by 2021.<sup>60</sup>
- Chinese companies are looking to improve their management and operation capabilities, in order to better address the demand within China's domestic transportation sector.
- Finally, trade flows between China and countries with which it has strengthened economic relationships in recent years are expected to increase, for instance, due to the implementation of the 'Belt and Road' initiative.

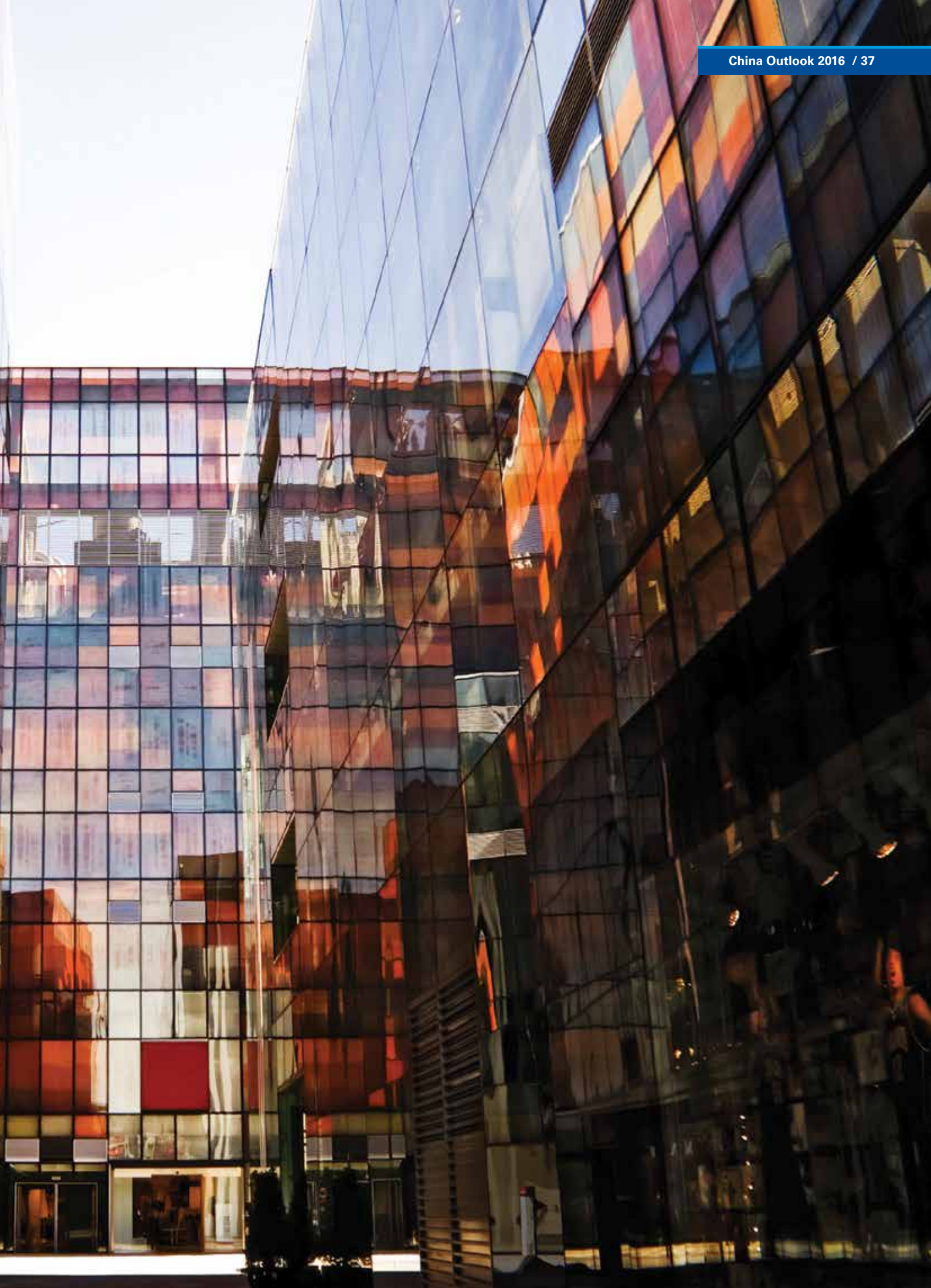
Some of the high-profile deals that were conducted in this sector during 2015 included the following:

- In July 2015, Bohai Leasing, which is majority owned by HNA Group, announced that it would acquire a 100 percent stake in Irish lessor Avolon, in a transaction with a total enterprise value of USD 7.5 billion. The acquisition was completed in early January 2016, making HNA Group the world's fourth largest lessor by asset value.
- In November, HNA Group announced that it had entered a partnership with Brazil's Azul Brazilian Airlines to become its largest shareholder by acquiring a 23.7 percent stake in the company for USD 450 million. Through this deal, both companies will expand their international routes, among other benefits.
- In July, HNA Group announced it had acquired a 100 percent stake in Swissport International for approximately USD 2.8 billion. The company is one of the world's largest providers of ground and cargo handling services, operating in more than 269 airports.

<sup>58</sup> 'Chinese outbound tourism remains on track to reach 200 million by 2020', CLSA, 19 January 2016, <https://www.clsa.com/about-clsa/media-centre/2016-media-releases/chinese-outbound-tourism-remains-on-track.php>

<sup>59</sup> 'Globe-Trotting Shopper: How the Chinese Travel Bug is Re-Shaping Luxury Growth', HSBC, February 2015

<sup>60</sup> 'Current Market Outlook (2015-2033)', Boeing, 2015, [http://www.boeing.com/assets/pdf/commercial/cmo/pdf/Boeing\\_Current\\_Market\\_Outlook\\_2014.pdf](http://www.boeing.com/assets/pdf/commercial/cmo/pdf/Boeing_Current_Market_Outlook_2014.pdf)

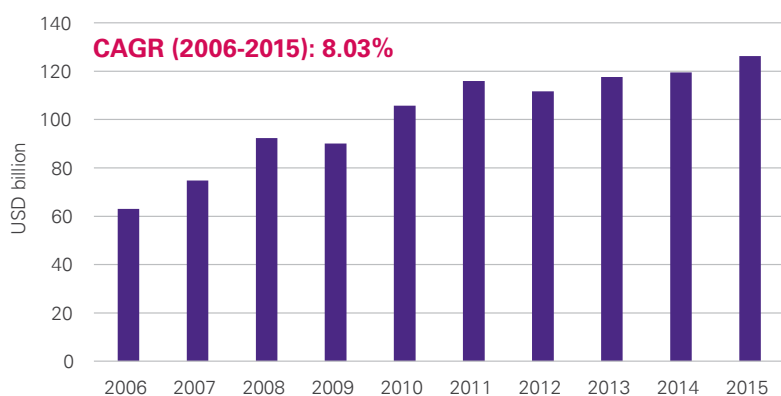


# Foreign Direct Investment (FDI)

## 2015 Highlights

In 2015, against the heavily publicised backdrop of a slowdown in economic growth rate and amidst heavy stock market and currency volatility, China saw another year of steady growth in foreign direct investment (FDI). In fact, non-financial FDI (i.e. excluding banking, security and insurance data) into China reached an all-time high of USD 126.3 billion, up from USD 118.7 billion the previous year or an increase of 6.4 percent YoY (see chart below). These statistics indicate that despite a slowing economy, opportunity exists for foreign investors in key sectors of the economy. Notably, inbound foreign investment activity appears to reinforce the emergence of a two-track economy in China, where services, advanced manufacturing and consumer markets exhibit growth opportunities, while basic manufacturing and heavy industry deal with complex restructuring and clean-up imperatives.

China's non-financial FDI flows, 2006-2015



Source: 'The Regular Press Conference of the Ministry of Commerce (January 20, 2016)'; MOFCOM, 22 January 2016: <http://english.mofcom.gov.cn/article/newsrelease/press/201601/20160101244116.shtml>; 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=A01>; KPMG analysis

## FDI flows into China – Manufacturing sector vs service sector

FDI investment patterns have been changing over the last decade. This has been in line with authorities' efforts to help China transition into a high value-added economy that relies more heavily on the service sector as a source of domestically driven, consumption-based growth. Official data from the NBS shows that in 2006, the manufacturing and service sectors accounted for 63.6 and 31.1 percent of total FDI respectively. By 2011, the service sector surpassed manufacturing as the largest recipient of FDI, and in 2015, FDI into services represented 61.1 percent of total FDI, while FDI into manufacturing was 31.4 percent of the total (see chart on p. 40).

