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Demystifying Chinese Investment in Australia

The Growing Tide:

China outbound direct investment in Australia

November 2011

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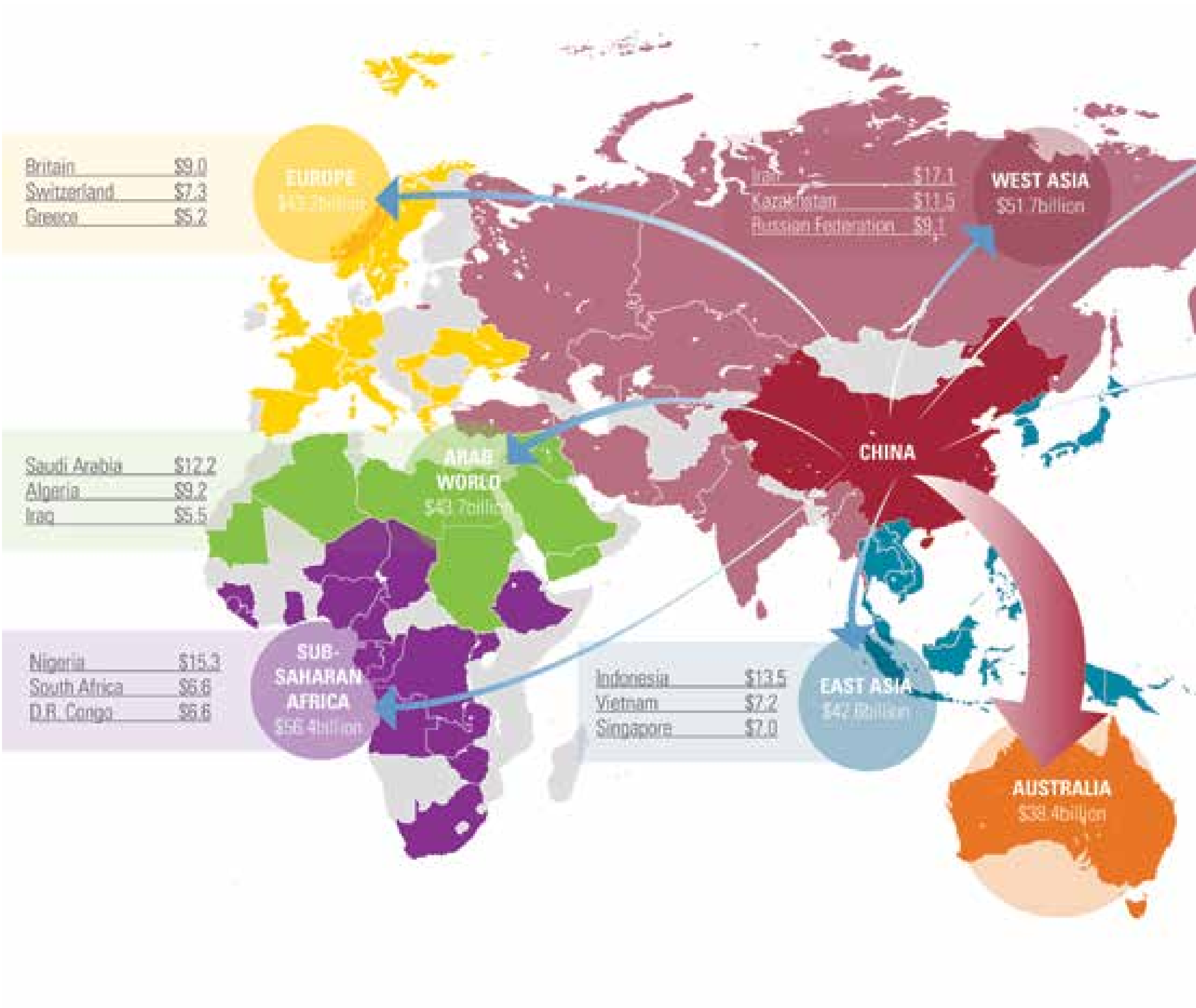
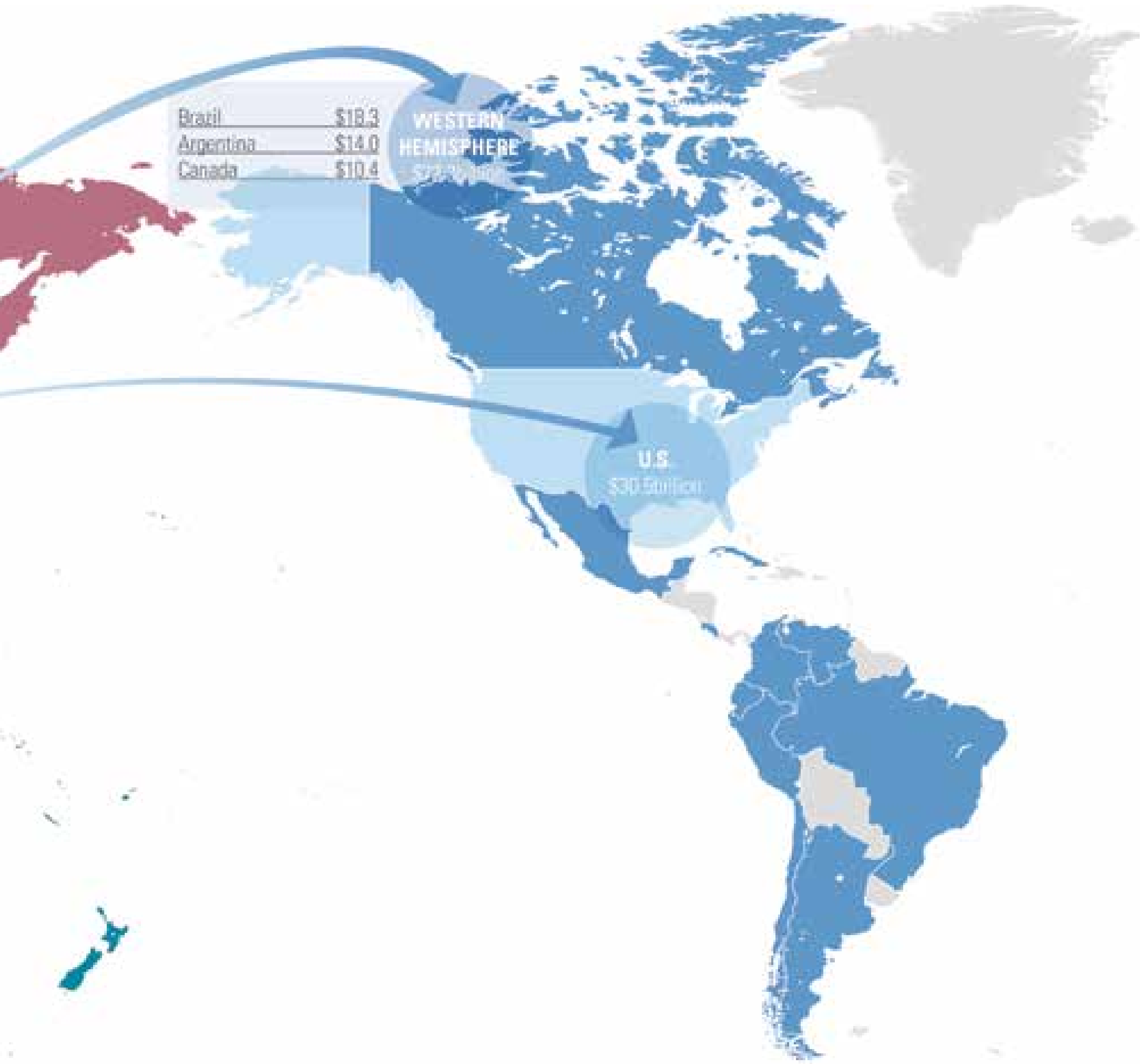


