



Investment in China: Numbers and Trends

Fourth Quarter, 2013

KPMG Global China Practice



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Executive Summary

Through the full year 2013, China's GDP growth rate was 7.7 percent, a decrease of 0.1 percentage points from the third quarter. The brief economic recovery seen in the second half of 2012 subsided in the first quarter of 2013 due to a number of factors, including overcapacity, weak domestic demand, and slowing exports. Economic output fell for the first two quarters of 2013. This prompted China's Premier Li Keqiang to publically announce that the economy will operate within a reasonable range. Through policy fine-tunings, the Chinese government guided market expectations. Under a series of stable growth policies, China's economy began to recover steadily, although slipping slightly in the fourth quarter. Other key takeaways from China's macroeconomic situation include:

- Industrial value added, which accounts for about 40 percent of China's economy, exhibited a slow and steady growth decline in the fourth quarter, dropping by 10.3 percent, 10 percent, and 9.7 percent for October, November, and December respectively.
- Fixed asset investment growth continued to fall during the fourth quarter, dropping from 19.2 percent in October, to 17.6 percent in November, and then slipping to 17.2 percent in December. The main drivers of growth were infrastructure investments and real estate.
- Exports continued to grow by 6.5 percent, 12.7 percent, and 4.3 percent for October, November, and December respectively, displaying an economic recovery amongst China's top trade partners: the US and Europe.
- Consumer prices were marginally lower than the third quarter. CPI in the fourth quarter began at 3.2 percent but steadily dropped to 2.5 percent by the end of December.

Through the full year 2013, total FDI into China broke previous records, reaching USD117.6 billion, up 5.25 year-on-year. While, the manufacturing sector FDI decreased by 6.78 percent year-on-year, receiving USD45.56 billion in FDI funds, the service sector FDI increased by 14.15 percent year-on-year, receiving USD61.45 billion in FDI funds. Since February 2013, FDI has now posted 11 consecutive months of growth. Other FDI highlights include:

- FDI from the European Union (EU) climbed by 18.08 percent year-on-year, while FDI from the US also increased by 7.09 percent year-on-year.
- The service sector's percentage of total FDI has been steadily increasing since the second quarter, rising from 50.2 percent of total FDI in the second quarter, to 50.5 percent in the third quarter, to 52 percent in the fourth quarter.
- FDI into the central region of China grew by 12.3 percent, receiving USD10.6 billion, accounting for 6.85 percent of the national total; the western region also posted significant growth, receiving USD10.6 billion, growing by 7 percent and accounting for 6.85 percent of the total; the eastern region grew by 4.72 percent year-on-year, accounting for USD96.88 billion, accounting for 78.5 percent of the total.

Part I: Macroeconomic Analysis

Q4 2013 Economic Analysis

In the fourth quarter of 2013, China's national economic output grew by 7.7 percent, slipping from 7.8 percent in the third quarter; this is in line with our forecast that "GDP growth in the fourth quarter of 2013 will be slightly lower compared to the third quarter" (as forecasted in "KPMG China Economic Globalization Watch: 3Q 2013"). For the full year 2013, GDP growth was also 7.7 percent, slightly lower than 2012 (See Table 1.1 for fourth quarter data (analysis of various indicators provided below the table)).

During the fourth quarter, YoY growth of industry value added was 10.3 percent, 10 percent, and 9.7 percent for October, November, and December respectively, reflecting a slow and steady downward trend. Since the industrial sector accounts for about 40 percent of China's economy, a decline in industry value-added will directly affect the overall growth of economic output.

Fixed asset investment growth also continued to fall over the last three months, first dropping from 19.2 percent in October, to 17.6 percent in November, and then slipping to 17.2 percent in December. Growth in December 2013 matched that of December 2012, the lowest level since February 2012. This shows that investment growth, which has been a main driver of economic growth, is contributing increasingly less to China's overall economic growth. Retail sales of consumer goods grew at a relatively stable rate in the fourth quarter.

Export continued to grow, driven predominantly by the US and Europe's economic recovery. In October, exports grew by 6.5 percent; November saw exports grow by 12.7 percent, which far exceeded expectations; and in December, exports growth slowed down to 4.3 percent after the US's record trade deficit in November. This trade deficit also reflects the continuing expansion of China's foreign exchange funds outstanding.

The China Federation of Logistics Purchasing (CFLP) PMI climbed to 51.4 in October and November, the highest in 2013, but fell back down to 51 in December along with production,

Table 1.1: 4Q 2013 Economic Data

Economic data (YoY, %)	Oct	Nov	Dec
1. GDP	Fourth quarter: 7.7; Full Year: 7.7		
2. Industrial value-added			
1) Industrial value-added of enterprises with annual operating revenue over RMB 20 million	10.3	10.0	9.7
2) Power generation	8.4	6.8	8.3
3. Investment			
1) Fixed assets investment	19.2	17.6	17.2
2) Real estate development	15	22.1	22.3
4. Total retail sales for consumer goods	13.3	13.7	13.6
5. Total imports and exports	6.5	9.3	6.2
1) Exports	5.6	12.8	4.3
2) Imports	7.56	5.34	8.3
6. Money supply			
1) Total social financing (unit: RMB trillion)	0.86	1.23	1.23
2) Broad money (M2) balance	14.3	14.2	13.6
7. Consumer prices	3.2	3.0	2.5
1) Food	6.5	5.9	4.1
8. Producer Price Index	-1.51	-1.42	-1.4
9. PMI			
1) China manufacturing PMI	51.4	51.4	51
2) HSBC manufacturing PMI	50.9	50.8	50.5
10. Fiscal balance			
1) National public revenue	16.2	15.9	
2) National public expenditure	21.9	4.1	

Source: Wind, National Bureau of Statistics of China, People's Bank of China, Ministry of Commerce, State Administration of Foreign Exchange, General Administration of Customs, Ministry of Finance, KPMG analysis

new orders, and export orders, indicating that demand is trending downwards. The SME-concentrated HSBC PMI also shadowed China's CFLP PMI trend. The indicator reached its peak for 2013 in October, and also fell in November and December.

New social financing was only RMB860 billion in October, down 33 percent YoY (absolute volume was RMB426.6 billion); social financing grew by 9.4 percent in November, but declined by 24.5 percent YoY to RMB1.23 trillion in December (absolute volume was RMB398.2 billion). The drop in social financing was primarily caused by the significant decline of trust loans. The decrease in debt financing may have been caused by high interest rates (see section on thematic analysis). Concurrently, M2 growth fell from 14.3 percent in October to 14.2 percent in November and 13.6 percent in December, hitting a new low for 2013 and possibly signaling the gradual stabilization of monetary policy. In the fourth quarter, liquidity indicators did not provide a strong basis for the economic growth rebound to continue.

Overall, the fourth quarter saw most indicators reflecting weaker economic growth relative to the third quarter.

2013 Economic Review

The momentum of China's economic recovery in the second half of 2012 subsided in January 2013. This is due to a myriad of factors, including: overcapacity, weak domestic demand and slowing exports; economic output fell over the first two quarters of 2013 (GDP grew by 7.7 percent and 7.5 percent in the first and second quarter respectively). In the second half of the year, the slowing economy prompted Premier Li Keqiang to publicly announce (in June and July) that the economy will operate at a reasonable pace, with economic growth and employment to stay above a "lower limit", and price hikes not to exceed an "upper limit".

Through policy fine-tunings such as: structural adjustments, the fostering of new consumption hotspots and export stimulus, the Chinese government guided market expectations (which allowed the market to gain upside momentum). Under a series of stable growth policies, China's economy began to recovery steadily, with GDP growth reaching 7.8 percent in the third quarter (representing a significant recovery relative to the second quarter) and 7.7 percent in the fourth quarter.

The economic trends of 2013 and 2012 are similar in some aspects, such as slower economic growth in the first half of the year, and the government's follow-up measures to stabilize growth. Based on the data available, the 2012 downturn occurred in the third quarter and the economy thereafter rebounded in the fourth. The 2013 economic rebound happened earlier in the year versus 2012, which was accompanied by an early rebound in industrial value-added and also power generation (which is a more accurate indicator of economic performance). Overall ex-factory price level (all industrial products) and PMI, which reflects industrial demand, also saw an earlier rebound in 2013 versus 2012. However, the economic drivers of the two rebounds were not the same; the 2012 rebound was driven by fixed asset investment growth (primarily infrastructure investment), while the 2013 rebound was the result of fixed asset investment growth (with a focus on the manufacturing sector) and a rebound in exports to developed economies.

In our KPMG China Economic Globalization Watch: 2Q 2013, we held the opinion that investment-oriented economic stimulus is gradually weakening as a driver of economic growth. This is due to the fact that the fundamentals of China's economy did not change as a result of the growth stabilization plan, instead what changed were the random (policy) factors, as well as the economic rebounds driven by policy factors. The key problem in China's economy is not the short-term decline of growth, but rather the potential of slower growth in the long-term. More specifically, China is bracing for challenges in its attempt to raise labor supply, return on capital, and total-factor productivity.

Consumption, which makes up approximately one-third of China's GDP, has been significantly lower than expected since the start of 2013. In January and February 2013, YoY growth in total retail sales of consumer goods fell 2.9 percentage points relative to December 2012, while the subsequent steady rise was limited in magnitude; by December, YoY growth had only recovered to 13.6 percent, which was just slightly higher than the lowest point in July and August 2012.

Since the 18th National Congress of the CCP, most Party and government organizations, as well as enterprises and institutions, have been promoting practical initiatives focusing on 'mass line'¹ recovery and education. Mass line education involves engaging the top cadres of the Communist Party with ordinary citizens of China, to promote a greater connection for what the market desires and values. This, to some extent, has helped curb extravagant spending, the use of public funds for entertainment purposes, and wasteful consumption; policies such as the 'eight-point regulation' and 'mass line policy' have had a greater effect on the spending of public funds, which in turn has had an impact on societal trends as a whole, with a significant drop observed in consumption growth for high-end dining and gifts.

Fixed asset investment fell to 19.6 percent in 2013, down one percentage point from 2012. The main drivers of investment growth were infrastructure and real estate investment. Manufacturing investment growth has dropped from 22 percent at the end of 2012, to 18.5 percent in 2013; on the other hand, infrastructure growth has rebounded from 13.7 percent at the end of 2012, to 21.2 percent in 2013, while real estate investment has risen from 16.2 percent at the end of 2012, to 19.8 percent in 2013, offsetting the fall in manufacturing investment growth.

As for foreign trade, 2013 saw greater fluctuations. Although total foreign trade grew at an acceptable level during the first four months of 2013, the extremely high growth in exports and imports from Hong Kong, coupled with the mediocre numbers for the US, Europe, Japan and other emerging markets, formed an abnormal structure that led to suspicions of fake export data. In early May, the SAFE issued the Circular of the State Administration of Foreign Exchange on Issues concerning the Strengthening of the Administration of Foreign Exchange Capital Inflows. After the 'Circular' was issued, trade growth plunged (even experiencing negative growth levels), suggesting that some degree of mis-statement had occurred in foreign trade data over the previous period. After July, import growth stabilized, while the overall figure for exports fell, and fluctuations have been exacerbated.