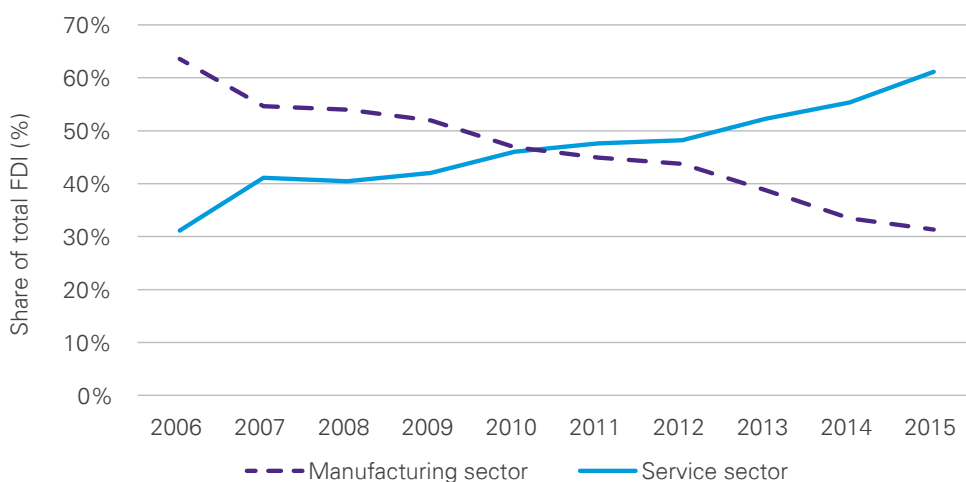




Growing investment in China's service sector indicates that international investors are increasingly viewing China as an 'end-destination' market, rather than a source of low-cost labour. For their part, manufacturing firms are shifting away from the production of cheap exports, and are increasingly producing goods that are higher in quality and that are designed specifically to meet the demands of the Chinese consumer. So, for instance, FDI into high-tech manufacturing has grown rapidly over the past years, and it currently represents almost a quarter of total FDI into manufacturing.

It should be emphasised that China is still at an early stage of transitioning to a services-driven economy. The service sector contributes an average of 70 percent of GDP in Organisation for Economic Co-operation and Development (OECD) countries.<sup>61</sup> As mentioned before, China's tertiary industry, which comprises the service sector of the economy, accounted for 50.5 percent of GDP in 2015,<sup>62</sup> indicating considerable room to grow as the country's economy matures. This point is further supported by a report from researchers at the Chinese Academy of Social Sciences, estimating that by 2020 the service sector will constitute 55 percent of China's economic output.<sup>63</sup>

**Share of total FDI: Manufacturing vs service sectors, 2006-2015<sup>64</sup>**



Source: 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=A01>; 'The Regular Press Conference of the Ministry of Commerce (January 20, 2016)', MOFCOM, 22 January 2016, <http://english.mofcom.gov.cn/article/newsrelease/press/201601/20160101244116.shtml>; KPMG analysis



















61 'OECD economic surveys: China', OECD, March 2015, <http://www.oecd.org/eco/surveys/China-2015-overview.pdf>

62 'Preliminary accounting results of GDP for the fourth quarter and the whole year of 2015', NBS, 21 January 2016, [http://www.stats.gov.cn/english/PressRelease/201601/t20160121\\_1307717.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160121_1307717.html)

63 'Service's contribution will be over 55 percent by 2020', Mr. Xia Changjie, Vice President of National Academy of Economic Strategy, Chinese Academy of Social Sciences, 16 January 2016, <http://finance.sina.com.cn/hy/20160116/130224168681.shtml>

64 Data excludes financial intermediation.

## Growth in China's FDI flows by sector

	2014 YoY	CAGR (2011-2014)
<b>Secondary industry</b>		
 Mining	54.1%	-2.8%
 Manufacturing	-12.3%	-8.5%
 Construction	1.6%	10.6%
 Production and supply of electricity, gas and water	-9.3%	1.3%
<b>Tertiary industry</b>		
 Wholesale and retail	-17.8%	4.0%
 Transport, storage and post	5.6%	11.8%
 Hotels and catering services	-15.8%	-8.3%
 Financial intermediation	79.5%	29.9%
 Real estate	20.2%	8.8%
 Leasing and business	20.5%	14.2%
 Health, social security and social welfare	20.5%	0.03%
 Culture, sports and entertainment	0.3%	9.1%
 Information transmission, computer services and software	-4.4%	0.7%
 Scientific research, technical service and geologic prospecting	18.3%	9.8%
 Management of water conservancy and environment public facilities	-44.6%	-12.8%
 Other services	10.8%	-26.5%

Source: 'China Statistical Database', NBS, <http://data.stats.gov.cn/english/easyquery.htm?cn=A01>

## FDI flows by destination region in China

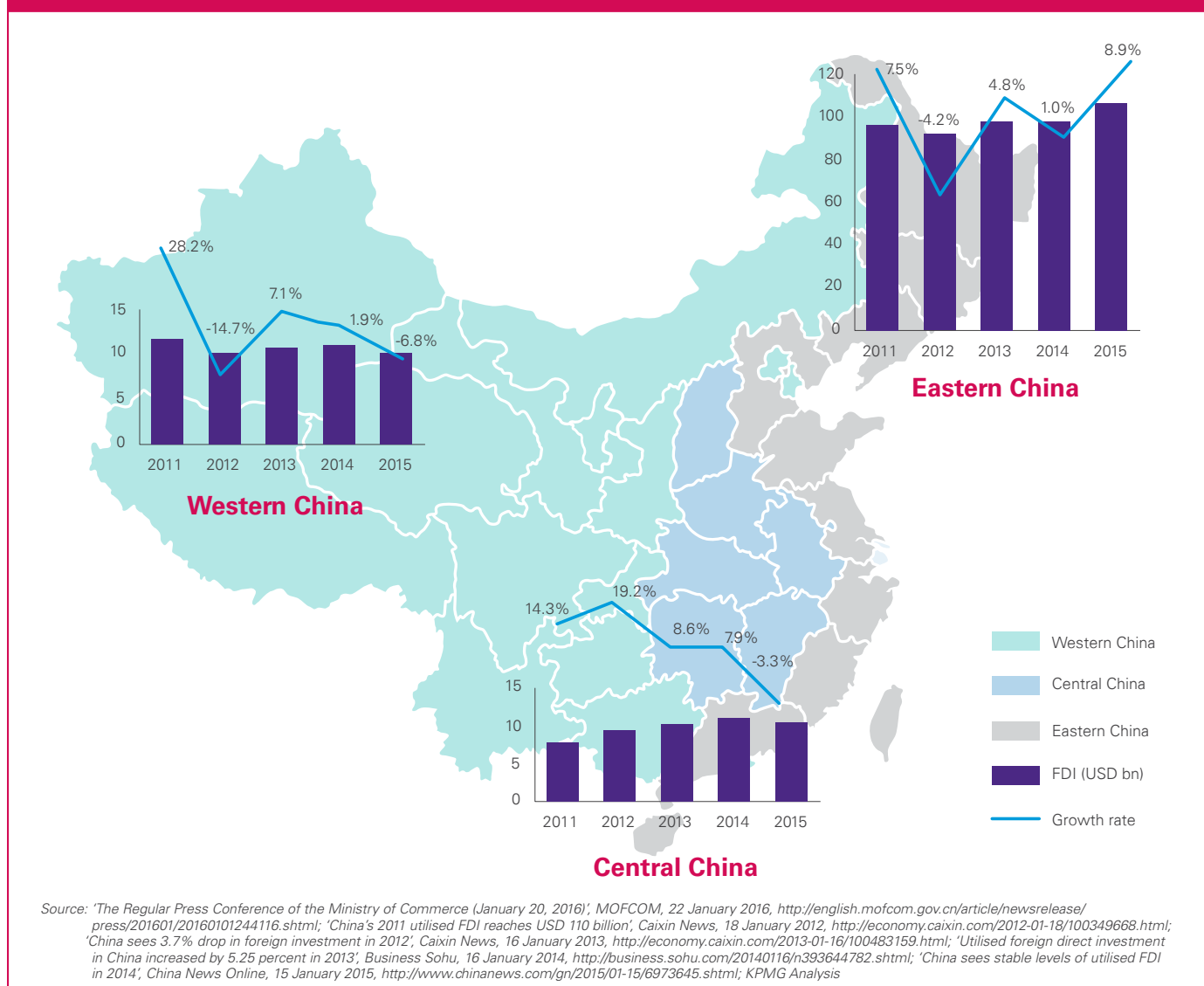
FDI in Eastern China presented a strong 8.9 percent growth YoY, and accounted for 83.8 percent of total FDI in 2015.<sup>65</sup> For the first time since 2010 when the government began to actively promote 'westward' growth initiatives, the eastern region's growth rate surpassed that of Central China, whose growth dropped 3.3 percent. Western China, for its part, experienced a 6.8 percent fall-off in FDI.<sup>66</sup>