China's worldwide reach

Australia is the largest single country destination for Chinese outbound direct investment.

Source: Heritage Foundation dataset, China's Outbound Investment: non-bond transactions over $100 million, January 2005 – June 2011. Figures in US$. Key nations shown.



China is investing heavily in Australia

Australia has been the biggest single destination for Chinese outbound direct investment (ODI) worldwide over the past 6 years with investments totalling more than US$38.4 billion[1].

The total stock of Chinese direct investment in Australia hit $19.5 billion[2] in 2010, an almost ninefold increase since 2005, as China seized a lead role in seeking investments in Australia and around the world through mergers and acquisitions and greenfield investments.

Direct investment in Australia has soared both in value and number of deals in the past few years: from 2007 to 2010, the value of completed deals totalled US$19 billion with 2009's tally hitting US$8 billion, roughly 3 times that of 2007's total, according to KPMG data.

Recent activity may just be the start of a surge of Chinese direct investment globally, with Australian businesses increasingly likely to be on the receiving end.

A further US$1 trillion to US$2 trillion of Chinese direct investment will be dispatched overseas by 2020, according to estimates in a recent study[3]. The investment money is a huge opportunity for Australian businesses, with enormous potential to sustain or lift growth in both resources and non-resources industries.

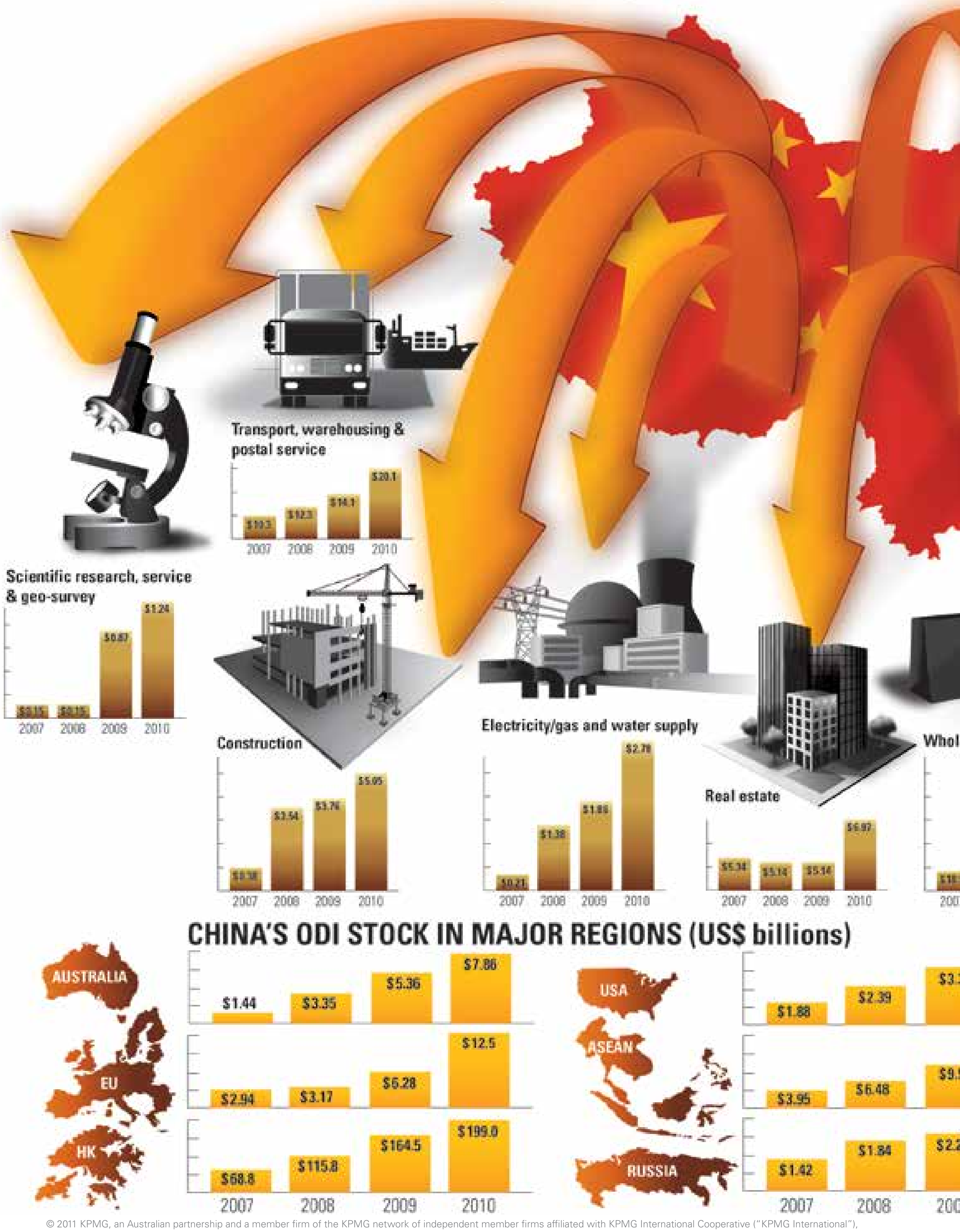
For the long-term, it's a compelling opportunity for Australia to embed itself as an essential strategic business partner for China. The coming upswing in Chinese investment should be welcomed by Australia.