On the monetary policy and liquidity front, June proved to be a watershed event. Based on the total social financing and M2 indicators, liquidity had been loose prior to June, but a policy shift occurred after June and liquidity began to tighten.

¹The Mass Line (in Chinese *qunzhong luxian*) is the political, organizational and leadership method developed by [Mao Zedong](#) and the [Chinese Communist Party](#). It is supposed to help "concentrate the correct ideas that the masses gain in everyday life" as described by a Revolutionary Communist Party USA.

Following that, the inter-bank offer rate surged, which resulted in a cash and liquidity “crunch”; in July and August, liquidity loosened slightly but remained tight in the fourth quarter. Incremental funds outstanding for foreign exchange has been high since the third quarter, but the impact from tight liquidity and a significant rise in interest rates are expected to persist into 2014 (see thematic analysis section).

2014 Economic Outlook

At the Third Plenary Session of the 18th CPC Central Committee, which was held in November 2013, a meeting communiqué and the Decision of the CPC Central Committee on Major Issues Pertaining to the Strengthening of Reforms was published, clarifying the direction that China's reforms will take over the next decade. The Politburo and the Central Economic Work Conference also designated 2014 as a year of reform. It is predicted that 2014 will see far-reaching reforms in a wide range of fields.

This time is different

For more than a decade, the progress of China's reform has been very limited. The common explanation is that reform will affect groups with vested interests and deeper reform will bring

about growing conflicts; with many facets of government involved in different interest groups, progress has indeed lagged. But we believe that the new leadership led by Xi Jinping and Li Keqiang will have a different attitude toward reforms; since the Third Plenary Session in 2013, the Xi-Li team has implemented a series of fresh initiatives in areas such as the government's executive power, anti-corruption, and antitrust. Moreover, the relevant government departments have also been introducing more specific policies directed at the main areas of reform. Therefore we believe that it may be different this time around.

Further strengthening of SOE reform

The Decision document proposed the active cultivation of a mixed-ownership economy. The belief is that "a mixed-ownership economy (whereby state capital, collective capital, and non-public capital are integrated) will form the important foundation for the basic economic system", and that "state-owned capital investment projects will be opened up to participation from non-state owned capital, and employee stock ownership will be allowed in a mixed-ownership economy, thus aligning the interests of capital owners and workers". At the same time, "improvements will be made to the state-owned asset management system; the state-owned asset supervision will be strengthened through a focus on capital management;

Table 1.2: Reforms predicted for 2014 and the next few years

Area	Key content of reform
Market access	<ul style="list-style-type: none"> Based on a list of exceptions, market players of varying types may have legal and equal access to sectors not included on the list Pre-established national treatment for foreign investment
Reforms to factors of production	<ul style="list-style-type: none"> More market-oriented reforms in sectors such as: water, oil, gas, electricity, transport, telecoms Unified urban and rural land construction market Mechanism for a market-oriented renminbi exchange rate will be further improved, interest rate liberalization will be strengthened
Financial system reforms	<ul style="list-style-type: none"> Opening up to domestic entities, including the establishment of small- and medium-sized banks and financial institutions with private capital IPO resumption and reform; a registration system for stock issuance Multi-channel equity financing channels, including an improved OTC market Further growth in the proportion of direct financing Bilateral opening up of capital markets, including more QFIIs and RQFIIs Deposit insurance system will be introduced Catastrophe insurance may be introduced
Fiscal reforms	<ul style="list-style-type: none"> Implementation of real estate tax legislation Environmental protection fee-to-tax conversion Clarification of central government and local governments' taxation responsibilities based on the principle of having mutually compatible powers and expenditure responsibilities
Urbanization	<ul style="list-style-type: none"> Rural concessions may participate in market transactions Large-scale farms may emerge Prudent implementation of pilot programs to promote rural housing property mortgages, guarantees and transfers Relaxation of the Hukou (household) system in small- and medium-sized cities Issuance of local government bonds
Trade liberalization	<ul style="list-style-type: none"> More free-trade zones
Healthcare reforms	<ul style="list-style-type: none"> Private capital may invest in/acquire public hospitals
Family planning reforms	<ul style="list-style-type: none"> Family allowed to have two children, if either husband or wife is an only child

Source: Third Plenary Session meeting communiqué and resolution, KPMG analysis

reforms will be carried out on the state-owned capital authorization management system; state-owned asset management companies will be formed, and state-owned enterprises that meet the requirements will be restructured into state-owned capital investment companies", and "the proportion of the capital gains made by SOEs that will go to the state will be raised to 30 percent by 2020, and it will primarily be used to safeguard and improve the people's livelihood".

It is predicted that major developments in SOE reforms will occur in 2014. Firstly, the non-state sector economy is now considered to be as important as the state sector economy, and to achieve mixed-ownership among SOEs, non-state capital will be encouraged to invest in or even hold controlling stakes in SOEs. In 2014 (similar developments were already observed in some provinces and cities in December 2013 and January 2014), it is expected that SOE mixed-ownership reform will enter a full-fledged reform stage, and private capital investment in, or perhaps control over SOEs, will no longer be a rarity. Secondly, SOE reforms will emphasize capital management, and with the adoption of Singapore's Temasek Holdings model, a large number of state-owned asset management companies will emerge in 2014. Thirdly, the proportion of capital gains that SOEs are required to transfer to the state will be raised, thus allowing government access to more financial resources for social security and projects to increase peoples' livelihoods.

Further improvements to develop the market system

The meeting communiqué mentioned, for the first time, that the market will play a decisive role in resource allocation. This differs significantly from its previous "fundamental" roles. Specifically, a range of domains will be involved, including: market access, reforms to factors of production, financial system reforms, tax reforms, urbanization, healthcare reforms and family planning reforms. With SOEs undergoing a mixed ownership reform path, and given the behavior of SOEs as market participants are more in line with the principles of market economy, the SOE reforms will be a critically important component of the market system's development.

"New normal" for economic growth in 2014 and thereafter

The fundamentals of China's economic growth have already changed, the old model that relied on external demand and high investment growth (guided by local governments) is transforming, and a new economic engine has yet to form, thus China will face a "new normal" characterized by slowing growth that will decline from the double digit figures of the past, to about 7-8 percent.

Moreover, the CPCCC Organization Department's latest 2014 circular indicated a different assessment format for local governments that de-emphasized the GDP indicator and instead added quality and efficiency and sustainability indicators; the assessment of government debt has also been strengthened, which in turn strengthens auditing during the term of office and post-term accountability. The People's Bank of China confirmed its key tasks at a 2014 work conference, one of which is its reiteration of systemic financial risk prevention (in contrast to 2013, regional financial risk was not mentioned). Considering issues such as local government debt risk (including financing vehicles), real estate bubbles and corrections, and the liquidity situation among financial institutions, we cannot rule out the possibility of outbreaks of regional financial crisis in 2014, and this may have a negative impact on economic growth.

GDP growth reached a high of 14.2 percent in 2007, but fell to

7.7 percent by 2013; it is expected that this trend will continue in 2014 with growth further slipping to about 7.6 percent and a repeat of the trend (high growth in the early and late phase, low growth in the middle) in 2012 and 2013. Regarding the three main drivers of economic growth (main drivers are investment and consumption, followed by net export of goods and services), our analysis is as follows:

Firstly, investment growth will slow. With gradual strengthening of reforms, investment growth, the driver of China's rapid economic growth over a long period of time will gradually slow down. Infrastructure, real estate, and manufacturing are the main components of fixed asset investment, these three components account for about 80 percent of total fixed asset investment. With respect to infrastructure, the new assessment format for local governments will provide less motivation for local governments to seek financing and carry out infrastructure investments, hence infrastructure investment growth is projected to be slightly lower than the 23 percent achieved in 2013. Specifically, the Central Economic Work Conference stressed "a focus on preventing and controlling local government debt", "the categorization of local government debt under fully-covered budget management", and "the undertaking of responsibility over regional local government debt by provincial and municipal governments". Concurrently, the CPCCC Organization Department also strengthened the government debt assessment component for government officials, and will seek accountability regarding the problems that emerge. This will adversely affect infrastructure investment growth. As for real estate, the construction of affordable housing will carry on to some degree so as to meet the 12th Five-Year target of 36mn units, and the urban shantytown reforms will also continue. Additionally, land acquisition area growth rose in the second half of 2013, with cumulative YoY growth being 22.2 percent as of the end of November, the highest since March 2013; this indicates that real estate investment growth may continue to climb in 2014. On the manufacturing investment front, given the impact of overcapacity and a decline in the real economy's return on investment, it is projected that manufacturing investment growth will slow down slightly in 2014.

Secondly, consumption growth will rise slightly. 1) The 2013 slowdown of urban residents' income growth resulted in slower consumption growth that year; with the expected launch of a series of reform measures in 2014 that will increase residential income, the hope is that income growth will accelerate. 2) The central government's regulation of the "three public consumptions" caused a decline in consumption growth, but this downward trend had already began to weaken in the second half of 2013, and the policy effects of the government's "containment" of extravagant behavior may dissipate by 2014. On the whole, it is projected that consumption growth will rise slightly in 2014.

Lastly, exports growth will rise slightly in 2014, with the main determining factor being the continued recovery or slow recovery of the developed economies (US, Europe, Japan).

China's Government Bond Yields

Rising government bond yields reflect opportunities for economic transformation

In 2013, one of the most important events, with respect to China's economy and financial market, was the rise in interest rates; the yield-to-maturity on the interbank fixed rate 10-year government bonds climbed to 4.72 percent on November 20, 2013, the highest since March 2005; within the full year 2013, rates surging by 132 basis points (see Figure 1). The rise in China's government bond yields may reflect the push towards interest rate liberalization by both the market and regulatory authorities, which will facilitate China's economic transformation.

Government bonds are regarded as risk-free debt because the government can, in theory, raise taxes or increase the money supply to repay maturing debt. Yields on short-term government bonds serve as risk-free rates of return and also the basis for calculating the expected returns on other assets.

Government bond yields are often determined by a number of factors, including: the national economy's real GDP growth, inflation, supply and demand factors, and risks. Government bond yields can be perceived as nominal GDP growth (real GDP growth + inflation rate) since it represents the actual return on investment (real GDP growth) and time value of money (based on inflation). Over the past 11 years, the yield-to-maturity (YTM) curve on ten-year government bonds and monthly CPI figures have basically stayed consistent (compare Figure 1 and Figure 2), and it was also partially consistent with the real GDP growth trend.