While the rapid growth of FDI into Eastern China in 2015 could be an anomaly, we believe it is indicative of a 'pull' in investment patterns that is in line with China's transition into a high value-added economy and increasing focus on innovation. Indeed, foreign capital is increasingly seeking companies in the technology and service sectors, and these industries are predominantly in Eastern China. For instance,

the Yangtze River Delta Economic Zone, a major growth area in the eastern region, saw the number of newly established foreign-invested companies increase by 7.8 percent YoY, reaching 11,974 companies, which accounted for 45.1 percent of all newly established foreign-invested companies in 2015.<sup>67</sup>

This trend is consistent with previous reform initiatives, in which investment first entered China's coastal cities in pilot programmes, and then gradually moved west. Furthermore, the establishment of free trade zones (FTZs) in Tianjin, Fujian and Guangdong suggests that FDI may continue to be concentrated in the east, then move more slowly to the west as China creates more projects in the western region through the country's 'Belt and Road' initiative.

### Regional FDI deal value and growth rate



<sup>65</sup> 'Ministry of Commerce: China FDI achieved steady growth in 2015, increasing 6.4% year-on-year', people.com, 20 January 2016, <http://xj.people.com.cn/n2/2016/0120/c188522-27586045.html>

<sup>66</sup> 'The Regular Press Conference of the Ministry of Commerce (January 20, 2016)', MOFCOM, 22 January 2016, <http://english.mofcom.gov.cn/article/newsrelease/press/201601/20160101244116.shtml>; According to the NBS method of grouping China's provincial-level administrative units: Eastern China comprises the municipalities of Beijing, Tianjin and Shanghai, and the provinces of Liaoning, Hebei, Shandong, Jiangsu, Zhejiang, Fujian, Guangdong and Hainan; Central China: the provinces of Heilongjiang, Jilin, Shanxi, Anhui, Jiangxi, Henan, Hubei and Hunan; Western China: the autonomous regions of Inner Mongolia, Guangxi, Tibet, Ningxia and Xinjiang, and the provinces of Sichuan, Guizhou, Yunnan, Shaanxi, Gansu and Qinghai, and Chongqing Municipality.

<sup>67</sup> '2015 FDI Utilization by Location', NDRC, 29 January 2016, [http://www.sdpc.gov.cn/fzgggz/wzly/wstz/wstzgz/201601/t20160129\\_773571.html](http://www.sdpc.gov.cn/fzgggz/wzly/wstz/wstzgz/201601/t20160129_773571.html)

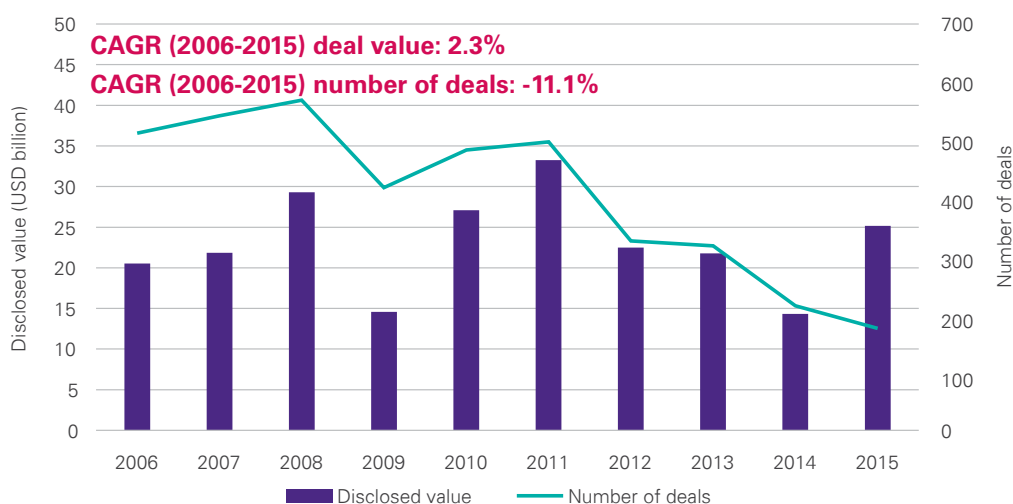
## Inbound M&A transactions

In 2015, China saw 202 inbound M&A deals announced by foreign companies, down from 248 in 2014. However, total value rebounded to USD 25.2 billion, after having hit its lowest point in 10 years in 2014, which saw USD 14.4 billion in inbound M&A deals.<sup>68</sup>

Overall, foreign companies from 26 different countries and regions conducted M&A deals in mainland China. Companies from developed economies accounted for 94.1 percent of the announced deals and for over 78 percent of the total value. There were 142 deals announced by companies from Singapore, the US, Japan and Taiwan, accounting for 67.9 percent of total value (see the table on p. 44).

The sectors exhibiting the highest value of M&A activity were driven by two stand-alone deals: the USD 10.4 billion investment by Japan-based ITOCHU Corporation and Thai company Charoen Pokphand Group for a 20 percent stake of CITIC in the holding companies/conglomerates sector, and the joint investment by two Qatari companies of USD 5.0 billion for a 49 percent share of ShanDong Dongming Petrochemical Group in the oil and gas sector. Outside of these two sectors, the three leading sectors by M&A value were real estate (USD 2.1 billion, 14 deals), financial services (USD 1.7 billion, 10 deals), and transportation (USD 1.1 billion, 12 deals).

### China's inbound M&A deals, 2006-2015














Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by foreign companies in China













<sup>68</sup> Excluding deals from companies in Hong Kong, the Cayman Islands and the British Virgin Islands

## Top countries and regions for Chinese inbound M&A transactions in 2015, by number of deals

Rank	Country/region	No. of deals	Investment targets
1	 Singapore	44	Computers and electronics, real estate, healthcare, transportation, utility and energy
2	 US	41	Computers and electronics, agribusiness and food, professional services, retail, transportation, utility and energy
3	 Japan	36	Chemicals, computers and electronics, healthcare, holding companies, metal and steel, professional services
4	 Taiwan	21	Computers and electronics, financial services, agribusiness and food, real estate, transportation
5	 Australia	11	Computers and electronics, financial services, agribusiness and food, mining, utility and energy
6	 South Korea	8	Automotive, computers and electronics, healthcare, textiles, transportation
7	 France	5	Computers and electronics, professional services, construction/building
7	 Germany	5	Automotive, consumer products, metal and steel, machinery, textiles
8	 UK	4	Healthcare, metal and steel, publishing
9	 Canada	3	Real estate, construction and building, food and beverage
9	 Sweden	3	Automotive, computers and electronics, consumer products





















Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by foreign companies in China

## Top countries and regions for Chinese inbound M&A transactions in 2015, by disclosed deal value (USD billion)

Rank	Country/region	Disclosed deal value (USD billion)	Investment targets
1	 Japan	10.6	Chemicals, computers and electronics, healthcare, holding companies, metal and steel, professional services
2	 Qatar	5.0	Oil and gas
3	 US	3.1	Computers and electronics, agribusiness and food, professional services, retail, transportation, utility and energy
4	 Singapore	1.9	Computers and electronics, real estate, healthcare, transportation, utility and energy
5	 Taiwan	1.5	Computers and electronics, financial services, agribusiness and food, real estate, transportation
6	 Canada	0.92	Real estate, construction and building, food and beverage
7	 South Korea	0.49	Automotive, computers and electronics, healthcare, textiles, transportation
8	 France	0.32	Computers and electronics, professional services, construction/building
9	 Russia	0.30	Computers and electronics
10	 Belgium	0.26	Agribusiness and food

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by foreign companies in China