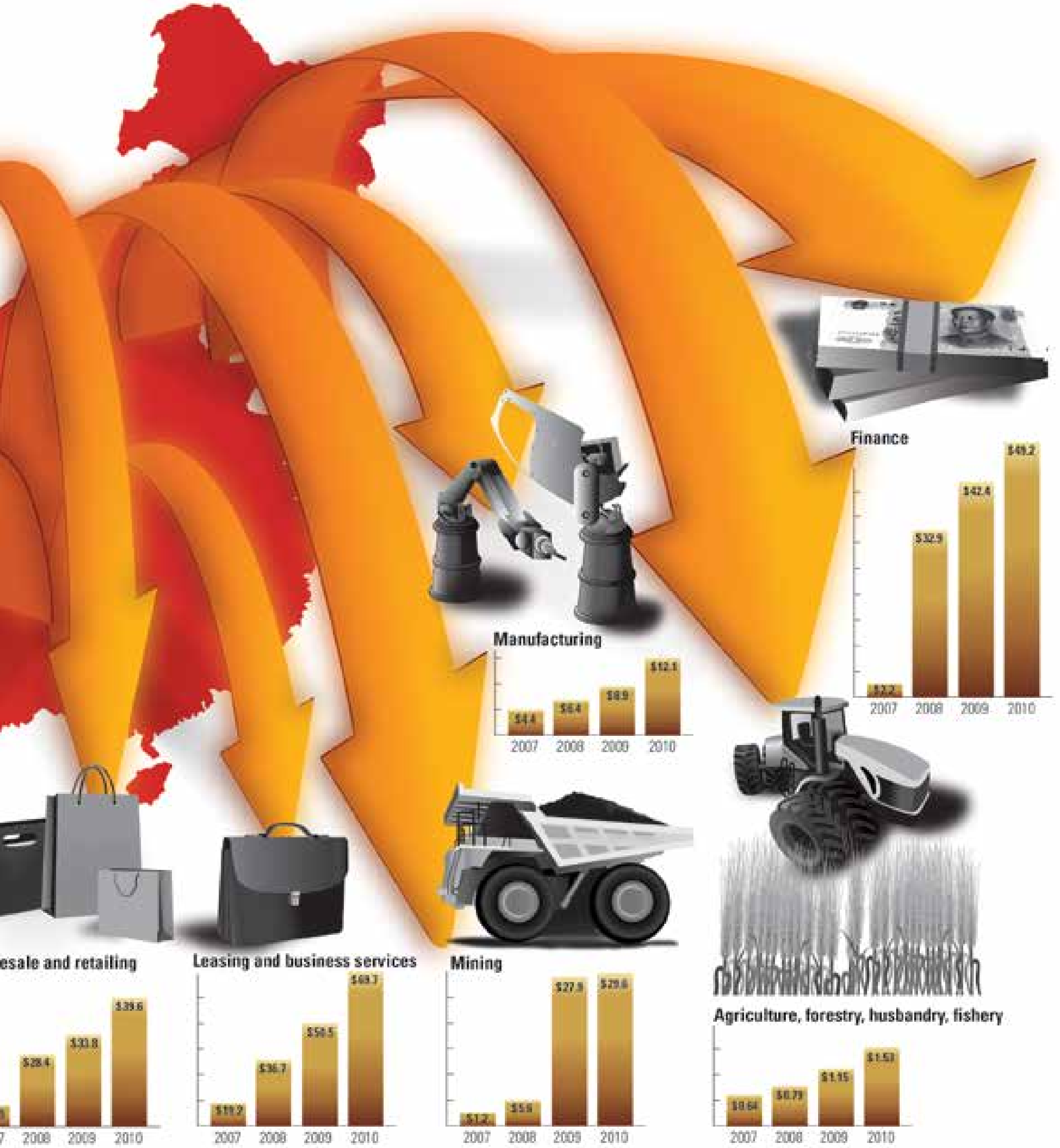
1 Heritage Foundation data, January 2005 to June 2011

2 Australian Bureau of Statistics ($ throughout denotes Australian dollars)

3 Asia Society Centre on US-China Relations, Kissinger Institute on China and the US, "An American Open Door? Maximising the Benefits of Chinese Foreign Direct Investment" May 2011

The Growing Tide of China's Outbound Direct Investment (ODI) in Major Regions*





CHINA'S TOTAL ODI STOCK ACROSS MAJOR REGIONS

*2010 Statistical Bulletin of China's Outward Foreign Direct Investment, Ministry of Commerce of Peoples Republic of China. Shows total stock (US$ billion) for key regions & sectors of investment.

The future will be different

'From mid-2007 to the start of this year, Chinese deals in Australia have been completed in publishing and media, real estate, pharmaceuticals, logistic equipment and services, agriculture, and hotels and casinos, according to KPMG data.'

While China's investments in Australia have been concentrated in the natural resources sector, the future will be different.

Agricultural and non-resource investments will grow, reflecting China's push to expand its domestic market and boost home-grown consumption. Production capacity is plentiful in China – in fact, overcapacity has been an issue for years. To grow and lift profits, Chinese companies already skilled in manufacturing must develop their distribution, marketing and innovation skills, and management expertise, among other things.