What was unusual about government bond yields, in the second half of 2013, was that yields rose without a significant increase in inflation or decrease in GDP growth. In 2013, and particularly in the second half, government bond yield movement has strayed from the usual trend over the past 11 years.

The rise in yields can be attributed to the efforts by regulatory

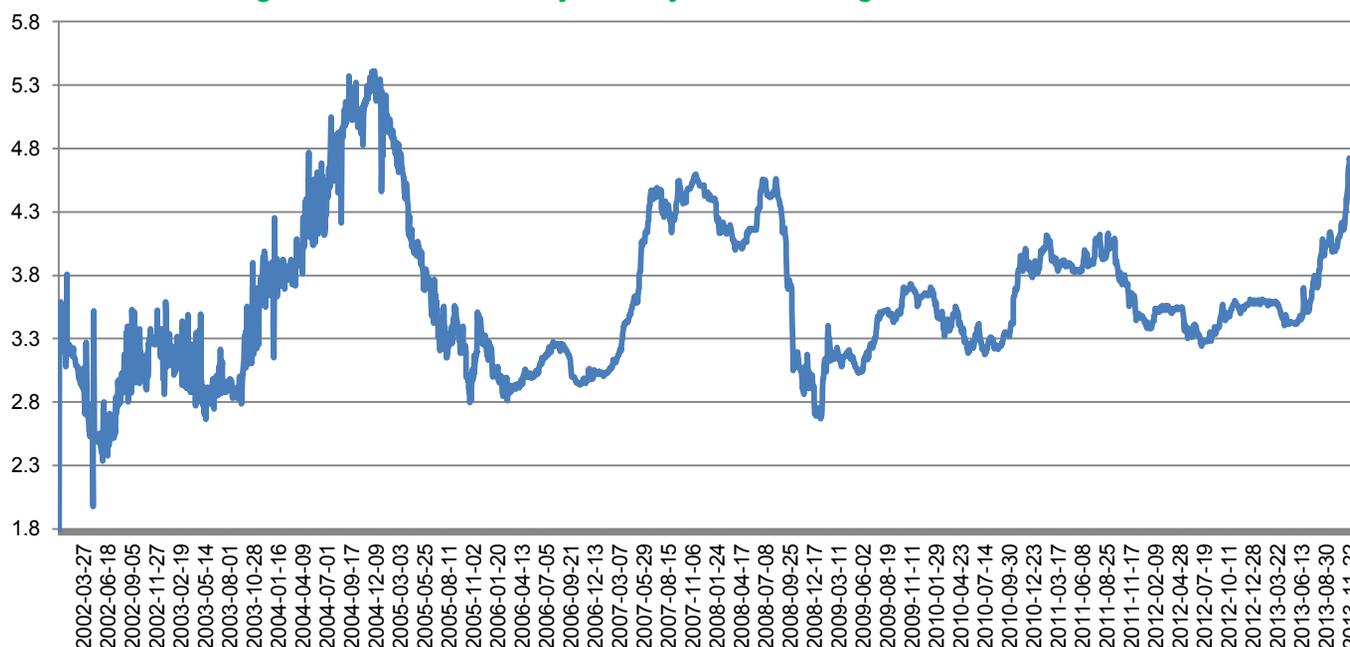
bodies to curb shadow banking activities of commercial banks. These curbs, such as putting off-balance-sheet financing items back on the balance sheet, as well as stricter regulatory requirements (such as the loan-deposit ratio), have resulted in tighter liquidity and higher interest rates. And due to the long-term funding demand of the real estate sector and local government financing vehicles (LGFVs), as well as the shift towards interest rate liberalization, higher interest rates were ultimately reflected in the interbank market.

Aside from demand and supply factors, default risks constitute another important factor (i.e. government defaulting on its debt obligations). Most empirical studies indicate that, in developed economies, rising public debts will lead to a corresponding rise in long-term government bond yields. For instance, a 2012 research paper by Tigran Poghosyan (Economist at the Fiscal Affairs Department of the IMF) showed that, in developed economies, a one percentage point rise in the government debt-to-GDP ratio will lead to a corresponding two basis points rise in government bond yields. Studies of developing economies have drawn similar conclusions. For example, another research paper also published in 2012 by the IMF showed that a one percentage point rise in the government debt to GDP ratio of a developing economy will lead to a corresponding six basis point rise in government bond yields. When the overall fiscal deficit-to-GDP ratio rises by one percentage point, the long-term government bonds yield will rise by 30 basis points.

The National Audit Office recently released data focusing on the Chinese local government debt situation. The data shows that, as of the end of June 2013, total local government debt stands at RMB17.9 trillion, growing by 67.3 percent since the end of 2010 (RMB10.7 trillion). The data also indicated that the growth of local government debt also increased. As of the end of June 2013, the outstanding debt of provincial, municipal and county-level governments stands at RMB10.6 trillion, representing an overall growth of 58 percent from the end of 2010 (RMB6.7 trillion) and an average annual growth rate of 20 percent. The rising government bond yields reflect the market's concern over government debt risks.

Aside from the government bond market, interest rates have

Figure 1.1 Yield-to maturity on ten-year interbank government bonds



Sources: Wind, www.chinabond.cn, KPMG Analysis

also risen across the board in other markets. In the money market, the interbank repo rate spiked to an all-time high (igniting widespread discussion about a cash crunch) on June 20 and surged again in December. The YTM of AAA-rated bonds hit 6.12 percent on December 31, 2013, and over the first few days of 2014, it climbed to a historically high 6.15 percent.

In contrast to the recent highs in yield levels, China's financial market has over the past decade has been characterized by its "financial repression", which was the result of artificially low interest rates.

Carmen Reinhart (Peterson Institute for International Economics) and Belen Sbrancia (University of Maryland) released a paper in 2011 that described the four components that make up financial repression: 1) suppression of interest rates through measures such as the suppression of government bond yields and deposit rates, 2) government's control over domestic financial institutions such as banks through equity ownership or other methods (including directives on lending practices), alongside efforts to raise the entry barriers into the finance industry, 3) higher deposit reserve ratios, requirements for domestic banks to hold government bonds, and restrictions imposed on other institutions with regard to the holding of government bonds, 4)

restrictions on cross-border capital flows through government's control over the capital account. In the paper, they defined financial repression as an implicit tax.

China's situation fits the one described by these two scholars. For instance, the government bond yields should in theory represent the nominal GDP growth rate of the country, but China's government bond yields have consistently been far lower than its nominal GDP growth rates and even its real GDP growth rates (see Figure 1, Figure 2 and Figure 3). Bringing down the risk-free rates will reduce the return on other risk assets. China's deposit rate has, for the most part, been lower than its inflation rate, which is referred to as a "negative real interest rate" situation. The Chinese government holds equity stakes in most domestic banking and non-banking financial institutions, hence it is not uncommon for the government to intervene directly or indirectly with respect to bank lending. At present, the renminbi deposit reserve ratio is 20 percent for large deposit-based financial institutions, this is far higher than that of the US (some countries such as Canada, the UK, New Zealand, Australia and Sweden do not even have reserve requirements in place) and among the highest in the world (ranked behind only Suriname and Lebanon in a table of 34 countries). China's bond market is essentially its interbank bond market. Cross-border capital flows are still restricted to a large extent.

Figure 1.2 monthly CPI (%)



Source: Wind, KPMG Analysis

Figure 1.3 China's quarterly real GDP growth (%)



Source: Wind, KPMG Analysis

Low interest rates have helped drive China's economic development over the past decade or so, as is evident in the significant changes to the infrastructure construction sector and the rapid development of foreign trade; but these developments have also produced a wave of problems that include overcapacity in the manufacturing sector, real estate speculation and bubbles, a reliance on low cost funding, and the gradually waning role of debt in driving economic growth. It was observed in our KPMG China Economic Globalization Watch: 2Q 2013 that the incremental aggregate financing required per unit of economic output has been gradually growing in China (debt constitutes over 95 percent of aggregate financing), which means that the unit contribution of aggregate financing (debt) to economic growth has been gradually declining.

The other aspects of low interest rates are lower household income and a declining consumption-to-GDP ratio. China's economy is imbalanced in the sense that its investment-to-GDP ratio is too high, while its consumption-to-GDP ratio is too low, and one of the main reasons for this is the low interest rate level.

The wave of policies introduced before and after the Third Plenary Session shows that the government and regulatory authorities are already in the process of lifting this "financial repression". The policies include: the removal of the lending rate floor for all loans (excluding residential mortgage loans), announced by the People's Bank of China on July 19, 2013; as well as market pricing for CD (certificates of deposits) rates, potential introduction of a deposit insurance system, and acceleration of the deposit rate liberalization process. The supervision of shadow banking activities by regulatory authorities has already led to a rise in various interest rates. A commitment was made at the Third Plenary Session to reduce entry barriers into the financial industry, which will allow for the establishment of small- and medium-sized banks through qualified private capital. State-owned enterprises (including banks) will be reformed to adopt mixed ownership structures. Another decision made at the Third Plenary Session also mentioned the call for "the promotion of an open, two-way capital market as well as orderly increase the convertibility of cross-border capital and financial transactions".

On January 6, 2014, it was reported that the Circular of the State Council General Office on the Strengthening of Supervision over Shadow Banking and Other Related Issues (State Council Document No. 107) had been issued. The fact that it was issued by the State Council and not financial regulators like the China Banking Regulatory Commission is testament to the importance of this issue to China's leaders.

Interest rates may continue to rise in 2014. It was also reported that rising yields may have resulted in the postponement or significant downscaling of corporate bond issuance by the Agricultural Development Bank of China, China Railway, electric car maker BYD, and internet giant Baidu. Rising interest rates will have an adverse impact on rate-sensitive areas such as real estate, local government debt and some small financial institutions. The bubbles in the real estate sector may be squeezed in some regions, which will adversely affect local government revenues and create liquidity risk for some small financial institutions; local governments will face higher interest rates and shrinking revenue, which will heighten default risk on government debt.

However, interest rate liberalization does not always lead to a rise in interest rates since measures could first be taken to curb the rise in risk-free rates. The IMF's Laura Jaramillo and Y. Sophia Zhang published a research paper in 2013 that showed

the ownership structure of government bond investors also plays an important role in determining yield levels. In particular, when government bond investors are mostly domestic non-banking financial institutions and central banks (domestic and foreign), the rise in government bond yields brought on by the rise in debt ratios will be partially offset by this factor: the most prominent example is the lower US treasury yields as a result of the PBOC's large holdings of US treasuries. Further liberalization of China's government bond market internally (including non-banking financial institutions) and externally (including the entry of more Qualified Foreign Institutional Investors and expansion of investment quotas for foreign central banks) will help to lower the risk-free rates, as well as aggregate market rates. Thus, the negative impact of rising interest rates on enterprises, local governments and financial institutions will be reduced.