## Top 10 sectors for announced inbound M&A deals in 2015, by value and number of deals

Rank	Sector	Disclosed value (USD billion)	Sector	Number of deals
1	 Holding companies/ conglomerates	10.4	 Computers and electronics	33
2	 Oil and gas	5.0	 Professional services	16
3	 Real estate (including hotels and restaurants)	2.1	 Agribusiness and food	15
4	 Financial services (including insurance)	1.7	 Real estate (including hotels and restaurants)	14
5	 Transportation	1.1	 Healthcare	14
6	 Computers and electronics	1.1	 Utility and energy	13
7	 Agribusiness and food	0.88	 Transportation	12
8	 Utility and energy	0.72	 Automotive	11
9	 Retail	0.64	 Metal and steel	11
10	 Construction and building	0.35	 Financial services (including insurance)	10

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by foreign companies in China



## Top 10 announced inbound M&A deals in 2015, by deal value

Rank	Deal value (USD billion)	Announced month	Acquirer	Acquirer's origin	Target	Shares acquired (%)	Target sector
1	10.4	January	ITOCHU Corporation; Charoen Pokphand Group	Japan/Thailand	CITIC	19.73	Holding companies/conglomerates
2	5.0	March	Qatra for Investment and Development; Hamad Bin Suhaim Enterprises	Qatar	ShanDong Dongming Petrochemical Group	49	Oil and gas
3	0.94	June	Morgan Stanley; Keywise Capital Management; CDH Investments; SAIF Partners; China International Capital Corporation	US	Zhong An Online Property and Casualty Insurance	19.40	Financial services
4	0.92	June	Ivanhoé Cambridge; APG Asset Management NV	Canada	Chongbang Development	Not reported	Real estate
5	0.51	November	Wal-Mart Stores	US	China Resources National Corporation (21 joint ventures under China Resources SZITIC Investment)	Not reported	Retail
6	0.45	June	Delta Air Lines	US	China Eastern Airlines	3.54	Transportation
7	0.40	April	The Coca-Cola Company	US	Xiamen Culiangwang Beverage Technology	100	Food and beverage
8	0.39	September	CJ Korea Express Corporation	South Korea	Shanghai Rokin Logistics	71.4	Transportation
9	0.38	May	CTBC Financial Holding	Taiwan	China CITIC Bank International	45	Financial services
10	0.32	March	Lafarge SA	France	Lafarge Shui On Cement	45	Construction/building

Source: Dealogic, accessed on 18 February 2016; KPMG analysis; includes all announced M&A transactions by foreign companies in China

## Looking forward

Taking stock of the emerging two-track economy, the continued shift towards services and consumption as the economy matures, and the pressing need for the government to satisfy critical social needs, we expect that 2016 will present numerous opportunities for foreign investors.

### Sectors:

Much analysis of the operating environment for foreign companies in China has focused on the perception of diminished opportunities; however, our belief is that this is an incomplete view. A clear-eyed analysis of the opportunities for foreign investors in China indicates some dramatic shifts in the areas of need being emphasised by the Chinese Government. These present significant opportunities for companies with targeted, well-positioned value propositions that deliver against emerging customer needs while simultaneously delivering a strong value proposition to the government's development goals. Below, we list some of the most important drivers behind China's near-term growth priorities:

- Recognition of the need for foreign technology, knowhow and capital in the service sector as the economy tries to keep up with the growing demands of China's expanding middle class – This will generate FDI opportunities in areas such as healthcare, logistics, e-commerce, computer technology and consumer goods. While China will certainly continue its drive to develop a more localised IT industry, global advancements will continue to be recognised by China market participants and create ongoing partnering opportunities.
- Strong aspirations for a cleaner, healthier and more inclusive society – Government spending will pivot to the 'lean, clean and green' categories that seek to improve healthcare coverage, reduce environmental impact, strengthen food safety and security, and ameliorate pollution conditions. We expect this to bring opportunities in sectors such as elder care, new energy vehicles, environmentally friendly technologies, food processing and cold chain logistics.
- A desire to increase the productivity and international competitiveness of China's manufacturing sector, as shown by the release of the 'Made in China 2025' and 'Internet Plus' plans – This will drive opportunities for foreign participants in advanced manufacturing and automation. We also expect the manufacturing aftermarkets to begin to mature more rapidly in China.
- The need for advanced technology and expertise in highly specialised fields within traditional sectors in order to reduce operating costs – This includes the development of non-conventional energy resources and technologies that provide for more efficient, cleaner utilisation of current energy sources.
- The government's capacity to provide public goods is being strained by the high local debt levels and the country's rapid urbanisation rates – This will drive significant opportunities for foreign capital to participate in social infrastructure projects including healthcare and education, among other areas. China has also signalled a willingness to encourage foreign investment through public-private partnerships (PPP) to meet these challenges, and we expect these efforts to accelerate in 2016 and to be highlighted in the forthcoming release of the 13th Five-Year Plan.

## Government initiatives

### Increasing market openness

As we anticipated in *China Outlook 2015*, the government continued opening China to foreign investment, and reiterated its commitment to do more. Both the *Report on the Work of the Government* and the *Plan for National Economic and Social Development in 2015*, were released during the Third Session of the 12<sup>th</sup> NPC and the 12<sup>th</sup> Chinese People's Political Consultative Conference in March 2015 (more commonly known as the 'Two Sessions'). These reports affirm that authorities will continue opening the service and manufacturing sectors to foreign capital, while also loosening restrictions in the finance sector.

The following policies will aim at increasing China's market openness and facilitating FDI:

- **Draft Foreign Investment Law:** In January 2015, MOFCOM issued a draft Foreign Investment Law which is intended to replace the entire regulatory framework covering foreign-invested enterprises. Based on past experience, the approval of the new legislation will likely be a relatively lengthy process. Once approved, the new law will provide a more transparent and predictable legal environment for foreign investors on paper:



- Foreign and domestic investors will be treated more equally at the pre-entry stage of an investment.
  - A 'negative list' of restricted and prohibited sectors for FDI, initially piloted in the Shanghai Free Trade Zone, will be adopted nationwide. Only if investments are in sectors included in this list or exceed a set limit will foreign investors have to apply to MOFCOM for approval. Investments in all other sectors will be permitted, and investors will only have to report periodically to MOFCOM on their status according to certain requirements.
  - Protection for foreign investors in terms of expropriation, state compensation, transparency and intellectual property, among others, will be reinforced.
- **Revised Foreign Investment Industrial Guidance Catalogue:** In April 2015, a revised version of China's *Catalogue for the Guidance of Foreign Investment Industries* came into effect.<sup>69</sup> The revised catalogue reduces the number of 'restricted' industries from 79 to 38. It also reduces the number of industries that require a majority Chinese ownership or a joint venture with a Chinese company from 44 to 35 and from 43 to 15, respectively. The revised catalogue increases the openness of several high value-added sectors to FDI, including telecommunications, transportation, healthcare and new energy, and loosens restrictions for FDI in oil, mining and certain manufacturing activities. Overall, these changes will benefit foreign companies in the service sector, as well as those with expertise in specialised processes within a number of industries.

- **Free trade agreements:** As outlined in the previous chapter, China's FTAs with Australia (ChAFTA) and South Korea came into force in 2015. Also, while the outlook for 2016 negotiations is uncertain, the Chinese Government has expressed its desire to complete the Regional Comprehensive Economic Partnership (RCEP) negotiations with South Korea and Japan, as well as its FTA with the Gulf Cooperation Council this year.<sup>70</sup>

Under ChAFTA, China has agreed to a range of commitments in the service sector, allowing Australian service providers to establish a commercial presence in Chinese territory. These include the sectors of health, aged care, shipping, architecture and urban planning, legal and mining services, as well as financial services including the banking, insurance and fund management sectors. The agreement also includes a most-favoured nation (MFN) clause, under which Australia's competitive position will be protected if China extends beneficial treatment to other trade partners.<sup>71</sup>

Regarding China's FTA with South Korea, negotiations on the pre-establishment phase of investments, as well as on a negative list indicating the sectors that will not be opened to investors from both countries, are set to begin two years from now.<sup>72</sup> Currently, the FTA includes standard provisions, such as MFN clauses and dispute settlement clauses.<sup>73</sup>



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*“2016 will be a pivotal year in China, both for the government and for global companies and investors. Surviving and thriving in the 'new normal' requires companies to think about new and innovative means of partnering to seize opportunities in a rapidly transforming economic landscape, and to understand the important role that an increasingly affluent middle class will play in driving this change. This is not to underestimate the challenges of being successful in China. But can a multinational that does not compete and win in China compete and be successful globally in the future?”*