These are areas in which Australian businesses could meet Chinese demand. At the same time, demand for food, energy and raw materials will remain robust, spelling the continuation of strong Chinese interest in Australia's resource sectors, including infrastructure for the resources industry, and rising demand for the offerings of Australia's agribusiness sector.

From investment in one or two strategic industries in Australia, Chinese enterprises have made inroads in recent years across a growing range of Australian industries.

From mid-2007 to the start of this year, deals have been completed in publishing and media, real estate, pharmaceuticals, logistic equipment and services, agriculture, and hotels and casinos, according to KPMG data. Sectors such as manufacturing, finance, business services, construction, transport and warehousing, wholesale and retailing and scientific research have also been recipients of Chinese investment money in recent years[4].

These forays suggest a robust potential for Chinese investment to continue spreading to other sectors of the Australian economy, from the established foundation of investment in natural resources. Beyond mining and energy companies, sophisticated Australian businesses such as those in resource-related infrastructure businesses and those in the financial services sector with wealth management and insurance capabilities are likely to see the most immediate opportunities for strategic partnerships with Chinese firms or for drawing Chinese investment.

China's 'Go Global' strategy, which saw its 10th anniversary last year, was slow to take off. To date, direct investment abroad has been focused mostly on securing raw materials and energy. However, the move has accelerated in recent years. Global FDI outflow was US$68 billion in 2010, more than 5 times the total outflow of 2005 with the total stock of FDI globally swelling to US$297.6 billion in 2010, more than 6 times that of 2005[5].

The diversity of targets and destination countries is staggering.

In 2010, Chinese companies made direct investments in 3,125 overseas companies, across 129 countries and regions. Industry-wise, agriculture, mining and energy experienced the most aggressive increase in Chinese interest[6].

The International Monetary Fund (IMF) believes China could become a net exporter of FDI as early as this year while China's Ministry of Commerce expects this to happen around 2015.

4 China Ministry of Commerce, National Bureau of Statistics - China, State Administration of Foreign Exchange – China. Data from 2007 to 2010, inclusive.

5 United Nations Conference on Trade and Development (UNCTAD) data, University of Sydney China Studies Centre

6 China Goes Global 2011: Survey of Outward Direct Investment Intentions of Chinese Companies – China Council for the Promotion of International Trade, the United Nations Conference on Trade and Development and the Asia Pacific Foundation of Canada, April 2011. Analysis based on 1024 responses and data collected in 2010.

'A stronger Renminbi lowers the cost of offshore acquisitions for Chinese companies.'

Powerful motivations

Incentives for Chinese firms to invest in Australia and other countries are changing. State-owned enterprises seeking to lock down supplies of natural resources and exert control of supplies or commodity prices represented the start of China's outward investment boom. Today, investments in energy and natural resources still make up the lion's share of the country's offshore FDI. State-owned enterprises, along with private or semi-private enterprises, are all investing abroad.

However, domestic developments such as economic rebalancing, exchange rate appreciation and increased competition in the domestic market are transforming the way Chinese enterprises view the future.

Business strategies are being reshaped and the strategic acquisition of assets to make China's firms more competitive at home and abroad is a key motivating factor, driving them overseas in an increasingly vigorous quest to acquire advanced technologies, management expertise, greater market penetration, stakes in highly-profitable foreign upstream businesses and globally-recognised brands.

The diversification of supply risks is also an important incentive, as well as improving the efficiency of offshore operations. Chinese companies also take into account other benefits a target country may offer such as financing services and low taxation.

The desire to head abroad is intensifying – a recent survey of Chinese enterprises showed that almost two-thirds of those surveyed plan to increase their overseas investments in the next 12 months – significantly, in some cases – while 88 percent plan to do so in the next 2 to 5 years[7]. Many Chinese companies have strong cash positions, arming them with both motive and opportunity.

The economic rebalancing that is underway aims to shift the focus of growth towards increasing domestic consumption and household income, and away from an over-reliance on the exports industry. Rebalancing will generate greater competitive pressures among Chinese companies that will further motivate them to seek increased internationalisation and a shift in their global business strategies.

Future growth in the manufacturing sector should be fuelled more by value-added services and technological upgrades – both of which are concentrated in advanced economies such as Australia – than by increased production.

Interest in property investments abroad has risen as real estate prices in China escalate. Interest in infrastructure and utilities is also growing as these sectors typically produce stable investment returns. In the infrastructure and construction sectors, large Chinese companies can leverage their substantial experience from a multi-decade infrastructure spree back home.

Another critical element of China's economic rebalancing efforts is an appreciation in the nation's exchange rate, a development that has accelerated in the past few years. A stronger Renminbi lowers the cost of offshore acquisitions for Chinese companies – providing further encouragement to make the move overseas.