Due to market factors, as well as the push for financial reforms by regulatory authorities after the Third Plenary Session, the resulting rise in government bond yields and other interest rates implies a rise in borrowing costs, which in turn implies the growing influence of market pricing on capital; this is consistent with the decision made at the Third Plenary Session to "let the market play a decisive role in resource allocation". The market-driven rise in interest rates implies the presence of excellent reform-based opportunities generated by interest rate liberalization. Rising interest rates will facilitate the elimination of obsolete production capacity, suppress the real estate bubble, improve the structure of the economy, raise household income and increase the contribution of consumption toward economic growth. As such, the imbalances in China's economy will be addressed to a significant extent and the sustainability of economic growth will be strengthened. As discussed in KPMG's Third Plenary Session Research Series Part 2: China's New Golden Decade Ahead, it is possible for China's economy to enjoy another golden decade.

Part II: Industry Analysis, Foreign Direct Investment into China²



Aerospace and aviation

Foreign aircraft manufacturers show interest in China's expanding commercial aviation market

Although, commercial aviation represents a significant sector for most developed countries, it has been hampered by strict controls on low altitude airspace in China. Reforms were announced in 2010 to reform low altitude airspace by 2015. Recently, the Civil Aviation Administration of China has issued a series of measures to support the development of commercial aviation. According to the Administration, administrative approval power will be handed down to government at lower levels, more commercial pilots will be trained and relevant infrastructure will be greatly improved. China plans to increase its aviation fleet size to 10,000 aircraft from the current 1,610 at a 22 percent annual compound growth.³ Meanwhile, the number of China's

billionaires is also on the rise, which should lift the demand for business jets. The potential growth of this market has already attracted interest from some Western commercial aircraft manufacturers to invest in China.

Austrian Diamond Aircraft was among the earliest group of foreign aviation manufacturers to set up production in China. Its joint venture in Shandong, Bin Ao Aircraft, has just won a new order for 36 planes. The company has sold 247 aircraft since its establishment and has a dominant position in China's pilot training aircraft market.⁴ American manufacture Cessna Aircraft has partnered with AVIC and the Chengdu government to set up local production capability for large-cabin business jets. US-based Bell Helicopter has also partnered with Chinese firms to form a pilot training school in Henan and two maintenance training centers in Guangdong.

These opportunities are not without imminent challenges. Commercial aviation is still in its infancy in China, and there is much work to do in terms of investment, including: building airports, training pilots and crew, opening flight schools and hiring maintenance companies.

² http://news.xinhuanet.com/fortune/2013-10/28/c_117904231.htm; <http://economy.caijing.com.cn/2013-09-17/113313945.html>;
<http://online.wsj.com/news/articles/SB10001424052702304791704579209550625940422>; <http://online.wsj.com/article/BT-CO-20131114-703779.html>; <http://www.aopa.org.cn/a/119/2013/1031/12668.html>; http://china.cncb.com/show_news.asp?id=2404;
<http://blogs.wsj.com/moneybeat/2013/11/10/temasek-takes-stake-in-formula-producer-yashili/>;
<http://www.yicai.com/news/2013/12/3171855.html>; <http://www.d1ev.com/news-25864/>;
<http://www.thethirdmedia.com/Article/201312/show327241c77p1.html>; <http://www.big-bit.com/news/159531.html>;
<http://www.electronicweekly.com/news/business/nxp-datang-establish-china-jv-for-auto-ics-2013-12/>

³ http://news.xinhuanet.com/fortune/2013-10/28/c_117904231.htm

⁴ http://news.xinhuanet.com/fortune/2013-10/28/c_117904231.htm

Industrial equipment and machinery

European equipment and engineering expertise helps China expand its hydropower capacity

Alstom Renewable Power, the French industrial conglomerate specializing in renewable power generation equipment and services, has upgraded and expanded its Tianjin hydro facility with an investment of 100 million Euros. Its new production facility is equipped with a global technology center that enables Alstom to become a complete value chain entity in China, capable of carrying out a vast array of hydropower activities. So far Alstom has a 20 percent market share of the total Chinese installed capacity of large hydropower equipment.⁵

The Chinese government is keen to push renewable energy in order to reduce pollution from coal-fired power stations. Hydropower is relatively safer and a more developed market position, compared to nuclear, wind, solar and other forms of renewable energy. According to China's 12th Five-Year Plan (2011-2015) for its energy sector, it plans to source 11.4 percent of its energy from renewable sources by 2015, of which hydropower will contribute two-thirds. By then China will have the capacity to become the world's largest hydropower generator.⁶ The market opportunity has lured a number of Western hydropower engineering companies; Alstom's two European rivals, Andritz from Austria and Voith from Germany, are also interested in the turbine and generator equipment for China's hydropower plants. They are actively seeking projects through joint ventures.

But foreign hydropower engineering companies have limited room for maneuvering in China. Domestic companies are aggressively building up their market share after having learned the industry from foreign partners. Harbin Electric and Dongfang Electric have dominated China's hydropower generator market in terms of installed capacity, and have become two of three top players in the industry other than Alstom. In this emerging competitive landscape, technique and quality are likely to be the selling points for foreign manufacturers to maintain a slight strategic lead over domestic manufacturers, who are more price competitive.

Insurance and financial services

China reinsurance market heating up - Swiss Reinsurance invested in New China Life Insurance

In November 2013, Swiss Reinsurance Co Ltd of Switzerland acquired 159.2 million ordinary shares, or a 4.9 percent stake in New China Life Insurance Co Ltd, a Beijing-based insurance company, from Zurich Insurance Co. Ltd. of Switzerland, a wholly-owned unit of Zurich Insurance Group Ltd of Switzerland, for CNY19.648 (USD 3.22) per share, or a total value of CNY3 billion (USD493 mil), in a privately negotiated transaction. China is the fifth largest life insurance market in the world, yet its market penetration is still very low. Based on gross total premiums, New China Life Insurance is the third largest life insurer in China offering health and life insurance products.

The motivation for Swiss Reinsurance to enter into this transaction is to tap into China's financial services industry, as it potentially opens up, and specifically its insurance sector. From Zurich's viewpoint, the transaction represents yet another (the second) share sale of New China Life Insurance since July

2013. In May 2013, Zurich Insurance received approval from China's insurance regulator to upgrade its Beijing branch to a wholly owned subsidiary, with the intention to expand its China business through this new subsidiary. The purpose of its divestiture was to avoid increased financial exposure due to a large single holding of shares. According to Basel III regulations, Zurich Insurance needs to set aside additional capital for maintaining a substantial investment in a financial firm. After the sale, Zurich plans to reinvest the proceeds into diversified investments in Asia, maintain balanced exposure to the Asian market, and benefit from diversification of its equity portfolios.

The result of the transaction was viewed as highly favorable in the global market: 150 qualified foreign institutional investors have expressed to buy insurance stocks listed in mainland China. Thus, it is expected that foreign investment will contribute to the steady growth of the Chinese insurance market.

Agribusiness – dairy products

Foreign investors target Yashili International for agribusiness growth

In November 2013, Temasek, Singapore's state-owned investment fund, as well as four other firms (which include foreign and domestic investment funds) agreed to buy a USD213 million dollar stake in Yashili International Holdings Ltd, a Chaozhou-based producer and wholesaler of milk formula products and nutrition products, and a majority-owned unit of China Mengniu Dairy Co. Ltd. of Hong Kong, from Mengniu.

Mengniu, China's largest milk producer by sales volume, offered a buyout bid worth USD1.6 billion for all outstanding shares of Yashili in June, 2013. However, the offer was short of the 90 percent threshold that would have enabled the firm to make a compulsory acquisition of the remaining shares and delist Yashili from the exchange. Upon execution of the offer in August, 2013, Mengniu was therefore required to sell down its stake in Yashili to ensure the still-listed company met Hong Kong's public float requirements.

Carlyle Group L.P. had owned a 24.4 percent stake in Yashili prior to Mengniu's investment. Among other moves by foreign players, Danone SA took a 4 percent stake in Mengniu through the creation of a joint venture in May 2013. In 2012, Denmark's Arla Foods also bought a 6 percent stake in Mengniu. The current inflow of foreign demand toward the Chinese dairy industry reflects a growing attraction to the dairy market in China. China's dairy industry is very fragmented, making quality control a challenge, which is now also pushing dairy companies to consolidate with foreign or domestic investors. In addition, due to ongoing food safety issues in China, this is an industry that has a high potential for growth amongst foreign and domestic agribusiness market players, and investors.

Consumer goods and services – nondurable goods

Hershey Acquires Shanghai Golden Monkey Food

Hershey Co. has announced that its wholly-owned subsidiary, Hershey Netherlands B.V., has signed an agreement to acquire 80 percent of Shanghai Golden Monkey Food Joint Stock Co. Ltd. (SGM). SGM was established in 1996; its products include

⁵ <http://www.alstom.com/china/cn/products-and-services/power-generation/alstom-power-in-china/>

⁶ http://www.gov.cn/zwqk/2013-01/23/content_2318554.htm

over 200 varieties of candy, chocolate, jelly, bean products, and snack foods. The transaction, reported to be worth over USD500 million, is expected to conclude in the second quarter of 2014 and is subject to China regulatory and SGM shareholder approval. SGM, founded in 1996, is a privately-held confectionery company based in Shanghai, China. The company has achieved double digit growth in recent years, with annual sales expected to be over USD225 million in 2013.

The acquisition shows that China has become a focus of Hershey's overseas expansion. According to the company's forecasts, China's chocolate market will net an average annual growth of 12 percent from 2012 to 2017, while its candy market will rise around 9 percent annually in the same period. Hershey has increased its investment in China over the past several years: in May of 2013, it opened its new Asia Innovation Center in Shanghai, which enables the company to develop and launch new products customized to the tastes of Chinese consumers. With the addition of SMG, Hershey could accelerate its expansion in China, a country that will probably develop into the company's second largest market in the world by 2017, second only to the United States.

The deal will offer Hershey an opportunity to penetrate deeper into China's second-, third-, and fourth-tier markets, which may see tremendous consumer growth potential in the mid-term. SMG has around 130 sales offices, 1,700 sales representatives and 2,000 distributors across the country and has a strong presence in small and medium sized cities and rural areas. Hershey could build on the success of SGM's effective sales force to develop a comprehensive national network in China.

Consumer goods and services - durable goods

Samsonite looks to China for growth, targeting strategic acquisitions

Samsonite, one of the world's largest luggage makers, plans to allocate up to USD1 billion to acquire local Chinese brands over next few years, as part of its efforts to extend its market share in the country, the company's CEO Tim Parker said in a recent press interview. Samsonite has already identified an acquisition candidate and looks to execute its first China M&A deal in over three years⁷.