69 'Catalogue for the Guidance of Foreign Investment Industries (Amended in 2015)', MOFCOM, 10 March 2015, [http://www.fdi.gov.cn/1800000121\\_39\\_4830\\_0\\_7.html](http://www.fdi.gov.cn/1800000121_39_4830_0_7.html)

70 'Remarks by H.E. Li Keqiang Premier of the State Council of the People's Republic of China at the 18th ASEAN Plus China, Japan and ROK Summit', Premier Li Keqiang, 23 November 2015, <http://gr.china-embassy.org/eng/zgyw/t1317373.htm>; 'China and Gulf nations resume free trade agreement talks', China Daily, 21 January 2016, [http://europe.chinadaily.com.cn/world/2016-01/21/content\\_23182530.htm](http://europe.chinadaily.com.cn/world/2016-01/21/content_23182530.htm)

71 'China-Australia Free Trade Agreement – Factsheet: Investment', Department of Foreign Affairs and Trade, Australian Government, updated on 5 January 2016, <http://dfat.gov.au/trade/agreements/chafat/fact-sheets/Pages/fact-sheet-investment.aspx>

72 'China-Korea Free Trade Agreement officially signed', MOFCOM, 2 June 2015, <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201506/20150601003067.shtml>; 'Framework for Korea-China FTA service and investment negotiations built at the 12th Korea-China FTA negotiation' Ministry of Trade, Industry & Energy, Republic of Korea, 18 July 2014, <http://english.motie.go.kr/wp-content/uploads/2014/10/Framework-for-Korea-China-FTA-Service-and-Investment-Negotiations-Built-at-the-12th-Korea-China-FTA-Negotiation.pdf>

73 'An Assessment of the Korea-China Free Trade Agreement', Jeffrey J. Schott, Peterson Institute for International Economics, 11 December 2015, <http://www.iie.com/publications/papers/schott20151211ppt.pdf>

- **New FTZs:** With the establishment of the new FTZs in Tianjin, Guangdong and Fujian, and the expansion of the Shanghai FTZ, China now has a wider platform to pilot policies that could be expanded nationwide if proven successful. This should help accelerate the integration of the Chinese market with the global market by opening more sectors to foreign investors and streamlining administrative procedures for FDI. The three new FTZs have proven quite attractive for foreign investors, as from January to October 2015, 5,159 foreign invested companies were established in these areas.<sup>74</sup> Furthermore, MOFCOM recently issued a directive supporting a more rapid development of FTZs in 2016.<sup>75</sup>

The support and encouragement of healthcare and e-commerce is common among China's newly established FTZs. Additionally, each of these FTZs will leverage the comparative advantages of their respective locations:

- Tianjin's FTZ will deepen regional economic integration between Beijing, Hebei and Tianjin in the area known as 'Jing-Jin-Ji'.<sup>76</sup> Additionally, this FTZ will support incoming green technologies, through the development of the Sino-Singapore Tianjin Eco-City project,<sup>77</sup> as well as the implementation of new initiatives. The shipping and insurance sectors are expected to be opened to foreign investment, with the anticipation that insurance companies will be able to establish branches in the mainland through the FTZ.<sup>78</sup>
- The Guangdong FTZ encompasses the Nansha Area of Guangzhou, the Qianhai and Shekou Area of Shenzhen, and the Hengqin Area of Zhuhai – and is intended to deepen connections between the mainland, Hong Kong and Macau. This FTZ focuses on service sectors, and enables foreign insurance companies from Hong Kong and Macau to establish branches in the mainland. Additionally, Hong Kong and Macau investors are encouraged to establish medical services companies in China through the FTZ.<sup>79</sup>

- The Fujian FTZ is intended to support joint-invested financial institutions with Taiwanese investors, facilitate cross-strait e-commerce, and increase connectivity between Taiwan and mainland China.<sup>80</sup>

#### • **China-US Bilateral Investment Treaty (BIT):**

Negotiations on the China-US BIT will continue into 2016. If implemented, this agreement will accelerate FDI by significantly increasing access for US companies to currently restrictive sectors in the Chinese market.

While the BIT would prove advantageous for US investors and an increasing number of US-bound outbound Chinese investors, its future remains uncertain. The negative lists discrepancy between the two countries did not advance significantly in terms of alignment in 2015, despite 94 executives signing an open letter on the matter to Presidents Obama and Xi during Xi Jinping's recent state visit to the US.<sup>81</sup> Furthermore, the recently implemented revisions to China's National Security Law have expanded protections based on a broad definition of security that includes economic and cultural interests. This definition exceeds the OECD national security definition, and will likely further complicate and slow progress towards BIT ratification.<sup>82</sup>

#### **Urbanisation and private-public partnerships**

The Chinese Government has stated that it intends to increase the percentage of the population in urban centres to 60 percent by the end of 2020, and issue 100 million urban *hukous* in the process.<sup>83</sup> Authorities are pushing forward the implementation of a number of regional development plans which will lead to the development of new urban centres, such as:

- In April 2015, the State Council approved the development of city clusters at the midstream of the Yangtze River, in the provinces of Hubei, Hunan and Jiangxi.<sup>84</sup>

74 '2015 business review IV: Foreign capital volume creates new high while reform and opening up measures rapidly push forward', MOFCOM, 7 January 2016, <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201601/20160101236042.shtml>

75 'The State Council Issues Opinions on Speeding up the Implementation of Free Trade Zone Strategy', MOFCOM, 7 January 2016, [http://fta.mofcom.gov.cn/enarticle/enrelease/201601/30157\\_1.html](http://fta.mofcom.gov.cn/enarticle/enrelease/201601/30157_1.html)

76 'Jing-Jin-Ji' is an abbreviation for the Beijing, Tianjin, Hebei economic region as captured in the Chinese character representation for these geographic areas. The JJJ plan seeks to increase coordination between these markets.

77 'About SSTECC: Sino-Singapore Tianjin Eco-City Investment and Development Co., Ltd.', SSTECC, accessed on 15 February 2016, [http://www.tianjineco-city.com/en/SinglePage.aspx?column\\_id=10304](http://www.tianjineco-city.com/en/SinglePage.aspx?column_id=10304)

78 'China (Tianjin) Pilot Free Trade Zone', accessed on 15 February 2016, <http://www.china-tjftz.gov.cn/html/cntjzmyq/yysy/List/index.htm>

79 'China (Guangdong) Pilot Free Trade Zone: Nansha Area of Guangzhou', Nansha District, Guangzhou City Government, accessed on 15 February 2016, [http://www.gzns.gov.cn/pub/nszmsyq\\_en/about/201503/t20150308\\_155616.html](http://www.gzns.gov.cn/pub/nszmsyq_en/about/201503/t20150308_155616.html)

'Investment Guide of Qianhai & Shekou Area', China (Guangdong) Pilot Free Trade Zone, Guangzhou City Government, 2015, [http://www.china-gdftz.gov.cn/en/INVESTMENT/Investment\\_Environment/201502/t20150224\\_704.html](http://www.china-gdftz.gov.cn/en/INVESTMENT/Investment_Environment/201502/t20150224_704.html)

'China (Guangdong) Pilot Free Trade Zone: Hengqin Area of Zhuhai', Zhuhai Hengqin New Area Administrative Committee Registration, 19 March 2015, <http://en.hengqin.gov.cn/ftze/About/201503/1ccc904eea6448b69ca84ca74dcdedcd.shtml>

80 'Fuzhou Area of China (Fujian) Pilot Free Trade Zone', Fuzhou Government, accessed on 15 February 2016, <http://ftz.fuzhou.gov.cn/English/About/Advantages/>

81 '94 American CEOs call on President Obama and President Xi Jinping to prioritize Bilateral Investment Treaty discussions during upcoming state visit', The US-China Business Council, 15 September 2015, <https://www.uschina.org/media/press/94-american-ceos-call-president-obama-and-president-xi-jinping-prioritize-bilateral>

82 'International Investment Perspectives: Freedom of Investment in a Changing World', OECD, 2007 <http://www.oecd.org/investment/internationalinvestmentagreements/40243411.pdf>

83 *Hukou* refers to China's household registration documentation and is divided into rural and urban categories. Administration of social services are divided based on an individual's *hukou* status.