Also, the internationalisation of the Renminbi – which is at an early stage – is progressing steadily. Around 7 to 10 percent of China's cross border trade is now settled in Renminbi, by some estimates. Chinese banks view this as a strategic opportunity to follow their customers' expansions overseas and develop their international payments clearing systems and businesses.

7 *China Goes Global 2011: Survey of Outward Direct Investment Intentions of Chinese Companies* – China Council for the Promotion of International Trade, the United Nations Conference on Trade and Development and the Asia Pacific Foundation of Canada, April 2011. Analysis based on 1024 responses and data collected in 2010.

China's ODI pattern in Australia

Despite the challenge of accurately recording China's outward investment flows, statistics from various sources all point to the fact that in the last 5 years, China's outward foreign direct investment is growing fast and Australian business has played an important role in absorbing Chinese capital.

How significant is China's stock of ODI in Australia? So far, it's relatively small, only accounting for about 4.1 percent[8] of the total stock of ODI from all countries in 2010 and concentrated in the resources sector. There's ample potential for further growth.

Still, the recent pick-up has been sharp: Chinese ODI inflows on a yearly basis jumped from $244 million in 2006 to over $2.4 billion in 2010 with annual inflows averaging $2 billion between 2006 and 2010[9].

Despite this dramatic increase in ODI recently, it's important to note that Chinese investment into Australia has been rather volatile. This could be the result of the limitations of the resource-focused business relationship between Australia and China that has been built over the past decade.

This lack of a diverse and multi-level engagement with China may lead to unstable foreign investment flows from China, which are subject to changes in resource prices and policies[10]. This suggests that encouraging Chinese investment in a spectrum of non-resource Australian industries may increase the potential for greater FDI stability – and growth – over the long-run. A drop in ODI inflows in 2010 could have been caused by the aggressive credit tightening campaign in China as the country sought to cool an overheated property sector, strong growth in fixed asset investment and inflationary pressures.

Still, Chinese investment in Australia is likely to be much greater than official data suggests. Although China has regained sovereignty over Hong Kong, both China and Hong Kong continue to treat the movements of capital and goods between them as 'foreign'. Consequently, China's direct investment in Hong Kong still assumes the nature of 'foreign' direct investment.

8 Australian Bureau of Statistics data

9 University of Sydney China Studies Centre

10 Analysis by the University of Sydney China Studies Centre

The IMF, World Trade Organisation and other relevant government statistical authorities including the Australian Bureau of Statistics (ABS) continue to treat China and Hong Kong as two independent entities.

However, this practice potentially underestimates the true Chinese ODI outflow to Australia, given evidence that large amounts of Chinese investment have been shipped to Australia via Hong Kong. Current statistics from sources such as Australian and Chinese authorities, and the *United Nations Conference on Trade and Development*, are very likely understating the magnitude of China's true ODI outflow to Australia[11].

From the 2003-04 to 2007-08 financial years[12], approvals for Chinese investment were granted in all Australian states, according to data from the Foreign Investment Review Board (FIRB).

From mid-2007 to January this year, Queensland snared the highest national share of completed merger and acquisition deals by value with China, with a total value of US$7.1 billion, according to data from KPMG.

Western Australia was second on the completed deals list with a total value of US$5.3 billion, Victoria was third with US$3.4 billion and New South Wales ranked fourth with US$2.3 billion.

Waves of Chinese investment have, from time to time, triggered public anxieties in Australia – just as Japanese and Korean investment had in past decades. Fierce media attention on a handful of prominent cases created the impression in Australia and abroad of a discriminatory attitude towards Chinese investors. Public concerns tended to centre on fears that the investment intentions of Chinese state-owned enterprises were more geopolitically driven than commercially-driven.

There is, however, no systematic evidence that China's state-owned enterprises, like those of other countries, are driven by more than typical commercial considerations.

11 Analysis by the University of Sydney China Studies Centre

12 Australian financial years, periods ending June 30

And despite the occasional flare-ups on either side, Australia is rated by Chinese companies as being one of the countries most open to China's direct investment.