According to its acquisition plan, Samsonite is looking to increase its allocation of foreign investment to tap into the fast-growing Chinese market, which currently accounts for approximately 10 percent of the company's global revenues. In addition, as the rise of China's middle class fuels leisure and business travel, Samsonite believes that China has the potential to overtake the US as the biggest luggage market in the world. However, there are risks to Samsonite's gamble on the Chinese market: employment costs are rising as well as property costs associated with rent. These pose risks to Samsonite's gross margin, should it attempt to take advantage of the burgeoning consumer sector in China.

On the upside, Samsonite, via its local brand acquisitions strategy, may be able to achieve higher Chinese market penetration in lower-tier cities, where consumers have ever-growing purchasing power. Samsonite generated around 33 percent of its revenues in second-tier cities this year, up from 25 percent just a year ago. These markets are becoming more

and more important in the country's commercial landscape; the company could take advantage of local brands' product portfolio and sales network to better serve the needs of people in small- and medium-sized Chinese cities.

Industrial - automotive

More JVs seek participation in the automotive electronics industry

NXP Semiconductors, a European technology corporation, recently announced a joint venture with Datang Telecom, a local Chinese State-owned enterprise, to co-establish a new company called Datang NXP. The new company intends to develop and market advanced automotive electronics using high-performance mixed-signal technology. The products will be applied for battery management and power conversion in hybrid and electric vehicles, with NXP set to transfer and license intellectual property over to the joint venture. NXP will hold a 49 percent share in the JV, with Datang Telecom representing 51 percent.

Datang's close relationship with the government and vast business network offers several advantages for NXP's expansion into the Chinese market. By forming a joint venture, Datang will get access to the patented technology of NXP, including specific power and battery management intellectual property, which will assist Datang by shortening the R&D process. Datang will also benefit from the experience that NXP brings in the automotive electronics market, which could accelerate Datang's business development in this field. China's central government has a five year program in place, supporting and promoting the use of electronic and hybrid vehicles. Thus, NXP will directly benefit from direct access to a market that is strongly supported by China's government, while being able to access a growing consumer demand for electronic and hybrid automobiles in China.

As the automotive electronics market looks to expand, many corporations are also taking the opportunity to enter this industry. STMicroelectronics and ON Semiconductor are investing in R&D laboratories to support localization of automotive electronics.

Logistics and warehouses

Foreign logistic companies eye warehouses to create economies of scale

The logistics industry in China continues to be an area where foreign investors are establishing and continuing to operate. Investors are seeking to take advantage of relatively lower overall fixed costs, such as rent expense. The Chinese logistics and warehouse market has some recent demand growth for logistics and business park investment growing in recent months, and analysts believe that the demand for logistics and warehouses will continue.

One such investor, Global Logistic Properties (GLP) announced on November 14, 2013, that it will commence a USD3 billion fund to invest in logistics and warehousing projects in China. This will be the world's largest logistics infrastructure investment fund in China. The fund will invest in new, wholly-owned logistics development projects in China during a three-year investment period; in addition, they plan to align with six other institutional investors within the next three years to scale up their investments. The Singapore-listed firm, which owns and operates

⁷ <http://www.alstom.com/china/cn/products-and-services/power-generation/alstom-power-in-china/>

logistics facilities in China, Japan, and Brazil, seeks to retain a 56 percent stake in the fund; Global Logistic, which currently has 8.2 million square meters of completed facilities in China, is the largest provider of warehouse facilities in the country. According to the experience that GLP brings to the Chinese market, it will continue to bring mutual benefits to local Chinese partners, and more than likely foster more cooperation activities between GLP and other local logistics projects/warehouses in China, as this industry had just started gaining industrial demand throughout the year.⁸

However, there may be risks related to strategic cooperation. Firstly, from the aspect of stock equity level, domestic (Chinese) enterprises normally are the majority shareholders and are not willing to be controlled by foreign investors. There also may be an adverse selection issue, with each party trying to exploit only what is value-adding for each side, and the incentive to cooperate may be weakened. Secondly, from the aspect of business strategy, local enterprises are more involved in the low-end logistic properties, but foreign enterprises prefer high-end logistic properties, therefore serious conflicts of strategy and other interests may impact bilateral cooperation.

High technology

Tech giants to build operations and innovation centers in China

On Dec. 20, 2013, IBM signed an agreement to build a software innovation center in Qingdao Hi-tech Zone, the first high-tech software innovation center in Qingdao. The main projects include: an IBM Software Innovation Center, IBM software-based joint solutions exhibition center, localized software products promotion platform, and a sales center. The strategic areas of cooperation cover smart city, networking, cloud computing, and intelligence analysis. Once completed, the project is expected to achieve sales of over RMB500 million in 3 years, as well as train approximately 6,000 professional certified engineers.⁹

SAP set a precedent in this area by moving operations to China. On November 22, SAP China opened its Nanjing Innovation Center, thus the world's software leader has officially settled in China and has begun operations. The site now focuses on innovation and R&D big data processing, as well as mobile applications and cloud computing. The center also cooperates with local organizations to enhance the construction of "Smart Nanjing", strengthening and improving city management, and supporting development of local enterprises.¹⁰

According to China's 12th Five-Year Plan (2011-2015), the government has stressed more effort and support toward attracting FDI in high-tech, high-end manufacturing and modern services, while encouraging MNCs to increase R&D investment, cooperate with Chinese enterprises on R&D projects to improve quality of FDI, and make FDI a drivers of economic growth. Some local government authorities have implemented policies including subsidies, simplified administration procedures, and tax exemptions. Some of the challenges MNCs face are: higher personnel costs, retaining top talent, and how to ensure innovation in China benefits global operations. Yet, despite the challenges, it is widely expected that MNCs' investment in R&D will increase in the long run.

⁸ <http://www.law360.com/articles/488626>; <http://online.wsj.com/article/BT-CO-20131114-703779.html>

⁹ iqilu.com, Dec. 21, 2013. <http://qingdao.iqilu.com/qdyaowen/2013/1221/1796296.shtml>

¹⁰ xinmin.cn, Nov. 23, 2013. <http://tech.xinmin.cn/2013/11/23/22735006.html>

Part III: Overview of Foreign Capital Utilization¹¹

A general overview of China's utilization of foreign capital

Through the full year 2013, total foreign direct investment (FDI) into China was USD117.6 billion, up by a modest 5.25 percent versus 2012. China's manufacturing sector attracted USD45.56 billion, down 6.78 percent from a year earlier, representing a 38.7 percent percentage of total FDI flows. Despite the manufacturing sector's annual decline, the service sector more than made up for the difference. China's service sector attracted the majority share of FDI, USD61.45 billion, rising by a substantial 14.15 percent year-on-year, accounting for 52.3 percent of total FDI.

The government has reiterated its FDI goal of USD120 billion annually over the next three years. Shen Danyang, the Ministry of Commerce spokesperson, said that "FDI statistics have kept a positive growth trend for several consecutive months (since February); one of the reasons for the solid increase in FDI was the rapid rebound of investment from both European countries and America".¹² Chinese officials from the Ministry of Commerce stated that "they expect a steady inflow of capital this year (2014) amidst a global economic recovery".¹³ In comparison, China's outbound direct investment (ODI) totalled USD90.17 billion for the full year 2013, an increase of 16.8 percent year-on-year. Although total ODI was still less than total FDI, the growth rate of ODI continues to outpace that of FDI.

The eastern region of China once again reigned as the largest regional recipient of FDI, totaling USD96.88 billion, accounting for 78.45 percent of the total share of FDI. The eastern region grew by 4.72 percent versus 2012. The central region received USD10.1 billion of foreign capital, representing 8.79 percent year-on-year growth, while accounting for 14.7 percent of the national total. The western region continued to attract foreign investment as well, receiving USD10.6 billion, accounting for 6.85 percent of the national total, growing by 6.96 percent year-on-year. The eastern region produced solid year-on-year FDI growth, but the marginally larger year-on-year FDI growth rates in the central and western parts of China lend proof that the FDI migration towards the more inner areas of China is creating economic diversity within the regions, which also supports the government objectives to develop the third- and fourth-tier inland central and western cities of China. The western region of China covers six provinces: Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan; one municipality: Chongqing; and three autonomous regions: Ningxia, Tibet, and Xinjiang, according to the definition given by the Chinese government.

Regional FDI and M&A summary

Breaking down FDI by the three largest global source regions shows a modest increase in year-on-year activity, with continued positive signs from the European Union (EU). The European Union's FDI to China jumped by 18.08 percent year-on-year, to USD7.21 billion, which bucks the trend from the end of 2012. In the fourth quarter of 2012, EU FDI was slack, as lingering sovereign debt issues may have handicapped regional willingness and ability to outwardly invest. However, throughout 2013 EU FDI investment flowed back into China at a strong pace, and has been targeting diverse investments within China's service and manufacturing industries including the manufacturing and consumer goods/services industries. FDI from the US also rose 7.09 percent, to USD3.35 billion in 2013, while FDI from the top 10 Asian economies, including Hong Kong, Japan, and Singapore increased by 8.79 percent year-on-year, to USD10.61 billion

Merger and acquisition (M&A) activity is a significant contributor to FDI, representing slightly over 30 percent of total FDI into China. Aggregate mergers and acquisitions activity through 2013 is summarized as follows: there were a total of 483 announced or completed transactions totaling slightly over USD36 billion of M&A activity. Thirty countries and regions made M&A investments in China year-to-date, with a substantial majority of total M&A investments from Hong Kong (approximately 220 total deals worth over USD18 billion). The US engaged in 37 deals through the full year 2013, totaling over USD3.2 billion. However, at an average of USD86.5 million per deal, the US had the largest average deal size (excluding countries with fewer than 10 deals). Deals originating from Hong Kong were spread across multiple industries, primarily targeting China's real estate, high technology, healthcare, and energy and power industries, while deals from the US were primarily targeting the healthcare/biotech and high-technology industries.

The three sectors that received the largest M&A deal flow through 2013 were real estate, consumer goods and services, and industrials, with consumer goods and services also generating the most total transactions (96 transactions). Of the top 10 largest M&A deals, three of the top 10 deals were in China's manufacturing industry, as foreign companies from Europe were looking to expand their automotive manufacturing capabilities in China. The largest transaction (USD1.3 billion) was an acquisition that occurred in China's energy and power industry during the third quarter.

¹¹ Thomson One; MergerMarket; Ministry of Commerce, People's Republic of China

¹² www.china-briefing.com/news/2014/01/17/fdi-in-china-springs-back-by-5-25-percent-in-2013.htm

¹³ English.caijing.com.cn/2014-01-16/113825317

2013 YTD Foreign Direct Investment Trend Analysis

FDI breaks record in 2013, buoyed by consistent monthly growth

Going back to January 31, 2013, foreign direct investment (FDI) into China looked as if it had peaked in 2011. At the end of January 2013, FDI into China had declined every month since May, 2012, and in 14 of the previous 15 months. Total FDI in 2012 was down 4 percent from its all time high in 2011, and after January 2013, the trend looked as if it was going to continue. However, the last 11 months of the year provided a different tone to China's FDI. Foreign investors have seemed to have regained confidence in China's Greenfield and M&A market, and are now committing more FDI into the country. We resume our FDI trend analysis as of December 31, 2013, and identify the current indicators driving stronger FDI flows, which saw 2013 break the FDI record that was set in 2011.