'National New-Style Urbanisation Plan (2014-2020)', Central Committee of the CPC, State Council, 16 March 2014, [http://www.gov.cn/gongbao/content/2014/content\\_2644805.htm](http://www.gov.cn/gongbao/content/2014/content_2644805.htm)

'The "13th Five-Year Plan" suggests: Encourage capable rural migrants to relocate their families to urban cities', Xinhua, 3 November 2015, [http://news.xinhuanet.com/politics/2015-11/03/c\\_1117030188.htm](http://news.xinhuanet.com/politics/2015-11/03/c_1117030188.htm)

84 'China to develop city clusters at the midstream of the Yangtze River', State Council, 5 April 2015, [http://english.gov.cn/policies/latest\\_releases/2015/04/05/content\\_281475083540554.htm](http://english.gov.cn/policies/latest_releases/2015/04/05/content_281475083540554.htm)

- Authorities are also advancing an ambitious urbanisation plan to reduce Beijing's population density by relocating most of the city's government functions to the Tongzhou district, which borders Hebei Province and Tianjin. This is part of the 'Beijing-Tianjin-Hebei Coordinated Development Plan', which looks to develop a megacity cluster by combining Beijing's high-tech industries with Tianjin's port facilities and the traditional industries in Hebei province.
- The 'Belt and Road' initiative is expected to contribute to the development of China's landlocked western provinces by improving regional infrastructure connectivity, thus facilitating urbanisation and local economic growth.

The significant increase in urban dwellers will create a new base of consumer demand, and also require an expansion of existing energy capacity, transportation systems, water and waste management infrastructure, and healthcare systems. The NDRC has stated that in the next five years, cities will require significant utility system upgrades in order to address current and future capacity gaps. To finance these upgrades, government agencies have already begun implementing a range of pilot PPP programmes to determine financial feasibility.<sup>85</sup>

Although China has experimented with PPPs for decades, many foreign investors have been deterred from entering into PPPs due to long contract length and perceived risks on retrieving capital. In order to assuage concerns and protect the investments of private and foreign companies, the NDRC implemented the Management Measures on Franchised Operation in Infrastructure and Public Utilities Law on 1 June 2015.<sup>86</sup> This law will join the *Guide on Operation of Public-Private Partnership Projects (For Trial Implementation)* which was implemented in 2014,<sup>87</sup> and is intended to provide clarity regarding the responsibilities of contracted parties and strengthen the rights of private corporations to arbitrate disputes.

Municipal governments of China's newly urbanised areas need alternative sources of financing to construct the social infrastructure that China will require to meet its development goals. Municipal debt levels have created greater demand for employing private sector capital in traditionally state-controlled industries. This increasing economic incentive has put pressure on the government to expand legal protections, and as a result, we will likely see more and better PPP opportunities, with better legal protection for private and foreign investors.

## SOE reform

Since the mid-1990s, China's SOEs have undergone a steady series of reform and modernisation initiatives. These reforms have gradually opened previously protected sectors to foreign companies through direct investment and partnership with state-owned asset entities.

In September 2015, authorities issued a guideline to deepen the reform process of state-owned companies,<sup>88</sup> and divided them into two categories: for-profit entities and those dedicated to public welfare. Among other objectives, the guideline aims to modernise SOEs, improve the way state assets are managed, and promote 'mixed' ownership by allowing private capital to be invested in for-profit SOEs. Along these lines, the 13<sup>th</sup> Five-Year Plan is expected to further open areas of the economy currently closed to private and foreign investment.

Though sectors that are considered sensitive for national security will continue to be restricted, the reforms will likely allow foreign enterprises, through equity investment, to acquire and restructure public service assets of SOEs in industries ranging from energy and power, and telecommunications services, to some areas of natural resources, agriculture, medical care, financial services, and insurance.

The deepening of China's SOE reform should therefore create two opportunities for private and foreign investors:

1. More acquisition targets: Smaller branches of central SOEs will likely be sold off, or allowed to accept equity shared ownership.
2. Wider market access: By taking equity stakes in SOEs targeted for 'mixed ownership', foreign companies should be able to enter additional markets that are currently still under state control. This mechanism may require patience and an incremental approach, but should result in the progressive opening of additional sectors if initial cooperation initiatives prove fruitful.

CITIC's sale of its stake of just under 20 percent in two Asian conglomerates, and China Eastern Airlines' sale of a 3.54 percent equity stake to Delta Air Lines – where Delta was granted an observer board seat with this share purchase – are examples of the global strategic cooperation initiatives that are encouraged by China's SOE reform programme.

85 'Guiding Opinions of the State Council on Strengthening the Management of Urban Underground Pipelines', State Council, 14 June 2014, [http://www.gov.cn/zhengce/content/2014-06/14/content\\_8883.htm](http://www.gov.cn/zhengce/content/2014-06/14/content_8883.htm)

86 'Management measures on franchised operation in infrastructure and public utilities', NDRC, 1 June 2015, [http://bgt.ndrc.gov.cn/zcfb/201504/t20150427\\_689400.html](http://bgt.ndrc.gov.cn/zcfb/201504/t20150427_689400.html)

87 'Guide on Operation of Public-Private Partnership Projects (For Trial Implementation)', Ministry of Finance, 29 November 2014, [http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201412/t20141204\\_1162965.html](http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201412/t20141204_1162965.html)

88 'Guidance for the deepening of state-owned enterprises reform', Central Committee of the CPC, State Council, 13 September 2015, [http://www.sh.xinhuanet.com/2015-09/14/c\\_134620921.htm](http://www.sh.xinhuanet.com/2015-09/14/c_134620921.htm)

### ‘Made in China 2025’ and ‘Internet Plus’

The recently announced ‘Made in China 2025’ and ‘Internet Plus’ plans set out a path for China to move up the value chain in the next decade by leveraging the latest advances in information communication technology, advanced manufacturing and automation technologies to increase the productivity of the country’s traditional industries. Data management technologies such as cloud computing and big data analytics, as well as the so-called ‘Internet of Things’, will allow Chinese firms to better address consumers’ demands, lower operating costs, and increase the added-value of their products.

These changes all imply that there will be greater opportunities for investment in information technologies, as well as emerging advanced manufacturing areas such as pharmaceuticals and biotechnology, automotive, and aerospace. The opportunities in the manufacturing aftermarkets service space will also be accelerated by the increasing integration of technology and manufacturing, as called for in ‘Made in China 2025’.

Through recent directives and more broadly within the initial goals of ‘Made in China 2025’ and ‘Internet Plus’, new opportunities for FDI are emerging to support China’s efforts to modernise its agricultural industry. The recent *Opinions on Implementing New Development Concepts to Accelerate Agricultural Modernization and Achieve Moderate Prosperity* supports the use of foreign investment to advance agro-industrial automation, big data, cloud computing and modern machinery.<sup>89</sup>

Both plans also give a strong push towards increasing the level of automation and sophistication of robotic technologies in lower-value industries. China became the world’s largest robotics market in 2013, and sales of robots in China have increased rapidly, with a 56 percent increase in sales in 2014. China’s low ‘robot density’ ratio – the number of multipurpose industrial robots per 10,000 persons employed – which stood at 36 in 2014, indicates that there are significant opportunities for growth.<sup>90</sup>

Given the strong emphasis on automation articulated through ‘Made in China 2025’, this trend is likely to continue and provide further opportunities for foreign investors.



89 ‘Several Opinions on Implementing New Development Concepts to Accelerate Agricultural Modernization and Achieve Moderate Prosperity’, Central Committee of the CPC and State Council, 27 January 2016, [http://www.gov.cn/zhengce/2016-01/27/content\\_5036698.htm?mType=Group](http://www.gov.cn/zhengce/2016-01/27/content_5036698.htm?mType=Group)

90 ‘World robotics 2015 industrial robots’, International Federation of Robotics, accessed on 15 February 2016, <http://www.ifr.org/industrial-robots/statistics/>



## Industry highlights: Services

### e-Commerce

The e-commerce sector will become increasingly important as China continues to transition into a consumption-based and innovation-driven economy. As mentioned in the first chapter of this report, the online retail sales of goods and services in China increased 37.2 percent YoY in 2015, reaching RMB 3.8 trillion, and are expected to nearly double by 2018.<sup>91</sup> E-commerce platforms will allow companies to expand their market reach without having to invest in bricks-and-mortar stores, which we think will be extremely beneficial, given the expected rise in regional consumption levels brought by the increase in urban dwellers.

Noteworthy M&A activity in 2015 included Walmart's acquisition of leading national online retailer Yihaodian, as well as its launching of an online-to-offline mobile platform in Shenzhen. Unilever also opened a flagship online store within the Beijing-based JD.com platform, providing Chinese consumers with access to many Unilever products for the first time. Additionally, more than 20 apparel brands including Zara and Timberland signed partnerships with e-commerce giant Alibaba.