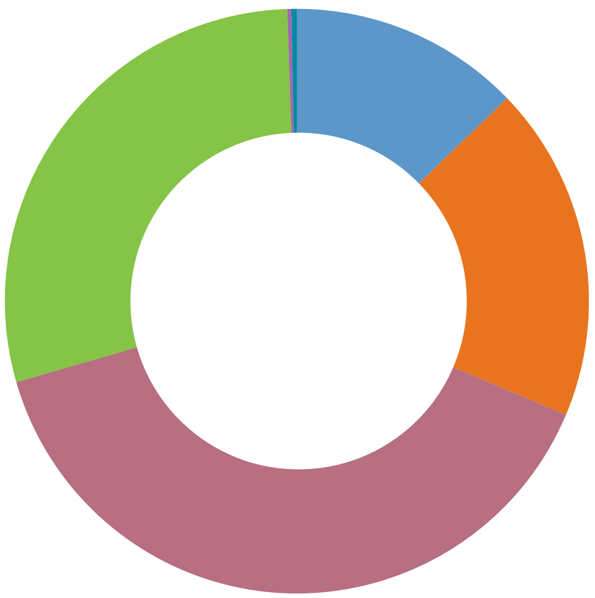
In a recent survey of Chinese enterprises, Australia was seen as the most open, after the United States. South Africa, Germany and Korea were ranked third, fourth and fifth respectively[13].

Chinese enterprises are generally challenged by the regulatory and business cultures in advanced economies such as Australia and require support from China-experienced Australian advisors. Large differences exist between regulatory cultures in China and those of advanced economies. Operating in Australia requires managers of Chinese companies to bridge language and cultural divides, comply with unfamiliar and sophisticated regulatory standards, acquire local market knowledge, manage local staff, negotiate with organised labour and other stakeholders, reach higher quality and safety standards, adhere to different tax and accounting rules and develop appropriate communications and public relations strategies.

As for any newcomer to a foreign country, the challenges are daunting. The assistance of local advisors with China experience and the ability to build trust and rapport with senior managers of Chinese companies is important to the success of ventures.

'Chinese ODI inflows on a yearly basis jumped from $244 million in 2006 to over $2.4 billion in 2010.'

13 China Goes Global 2011: Survey of Outward Direct Investment Intentions of Chinese Companies – China Council for the Promotion of International Trade, the United Nations Conference on Trade and Development and the Asia Pacific Foundation of Canada, April 2011. Analysis based on 1024 responses and data collected in 2010.(For the purpose of this report, rankings exclude Hong Kong SAR – which is seen as the most open to Chinese investment according to the survey.)