Total FDI for 2013 was a robust USD117.6 billion, growing by 5.25 percent year-on-year. As we pointed out in previous trend summaries, currently there is a structural shift that continues to develop, whereby greater investment and government focus is being given to China's service industry. The market is now starting to see how important it is to receive positive government support in certain industries, and the FDI shift continues from manufacturing to services at a very brisk rate. Service industries that are garnering substantial foreign interest include: new energy and power, high technology, healthcare, and consumer goods and services. Through the full year 2013, China's service industry continued to post impressive FDI numbers, receiving USD61.45 billion in FDI, rising by 14.15 percent versus full year 2012 data. The service industry accounted for 52.3 percent of total FDI in 2013. Within the service industry, a myriad of sectors are posting significant FDI investment growth from diverse countries and regions. The US, for example, continues to pump more investment into China's healthcare, biotech, and high-technology service sectors. The EU has also re-emerged as a strong contributor of foreign direct investment into China, investing into China's financial services, retail products, and food and beverage service sectors. Hong Kong and Singapore continued to show interest in China's real estate (services), high technology, consumer

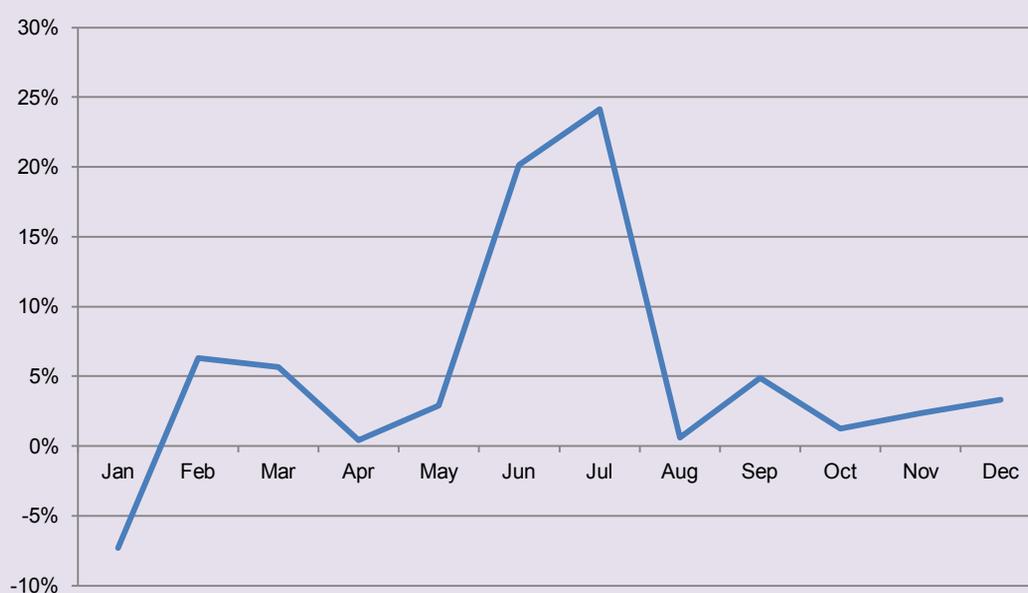
goods and services, and energy and power sectors.

The other significant destination for FDI to China is the manufacturing/industrial industry. While China's service economy continues to receive increased level of FDI, China's manufacturing industry continued to retreat slightly through the fourth quarter of 2013. The manufacturing industry accounted for 38.7 percent of total FDI in 2013. Manufacturing inflows for the first half totaled USD45.56 billion, decreasing by 6.78 percent from the prior year. Despite the year-on-year decline, large investments and international interest can still be identified. The EU, for example, is still very much committed to investing in China's manufacturing industry, investing large amounts of FDI into China's auto manufacturing industry throughout the year.

It would also be useful to examine annual trends by looking at individual monthly results. In the first quarter, January FDI declined by 7.3 percent year-on-year. However, February and March posted robust single digit gains of 6.3 and 5.7 percent respectively. In the second quarter, April and May experienced relatively flat periods of FDI growth, increasing by 0.5 percent and 0.29 percent respectively. However, June and July saw strong FDI numbers, increasing by 20.12 and 24 percent respectively, representing the two largest single months of FDI growth in over two years. After that, modest growth once again became the trend, and continued throughout the rest of the year, ending on a modestly upward trend in December.

The moderate growth pattern now seems to be persistent. However, continued FDI growth depends on the health and stability of the global economy, as well as the continued attractiveness of the Chinese market and its government supported industries. If the global economy continues to grow, and China's service industry continues to develop in a robust manner, one could expect China's FDI to continue to exceed the USD 120 billion goal set by China's central government at, perhaps in 2014.

Monthly FDI Growth, Year-on-Year

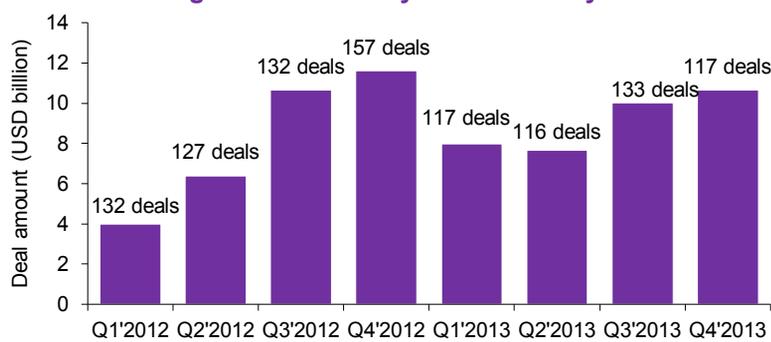


M&A Deals Overview

Year-to-date overview: There were a total of 483 'announced' or 'completed' inbound M&A deals through the full year 2013, versus 548 deals through the full year 2012. Year-to-date M&A deal flow into China was USD36.3 billion, which compares unfavorably to USD40.1 billion received through the full year of 2012. However, without one¹⁴ extraordinary deal in 2012 worth upwards of USD7.4 billion, then 2013 total M&A deals would have exceeded by roughly 2.5 billion, on 11 percent 2012 deals. In regards to outbound M&A, there were 422 announced or completed deals through 2013, versus 329 in 2012. In addition, total outbound M&A deal value rose, totalling USD70.04 billion through 2013, versus USD66.48 billion through 2012, representing an increase of approximately 5.4 percent year-on-year.

Quarterly overview: There were a total of 117 deals in the fourth quarter of 2013, versus 157 deals in the fourth quarter of 2012. In both years, Q4 had the highest value of any quarter of the year, with Q4'2012 anchored by a large and extraordinary transaction as mentioned above. After adjusting for extraordinary deals,¹⁵ the last eight quarters produced a deal average of approximately USD8.6 billion. M&A deal flow for the first, second, third, and fourth quarter in 2013 was USD7.97, USD7.6, USD10.01, and USD10.67 billion respectively, exceeding the two year average by approximately USD.5 billion. With steady performance in 2013, the Chinese M&A market looks get to continue its stable rate of growth into 2014.

Figure 3.1 Quarterly deal summary

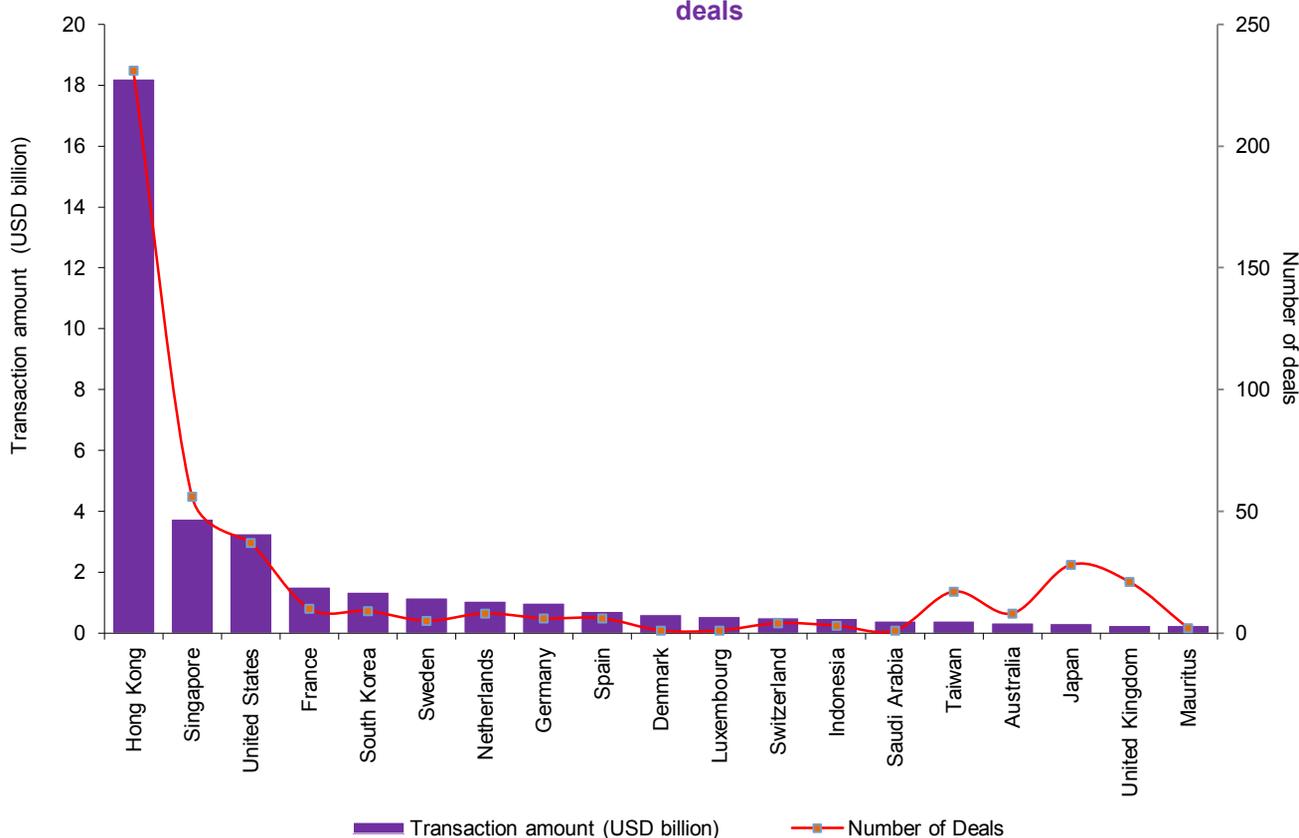


Sources: Thomson One; MergerMarket; KPMG analysis

M&A Regional Analysis

To wrap up the full year 2013, a total of 30 countries and regions (19 listed in Figure 3.2 below) invested in Chinese companies via inbound M&A. These M&A transactions primarily originated or were transacted through from Hong Kong, as well as various European countries, Singapore and the US. As shown in Figure 3.2, Hong Kong engaged in many more deals than any other country – over 220 deals, totaling over USD18 billion – for an average deal amount of USD78 million. The US engaged in 37 deals through the full year 2013, totaling over USD3.2 billion, for an average deal amount of USD86 million – the largest average deal size amongst leading countries. Singapore was second only to Hong Kong in total number of deals, engaging in 56 deals worth USD3.75 billion. Comparatively there were a total of 67 countries and regions that were recipients of outbound M&A investment from China through the fourth quarter. The largest region was Asia, receiving USD21.26 billion of M&A investment from China.