In May 2015, the foreign equity share caps for e-commerce were removed. This policy change suggests that there will be greater opportunities for foreign investment in the e-commerce sector in 2016.

### Logistics

Fuelled in large part by the rapid advancement of the e-commerce industry, there was also significant foreign investment activity in logistics. Dealogic data shows that since 2013, logistics has been the largest sub-sector category for FDI within the transportation sector, constituting 59 percent of total investment in the transportation sector since 2011.

Among the most important investment activity in 2015 by foreign companies in the logistics sector was the Carlyle Group's agreement to invest USD 120 million in Shanghai ANE Logistics. UPS has also announced its intention to enter more Tier 2 and 3 cities in the coming years.

In May 2015, the government issued the *Planning of National Circulation Node Cities 2015-2020*. This document highlights the importance of the government and private sector continuing to support the growth of China's logistics capacities, and listed 37 cities as being key to China's improvement of the country-wide distribution network. This policy change will present opportunities for FDI for upgrading logistics capacity, especially in listed Tier 2 and Tier 3 cities.

<sup>91</sup> '2015 China E-commerce & O2O Summary Report', iResearch, 19 January 2016, [http://www.iresearchchina.com/content/details8\\_19531.html](http://www.iresearchchina.com/content/details8_19531.html)



## Industry highlights: Healthcare

As outlined in the previous chapter, we expect the coming years to see an increase in China's demand for high-end healthcare services and products, as well as advanced medical devices for treating chronic diseases and taking care of the country's elderly population.

In addition to this, and in line with the objective of developing a "moderately well-off society," the Chinese Government has stated that all citizens should have access to basic healthcare by 2020. As current funding mechanisms are likely to struggle to keep up with the challenges presented by China's rapidly ageing population, payment exemptions for the retired, and the broad disparity among regions in insurance deductibles, we expect there to be significantly more business opportunities for private capital in China's healthcare sector.

With respect to foreign investors, however, opportunities are complicated by the various nuances in the relaxation of investment restrictions. Therefore, while there are opportunities for FDI, it is critical to understand which sub-sectors present short-term versus long-term investment opportunities.

### Hospitals

Chinese authorities have increasingly encouraged investment in private healthcare facilities as a way to ease the burden on public hospitals. Furthermore, the relaxation of restrictions on FDI for the establishment of hospitals has also been driven by a desire to expand the adoption of international standards and practices, as well as to accelerate access to quality care for China's rapidly ageing society. Given the magnitude of the strains on China's healthcare system, the government has seen foreign capital participation in the sector as a key lever to improving the situation efficiently.

In July 2014, foreign investors were permitted for the first time to establish wholly foreign-owned hospitals, but only in Beijing, Tianjin, Shanghai, Jiangsu, Fujian, Guangdong and Hainan. This liberalisation was limited in practice, however, by the inclusion of medical institutions in a restricted category of foreign investments in the 2015 *Catalogue for the Guidance of Foreign Investment Industries*, which required the formation of Chinese partner joint ventures. The signing of ChAFTA allowed for Australian investors to establish wholly foreign-owned entities. We expect further liberalisation in this direction in the 13<sup>th</sup> Five-Year Plan.

Thanks to these trends, foreign investors are showing an increasing interest in China's hospital market: according to data from Dealogic, 2015 saw 11 hospital care inbound M&A deals, with a total transaction value of USD 354.7 million; while 2014 saw only one deal, worth USD 9.1 million. We expect this trend to continue, given the China Government's acute need to rapidly improve the availability and quality of hospitals and care facilities in China.

In January 2016, UK-based International Hospitals Group (IHG) and Wanda Group entered into an agreement under which Wanda will invest USD 2.28 billion to build three international hospitals in Shanghai, Chengdu and Qingdao, which will be managed by IHG.<sup>92</sup> Also in January, Malaysia's IHH Healthcare Berhad had an official lease-signing ceremony for the establishment of a hospital in Chengdu, which will reportedly see an investment of RMB 900 million.<sup>93</sup>

### Pharmaceutical products

Dealogic data shows that in 2015, announced inbound M&A transactions targeting Chinese companies in the pharmaceutical sector recorded a total announced value of USD 121.9 million, the lowest since 2005.

Notable M&A transactions included the acquisition of SciClone Pharmaceuticals, Inc. for USD 6 million by US-based Theravance Biopharma, and the purchase of a 51.5 percent stake in Shandong Lukang Record Pharmaceutical Co., Ltd. for USD 25.1 million by South Korean company Amicogen.

The 2015 *Catalogue for the Guidance of Foreign Investment Industries* no longer requires equity or contract joint venture status for investment in vitamins, calcium, narcotics and blood products, which should accelerate FDI in the space in the near term. Additionally, "Planting and cultivation of traditional Chinese medicines" was added to the 'Encouraged Foreign Investment Industries' list.<sup>94</sup> Pharmaceutical products are a key sub-sector within China's development agenda, but investment from foreign companies has been volatile. Although these policy changes, and initiatives in Shanghai and Guangdong's FTZs create incentives to encourage greater foreign investment in life sciences, it remains uncertain whether FDI in the space will rebound in 2016.

### Medical devices

The value of M&A into medical devices over the past five years had a CAGR of -32.9 percent. However, policy changes may be creating incentives for increased investment activity. 2015 deal value increased 85.03 percent versus 2014, which is the first YoY increase since 2011.

The only significant M&A deal was the acquisition of Tong Da Medical Device, a Chinese developer of advanced medical equipment, by Singapore-based SHC Capital Asia for USD 87.3 million in March 2015.

Medical devices have been listed on the 'Made in China 2025' list of key investment fields. However, it is unclear whether the FTZ policy changes and the 'Made in China 2025' agenda will provide favourable enough incentives to reverse the decline of foreign investment in this sector.

92 'Wanda announces RMB15bn investment in international hospitals', Wanda Group, 6 January 2016, [www.wanda-group.com/2016/latest\\_0106/1056.html](http://www.wanda-group.com/2016/latest_0106/1056.html)

93 'Media release: IHH Healthcare formalises lease agreement with Perennial for ParkwayHealth Chengdu Hospital', IHH Healthcare Berhad, 15 January 2016, <http://ihh.irplc.com/medianews.htm?filepath=IHH/IHH%20HEALTHCARE%20FORMALISES%20LEASE%20AGREEMENT%20WITH%20PERENNIAL%20FOR%20%20PARKWAYHEALTH%20CHENGDU%20HOSPITAL.pdf>; 'Singapore developer plans healthcare hubs in 20 to 40 Chinese cities', The Straits Times, 16 January 2016, <http://www.straitstimes.com/asia/east-asia/singapore-developer-plans-healthcare-hubs-in-20-to-40-chinese-cities>

94 'Catalogue for the Guidance of Foreign Investment Industries (Amended in 2015)', MOFCOM, 10 March 2015, [http://www.fdi.gov.cn/1800000121\\_39\\_4830\\_0\\_7.html](http://www.fdi.gov.cn/1800000121_39_4830_0_7.html)



## Industry highlights: Environment

Recent government decisions to include environmental quality key performance indicators (KPIs) as part of the evaluation criteria for political promotion indicates the importance of this subject to the national leadership. While this shift in rhetoric remains to be tested in implementation, we expect government action to increasingly align with the ambitious goals being set for improving the environment.

Stricter air quality laws will likely increase opportunities for investment in clean coal, shale gas and other alternative energies. Additionally, ambitious goals set out by China at the UN's Conference on Climate Change held in Paris in November 2015<sup>95</sup> will solidify investment opportunity categories to help the country accelerate its environmental amelioration efforts.

### Clean power

According to the 'Intended Nationally Determined Contributions' that the Chinese Government submitted to the Secretariat of the UN Framework Convention on Climate Change during COP21, China will "[i]ncrease the share of non-fossil fuels in primary energy consumption to around 20 [percent]" by 2030.<sup>96</sup> To meet this target, China must deploy an additional 800 to 1,000 gigawatts of zero-emission generation capacity by 2030. This goal will therefore significantly increase demand for investment in clean energy such as nuclear, wind and solar.<sup>97</sup>

In addition, China announced at COP21 that it will attempt to reduce pollution from coal-fired power plants by 60 percent by 2020. This will likely drive technology and equipment FDI opportunities.<sup>98</sup>

Highlighted 2015 China inbound deals in the space include US-based Solar Power Inc. acquiring Gonghe County Xinte Photovoltaic for USD 33.6 million; US-based SunEdison acquiring a wind power station in Inner Mongolia for USD 109 million; and Singapore-based ecoWise Holdings' investment in Changyi Enersave Biomass-To-Energy.