Figure 3.2 Full year 2013 China inbound M&A, by country deal size and number of deals



Sources: Thomson One; MergerMarket; KPMG analysis

¹⁴ <http://www.ft.com/cms/s/0/26418eda-5974-11e2-88a1-00144feab49a.html#axzz2l0t04Ysb>

¹⁵ A single, extraordinary deal of USD9 billion was removed due to abnormal size in Q4 2012

Table 3.1 lists the value and number of foreign acquisitions in China, sorted by region, for the full year 2013. The Asia-Pacific region was the predominant source of M&A into China, as it accounted for approximately 70 percent of YTD M&A activity (USD24.9 billion). Hong Kong, Macau, and Taiwan accounted for the lion's share of YTD Asian M&A investment (USD18.6 billion, 75 percent of Asia deals).

Europe was the second largest location for M&A activity (USD7.4 billion). Key fourth quarter acquisitions include Spain's Banco Santander purchased a share of Shanghai Bank in a deal worth USD647 million, directly from HSBC, as part of a long desired move by Spain's largest lender by assets to rebalance its business away from Europe and Latin America by building its presence in China.¹⁶ In addition, Switzerland's Swiss Re bought a 4.9 percent stake in New China Life Insurance for USD493 million, enabling them access to tap into the growth potential of China's insurance market. Other key deals from previous quarters include: Sweden (investment of USD900 million in Dong Feng Commercial Vehicles); France (investments of USD843 million and USD631 million in Magic Holdings and Tian Ping Auto Insurance respectively); Germany (investment of USD873 million in BAIC Motors) and Denmark (investment of USD600 million in Chongqing Brewery Company).

Table 3.1 2013 Geographical distribution and transaction amount of foreign investment in China M&A

Region	Transaction amount (USD million)	Number of transactions
Global	36,269	483
Asia	24,894	352
HK, Macau, Taiwan	18,600	250
Southeast Asia	4,243	64
Japan & South Korea	1,652	37
South Asia & Middle East	400	1
America	3,292	42
North America	3,270	41
Central, South America	22	1
Europe	7,417	74
EU member countries	6,924	70
Non-EU member	493	4
Oceania	399	11
Africa	266	4

Note: Note: This is an analysis of 'announced' and 'completed' inbound M&A transactions sourced from Thomson One Banker and MergerMarket. Total announced and completed merger activity may differ significantly from what the Chinese government counts as total 'foreign direct investment', as per the Q3'2013 total FDI statistical data, provided by MOFCOM.

Sources: Thomson One; MergerMarket; KPMG analysis

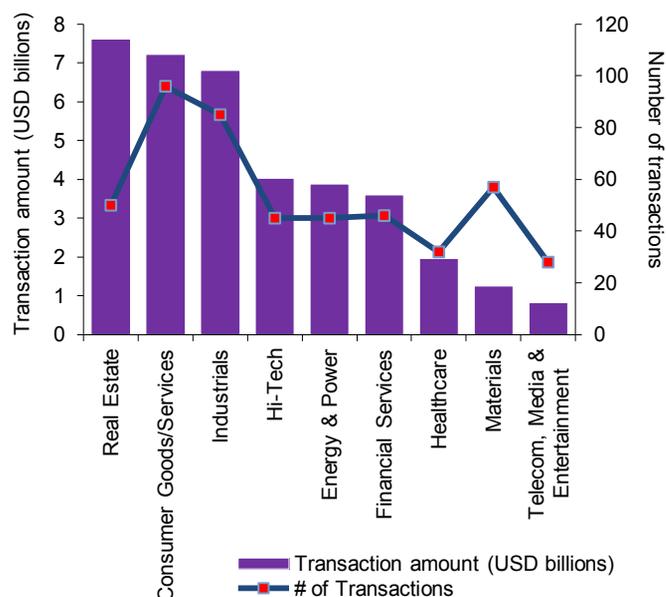
M&A industry analysis

Figure 3.3 displays the nine major industries involved in inbound China M&A activity through 2013. These industries represent the target firm, not the purchasing firm, as purchasing firm industries may differ significantly. As of December 31, 2013 the industry that received the largest

inbound M&A deal flow was 'real estate', followed closely by 'consumer goods and services' (GCS). The CGS industry was the recipient of USD7.22 billion, which was right behind real estate at USD7.6 billion. CGS M&A activity reflects the central government's support for developing the services industry in China and shifting from an investment and net export-driven economy, to one that is driven more by consumer spending. The majority of real estate deals originated from Hong Kong or Singapore, while significant CGS deals were much more diversified (originating from Hong Kong, Southeast Asia, Europe, and the US). CGS actually had the highest number of M&A inbound deals, taking advantage of the lucrative services market in China, and the openness and support from the government to develop the sector.

The 'materials' industry also do serves analysis, not because of the size of its transactions, but because of the total number of transactions. Sub-sectors include: construction materials, chemicals, and metals and mining. Through 2013, the materials industry received approximately USD1.25 billion from overseas investors, but reported over 55 announced or completed deals, which ranks third in number of transactions, but second to last in transaction amount. Reasons for this discrepancy include: 1) many deals that announced or completed were small due to the implicit value of the company being acquired and 2) many of the deals were announced did not state a financial value and are still awaiting completion. Thus, the chart shows a relatively low deal value but relatively high number of deals being completed or announced. Materials would be an industry to watch in the future due to the high amount of foreign interest in smaller to mid-sized companies.

Figure 3.3 Full year 2013 inbound M&A in China, by industry

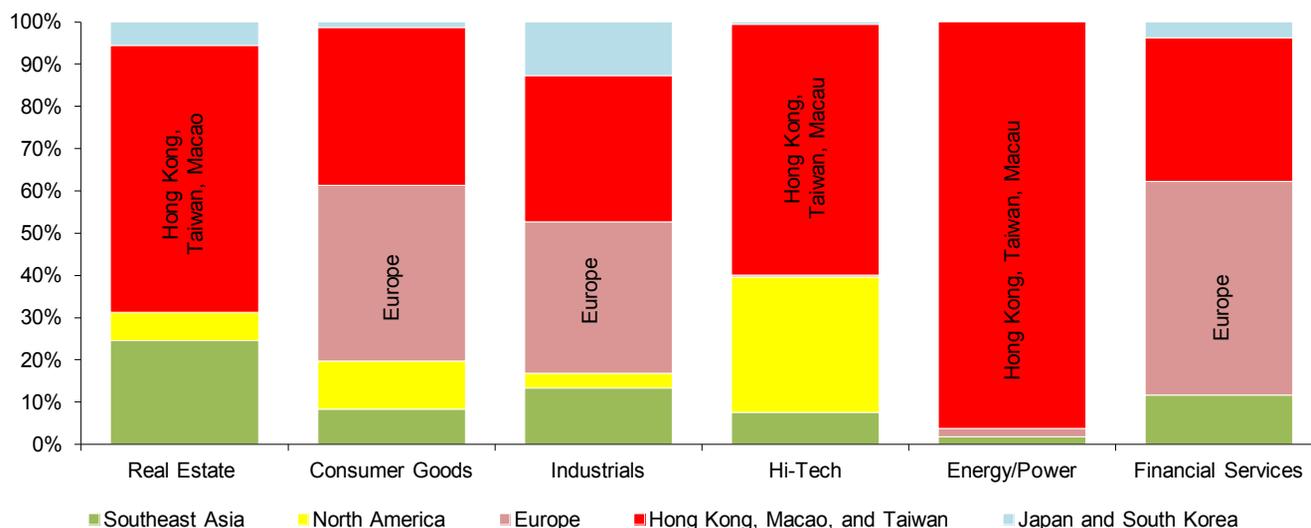


Sources: Thomson One; MergerMarket; KPMG analysis

Figure 3.4 displays the top five sectors for overseas M&A in China, as well as the regional acquirers responsible for these transactions. It should be noted again that these categories reflect the target (Chinese) firm industry, not the foreign firm industry. Transactions in China's real estate market were predominantly from two regions, Southeast Asia and Hong Kong. Hong Kong also was heavily involved in energy and power deals on the mainland. Amongst the top six industries, Europe showed

¹⁶ <http://www.ft.com/intl/cms/s/0/f032d242-61cc-11e3-916e-00144feabdc0.html#axzz2rerxn8Xy>

Figure 3.4 Full year 2013 Top 5 inbound investment industries, by regional acquirer



Sources: Thomson One; MergerMarket; KPMG analysis

up as a leader in three: consumer goods, industrials, and financial/insurance services. This emphasizes the rather substantial interest from European firms toward China's developing service sector. In 2014, China should expect to see more M&A flows from Europe and Hong Kong into sectors such as technology, real estate, and consumer goods. North America was not a leading contributor to M&A activity in 2013, however. Most of the deals from North America were related to the high-tech industry (also some in healthcare). Both high-tech and healthcare represent another aspect of China's service developing service economy toward which the government is directing attention and support.

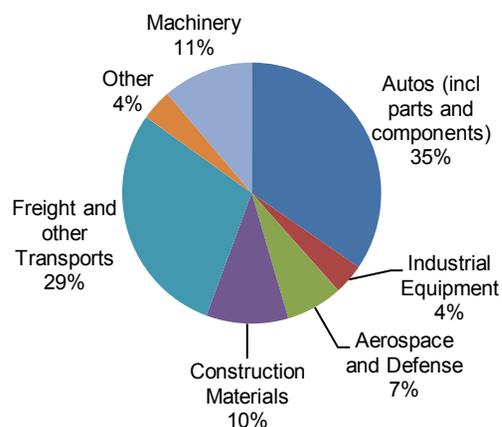
Financial services represented a diverse and sizable market in China this year, although the sector is highly regulated by China's central government. Segments such as insurance products continue to gain interest from foreign entities. Switzerland's Swiss Reinsurance was responsible for the majority share of the insurance M&A market, purchasing a stake in China New Life Insurance for nearly USD500 million. In the banking sector, Banco Santander from Spain took a minority stake in the Bank of Shanghai in a deal worth USD647 million.

Sector Analysis

Within any industry we can drill down into its sub-industries (or sectors) to look more specifically at where foreign investment is flowing. For this report, and due to the diversity and potential interest in the respective sectors, the industrials and consumer goods and services industries are broken out into further detail. The results can be seen in Figures 3.5 and 3.6 below.

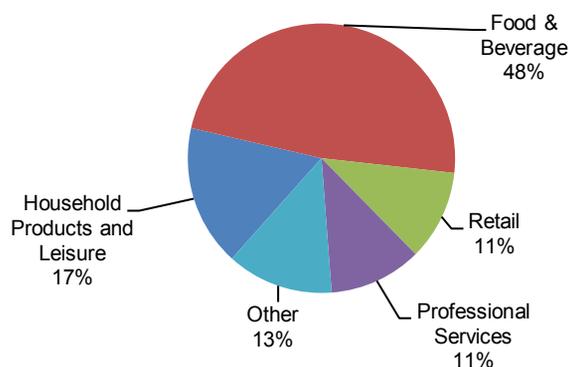
The manufacturing industry in China was a primary beneficiary of European investment throughout 2013. Companies such as Volvo, Daimler Chrysler, and industrial or investment firms took advantage of strategy opportunities to partner with automobile parts, suppliers, machinery, transportation, and dealerships to better align their global strategy of occupying the high-tech manufacturing markets in China. The largest individual transaction was from Volvo, investing over USD 900 million in Dongfeng Automobiles, however there were 23 other deals valued at over USD50 million that occupied the freight and other transport sector, construction materials, auto parts, machinery, and even aerospace and defense. As China's economy becomes efficient and technologically driven, automation and high-tech industrial engineering should play a much larger role, which could attract investment from countries outside the EU and Hong Kong. The M&A data suggests the US has not been a major investor through M&A in China's high-tech industrial manufacturing industry but that could change as China's manufacturing sector matures.

Figure 3.5 YTD industrials transactions, by sub-sector



Sources: Thomson One, MergerMarket

Figure 3.6 YTD consumer goods and services, by sub-sector



Sources: Thomson One, MergerMarket

The consumer goods and services (CGS) industry may be one of the more interesting and important industries for China's future economic development. As the name implies, it includes areas where consumers spend on disposable or discretionary items (for either goods or services) and is correlated with the Chinese consumer's willingness and ability to purchase products/services in the marketplace. CGS has also become a very important area for MNC investment into China, as many government initiatives fall in the realm of consumer goods/services, which is currently a contributor of GDP that the government would like to progressively expand.

CGS sectors include but are not limited to: retail products, household products and leisure, food and beverage products, professional services (such as educational or employment services), and other goods and services (such as textiles and apparel). The development and ongoing external investments into this industry should provide a leading indicator of what foreign companies consider sustainable and/or high growth industries.

Figure 3.6 shows that, transactions for the full year were fairly distributed through multiple consumer goods and services sectors. There were several large transactions in the food and beverage industry, as China continues to become a focus for global food companies. Carlsberg, the Danish beer producer/distributor, and Hershey's Chocolates (Netherlands) were the two primary acquirers in the CGS space. Carlsberg's acquisition was in the realm of 600 million in the first quarter, while Hershey was right behind at 594 million in the fourth quarter. Other consumer goods and services deals originated from various countries, including: Hong Kong, the US, Malaysia, and Singapore.

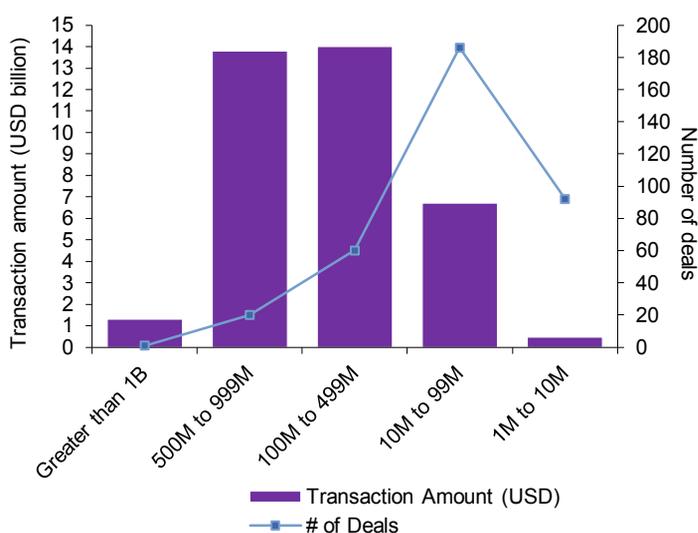
The size of M&A investment was equally diverse in this industry, ranging from USD0.11 million to USD600 million. The interest in the food and beverage industry may indicate that foreign companies are anticipating a more prosperous middle class Chinese consumer, with a high propensity to purchase a variety of products/services. Other than food and beverage, activity was split roughly equally between professional services, household products and leisure, retail products and other, showing that investor interest spans multiple categories in this sector.

M&A Analysis of Transaction Size

Figure 3.7 shows inbound M&A transactions for the year 2013. Of the 186 deals, there was 1 deal over USD1 billion, 20 deals between USD500 million and USD999 million, 60 deals between USD100 million and USD499 million, 186 deals between USD10 million to USD99 million, and 92 deals between USD1 million and USD10 million. Most of the M&A deals (186 deals) were of small and medium-sized companies, announced or completed in the 'USD10 million to USD99 million' range.

Real estate, consumer goods and services, and industrials were three industries that had relatively higher deal values, they also occurred with much greater frequency than the previously aforementioned industries (except materials). This suggests that smaller acquisitions of companies in the materials (commodities) or high-tech industries continue to add value for global purchasers, and should continue to receive M&A interest in the future.

Figure 3.7 Full year 2013 transaction amount, by size of transaction



Sources: Thomson One; MergerMarket; KPMG analysis

Analysis of Top 10 M&A deals

Table 3.2 lists 2013's, 10 top M&A deals in China, by deal value. Total deal value of the top 10 deals was about USD8.54 billion, which represents about 24 percent of total M&A deals in 2013 (USD36.3 billion). Six of the top ten deals were from different countries, spread across six different industries, depicting the moderate diversity of large-scale M&A investment demand into China. The manufacturing industry showed the most prominent large-scale activity, as three of the top five deals were in China's manufacturing sector. The largest transaction occurred in the energy and power industry, and was announced in the third quarter. It is the only M&A deal above USD1 billion.

The main trend to note was the re-emergence of large M&A transactions from companies in the European Union (EU). In 2012, companies from the EU were not among the top 10 acquirers. In 2013, there were three significant deals from companies in the EU.

Other significant deals include: L'Oreal SA acquisition of Magic Holdings for USD843 million, and Nan Fung Development's acquisition of Sino Ocean Land Holdings. These deals were in the consumer goods and real estate industries respectively, and both were announced or completed in the third quarter of 2013. AB Volvo of Sweden represents the second largest deal in 2013. Volvo invested in Dong Feng Commercial Vehicles in the second quarter. The deal is said to strengthen the positions of both Volvo Group and Dong Feng in the mid to heavy-duty truck market, and also make Volvo the world's largest manufacturer of heavy-duty trucks.¹⁷ There were no deals from the fourth quarter added to the top 10 list.

¹⁷ <http://www.volvogroup.com/group/global/en-gb/newsmedia/pressreleases/layouts/CWP.Internet.VolvoCom/NewsItem.aspx?News.ItemId=137906&News.Language=en-gb>

Table 3.2 Full Year 2013 Top 10 Foreign M&A Inbound deals to China

Rank	Acquiror			Acquiree		Deal value (USD million)
	Acquiror	Industry	Country	Target	Industry	
1	Rising Vast Ltd	Financials	Hong Kong	Shi Yi Investments Ltd.	Energy and power	1,289
2	AB Volvo	Industrials	Sweden	Dongfeng Commercial Vehicles	Industrials	902
3	Daimler AG	Industrials	Germany	BAIC Motor Co., Ltd.	Industrials	873
4	L'Oreal SA	Consumer goods/ services	France	Magic Holdings Ltd	Consumer goods/services	843
5	Nan Fung Development Ltd.	Real estate	Hong Kong	Sino Ocean Land Holdings	Real estate	808
6	China Public Procurement Ltd.	High Technology	Hong Kong	Fortress Paradise Ltd	High-technology	773
7	Stryker Corp	Healthcare	United States	Trauson Holdings Co., Ltd.	Healthcare	764
8	Cedar Strategic Holdings Ltd.	Real estate	Singapore	Hua Cheng Group	Real estate	748
9	Conglomerate Investor Group	Financials	United States	Pactera Technology International Ltd.	High-technology	676
10	WSP OTC Group	Industrials	South Korea	WSP Holdings	Industrials	654

Sources: Thomson One; MergerMarket; KPMG analysis



International definition of foreign direct investment



According to the International Monetary Fund's (IMF) definition, foreign direct investment (FDI) refers to an investment by an investor from one country, in the production and business operations located in another country, with the investor holding a certain amount of control over the business operations. In other words, FDI is an investment made by residents or entities (foreign direct investors or parent companies) of one country (region) in enterprises (foreign direct invested enterprises, branch enterprises or overseas branch offices) in another country, where the investors establish long-term relationships with the invested enterprise and hold a permanent interest in and control over the invested enterprise. According to the United Nations Conference on Trade and Development (UNCTAD), foreign direct investment can be categorized into outward foreign direct investment (outward FDI) and inward foreign direct investment (inward FDI) according to the direction of the relevant cash flow.

According to the UNCTAD's definition, FDIs can be categorized into two types according to the nature of the investment transaction: greenfield FDIs and cross-border M&As. Greenfield FDI projects require the establishment of new entities overseas, including offices, buildings and factories. Greenfield FDIs involve capital flow. Cross-border M&As involve taking over or merging with the overseas enterprise's cash, assets and liabilities. In the past few years, cross-border M&As have been the main driving factor for FDIs, particularly in developed countries and in some developing countries, where the value of many large-scale M&As account for the majority of total FDIs. In practice, it is difficult to distinguish between greenfield FDIs and cross-border M&As, and in the long-term, the difference in impact of the two on economic development will become even more indistinguishable.



cutting through complexity

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Today, KPMG China has around 9,000 professionals working in 13 offices; Beijing, Shanghai, Shenyang, Nanjing, Hangzhou, Fuzhou, Xiamen, Qingdao, Guangzhou, Shenzhen, Chengdu, Hong Kong SAR and Macau SAR. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently and rapidly, wherever our client is located.

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There are currently over 50 China Practices in key investment locations around the world, from Canada to Cambodia and from Poland to Peru. These China Practices comprise locally based Chinese-speakers and other professionals with strong cross-border China investment experience. They are familiar with Chinese and local culture and business practices, allowing them to effectively communicate between member firms' Chinese clients and local businesses and government agencies.

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

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