### New energy vehicles

In recent years, a series of policies have been released to boost the development of new energy vehicles (NEVs). In 2015, 379,000 NEVs were produced, representing almost a four-fold increase over the previous year.<sup>99</sup>

In January 2016, the Chinese Government implemented new policies to provide financial support for the further development and usage of NEVs.<sup>100</sup> This will likely

further accelerate investment interest among global automakers, although consideration of intricate partnering dynamics will most certainly apply to any investment considerations.

### Waste management

There has been a significant increase in inbound M&A activity in waste management in recent years. Based on our calculations using Dealogic data, the sector's 2006-2015 CAGR stood at 15.7 percent. 2015 saw five deals, four of which have total a disclosed value of USD 175.78 million, up from one deal in 2014. In 2015, deal value was 14 percent greater than the five-year average (2011-2015). This is in line with the government's growing prioritisation of environmental clean-up and sustainability.

Notable M&A deals in 2015 included the acquisition of Harvest Champion Limited for USD 124.82 million by Australian company Central West Gold NL. Also, Singapore-based Darco Water Technologies acquired a 60 percent stake in Wuhan Kaidi Water Services for USD 7.9 million.

China's urban centres will produce an increasing amount of waste, estimated at 23 percent over current levels, by 2020. At the same time, municipal managers are increasingly being held accountable for living standard KPIs. The intersection of these two forces will likely generate new technology-driven investment opportunities for foreign companies.<sup>101</sup>

### Green buildings

In 2014, the Chinese Government issued the *National New-style Urbanization Plan (2014-2020)* which set the ambitious target that 50 percent of new construction in urban areas should qualify as 'green buildings' by 2020.<sup>102</sup>

According to estimations by CBRE, the total new construction of urban green buildings in China is expected to reach 7 billion square metres by 2020.<sup>103</sup> These statistics imply a large potential market for well-positioned foreign building supply companies across the construction supply chain.

The market development initiatives being undertaken by innovative non-governmental organisations (NGOs) in this area such as the Paulson Institute, which facilitates the joint cooperation of Chinese and US companies in this space, are indicative of the opportunities available to foreign investors who deploy creative go-to-market models.

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100 Ibid.

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## Industry highlights: High-tech manufacturing

In 2015, FDI into the high-tech manufacturing sector reached USD 9.4 billion, a 9.5 percent YoY increase compared to the 5.9 percent rise in overall FDI in the same period. This investment category represented 23.8 percent of total manufacturing FDI in 2015.<sup>104</sup> As China's manufacturing sector moves up the value chain and the country transitions from a quantity- to quality-focused producer, there will continue to be opportunities for advanced manufacturing-related FDI. These opportunities will be further accelerated by a general ongoing shift in many companies' strategies from 'in China for the World' to 'in China for China', whereby the end-customer increasingly resides in China for many companies' manufacturing outputs. These trends will combine to create a large market for smart equipment and other advanced production inputs in China, creating a new focus area for foreign investment.

In 2015, inbound M&A transactions were led by large tech companies, venture capital, and private equity funds, with venture capital funds investing the highest share. Foreign investment into China's computer software sector is partly linked to the demands of domestic producers for more sophisticated support systems. Dealogic data shows that of the 14 inbound computer software deals that took place in 2015, three involved firms located in Beijing and two in Hangzhou. Beijing's Zhongguancun district, and Hangzhou's growing tech scene, spurred on by local tech giant, Alibaba Group Holdings Limited, are hotbeds of domestic innovation in China. As China's domestic tech sector grows, foreign investors will likely find more opportunities in these cities, along with Shenzhen, Shanghai, Chongqing and Chengdu.

<sup>104</sup> 'Deepening reform and liberating production capability are key for the supply side reform', people.cn, 21 January 2016, <http://finance.people.com.cn/n1/2016/0121/c1004-28074611.html>



## Industry highlights: Financial services

Financial sector reform is increasingly critical to China's continued development. Recent years have seen a series of regulatory changes that hold the prospect of further opening the sector to foreign investment.

Amendments to the *Catalogue for the Guidance of Foreign Investment Industries* have removed restrictions on foreign investment in financial companies, trust companies, currency dealers and insurance agents.

In particular, FTZs have begun to be used to pilot ways to open the financial sector – particularly the insurance industry – to increasing foreign competition. We can expect that as the pilots continue to operate and experiment within the FTZs, these evolutions have the potential to expand nationwide. While the policy vision in both the banking and insurance sectors calls for a series of far-reaching changes,<sup>105</sup> practical experience suggests that these measures will proceed at a relatively measured pace.

### Insurance

In 2015, the deal value of inbound M&A in the insurance sector increased 23.2 percent YoY. The only deal in this sector was the USD 943.5 million investment by a consortium comprising Morgan Stanley Asia Securities, Keywise Capital Management, CDH Investments, SAIF Partners and China International Capital Corporation for the acquisition of a 20 percent stake in Zhong An Online Property and Casualty Insurance, an online insurance company launched jointly by Alibaba, Tencent and Ping An Insurance.

The development of online financial services is already creating disruptions within China's insurance industry. Online platforms enable foreign companies to market directly to end-consumers without on-the-ground distribution networks. Recently established FTZs now offer private foreign insurance companies opportunities to enter China's insurance market, though in limited geographies. Expansion of these pilot programmes in FTZs, and ultimately on a national scale, will create more FDI opportunities.

### Retail banking

2015 did not see significant FDI in the retail banking sector. Although this sector has been slow to generate significant expansion of foreign participation, the joint partnership and profitability requirements for foreign banks have continued to be reduced.

In 2015, foreign participation in China's domestic banking sector increased. HSBC announced its plan to add 3,000 employees in China's Pearl River Delta to extend the scope of its retail banking business.<sup>106</sup>

There are three key drivers for the further growth of China's commercial banking sector:

1. Interest rate liberalisation: Progressive reliance on market-based interest rates will increase the incentive for individuals to save money through formal institutions.
2. Rising income levels: Increases in disposable income will raise the total amount of savings available for bank deposits.
3. Expanding consumption: Demand for more sophisticated investment vehicles will increase as income levels and purchasing power continue to rise.

These three drivers will increase the opportunities for commercial banking, and with a growing domestic market, there will potentially be increasing opportunities for FDI in support of retail network expansion. However, China's evolving policy vision with regard to foreign participation in the sector has typically been realised at a very measured pace. We therefore expect the opportunities for continued foreign participant expansion in this sector to be relatively slow to materialise.

<sup>105</sup> 'Decision on Revising "The Regulation of the People's Republic of China on the Administration of Foreign-funded Banks"', State Council, 20 December 2014, [http://www.gov.cn/zhengce/2014-12/20/content\\_2795314.htm](http://www.gov.cn/zhengce/2014-12/20/content_2795314.htm)

<sup>106</sup> 'HSBC plans retail expansion in China's Pearl River Delta', The Wall Street Journal, 21 September 2015, <http://www.wsj.com/articles/hsbc-plans-retail-expansion-in-chinas-pearl-river-delta-1442830370>

## A note on the data and information presented in this report

KPMG's Global China Practice has made every effort to verify the accuracy of the data and other information presented in this report, which is current as at 18 February 2016 unless otherwise stated. The majority of the data in this report was sourced from official Chinese Government sources, such as the National Bureau of Statistics of China and the Ministry of Commerce, as well as from Dealogic.

All currency conversions were done using the OANDA fxTrade Forex Trading Platform, which can be accessed here: <http://www.oanda.com/currency/historical-rates/>.



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In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG China was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong office can trace its origins to 1945. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm’s appointment by some of China’s most prestigious companies.

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## KPMG's Global China Practice



KPMG's Global China Practice (GCP) helps Chinese companies invest overseas and multinational companies enter or expand in the China market. Local China Practice teams are stationed in key regions for global investment, especially in countries and regions along the 'Belt and Road'. The GCP team comprises experienced investment advisors and professionals providing a wide range of professional services across all industries, who are well-versed in Chinese language, culture and business concepts. Team members include senior and mid-level managers with strong professional track records and project experience, who have been seconded overseas by KPMG China or are local citizens of Chinese origin. These experts serve as the 'bridge' connecting KPMG's Chinese clients with the local project teams: they help Chinese companies navigate the local business climate, overcome cultural differences, and enhance communications.

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