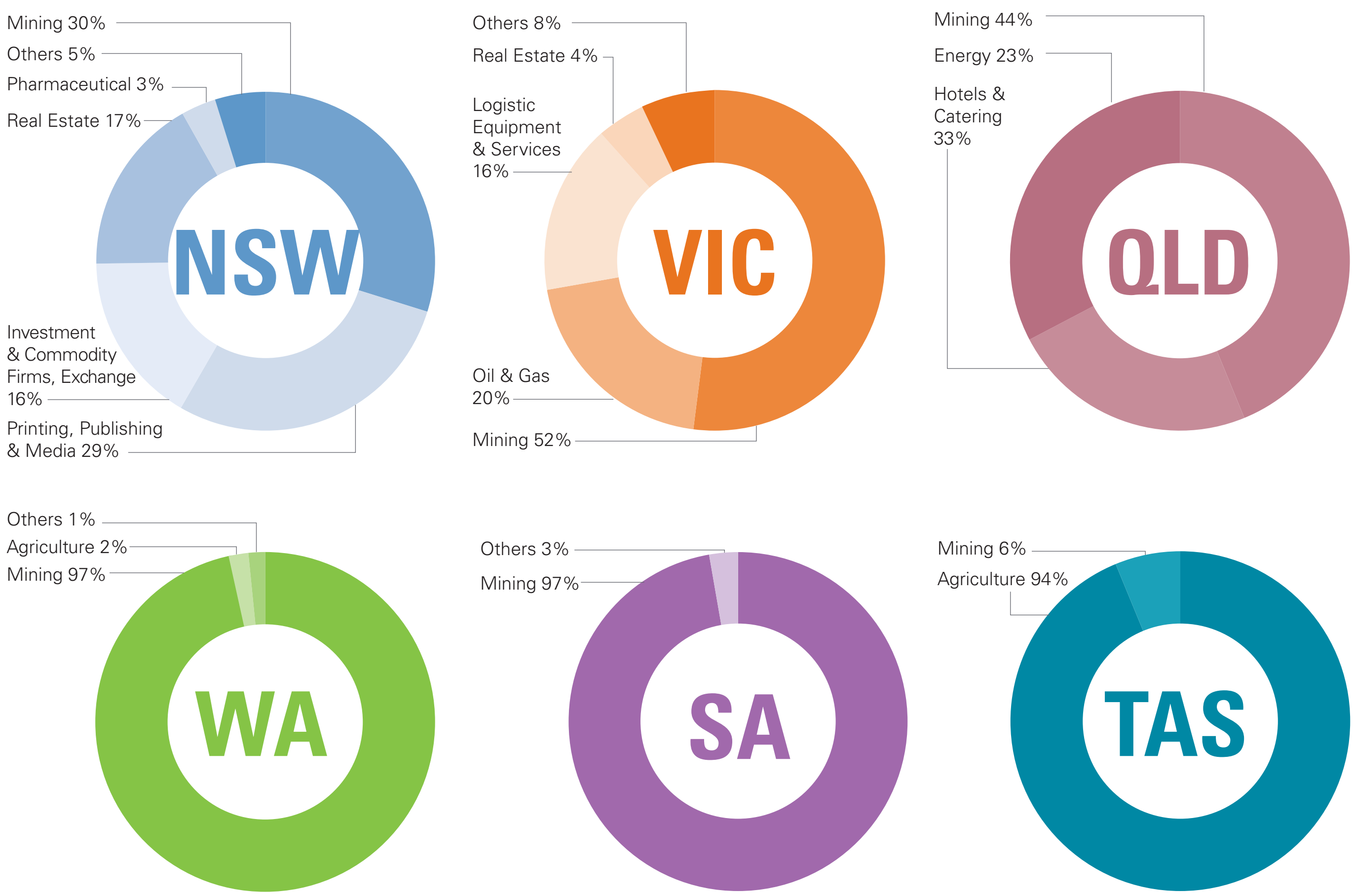


Completed Chinese deals by state

Source: KPMG analysis and University of Sydney China Studies Centre

The data below represents each state's share of total completed deals from July 2007 to January 2011

- NSW $2329 million:12.79%
- VIC $3380 million:18.57%
- QLD $7132 million:39.18%
- WA $5269 million:28.94%
- SA $42 million:0.23%
- TAS $54 million:0.30%



Today's opportunities

Australia represents approximately 2.5 percent[14] of China's global ODI stock today. If a mere 3 percent of China's expected outflows target Australia over the coming decade, the volume of investment will be massive.

The expected flood of Chinese capital seeking investment opportunities requires a strategic response from Australian businesses in order to realise the opportunities and maximise the benefits. China's investments around the world will grow rapidly in coming years and decades – we see benefit in encouraging the Chinese to invest here.

We see immediate opportunities to make the most of evident Chinese interest in acquiring assets and expertise in agriculture, financial services and infrastructure.

Joint ventures, partnerships and other innovative arrangements with Chinese partners should be considered. The increasing global commercial clout and financial strength of Chinese companies, as well as China's vast international business networks, could assist the entry of Australian business partners in third-country markets.

Agriculture

More Chinese ownership of Australian agricultural assets, for example, may be welcomed if it were accompanied by capital injections into the relevant industries and transfers of management skills and technological innovation. It could be a way of overcoming some of the constraints imposed by the relatively small capacity of typical Australian agricultural enterprises.

Partnerships, joint ventures, alliances and other commercial arrangements with Chinese investors could be other ways to develop Australian agribusiness and improve their access to Chinese markets[15].

China both produces and consumes one-sixth of the world's wheat, one-fifth of the world's corn, one-third of the world's rice, and half of the world's pigs[16]. However, the structure of China's agricultural industry and the limited availability of agricultural land are hindrances to domestic supply. Growth in grain output, for example, will struggle to keep pace with urban demand growth.

Technical improvements have lifted productivity growth in China's agricultural sector but farming efficiency is lagging. Other constraints on China's agricultural production include water scarcity – per capita water resources are only a quarter of the global average and acute water pollution problems have persisted.

Austrade has reported Chinese interest in a range of Australian food products that reflect not just demand for food supplies but the 'westernised' tastes that China's increasingly wealthy middle classes have acquired – a trend that's set to intensify.

Chinese interest encompasses dairy products, seafood, fresh fruit, wheat, barley and rice, frozen red meats, processed foods, beer, natural fruit juice, convenience and instant foods, and confectionary and snack products.

Chinese consumers will increasingly pay a premium for quality, freshness and novelty. Good packaging and convenience are also valued.

More sophisticated attitudes towards health and nutrition suggest that interest in organic food should grow. China's Ministry of Agriculture estimates that the country has more than 6,000 organic food producers – the market is expected by some observers to grow at around 20 percent a year in coming years[17].

Australian exporters who can master the logistics of getting fresh product into China reliably and at reasonable cost could do exceptionally well[18]. On the other side of the coin, Australia's agricultural and agribusiness industries are in a strong position to assist China's domestic agricultural production efforts and address its need for self-sufficiency in food supplies by offering expertise across the entire agricultural and agribusiness supply chain – from clean water technology, irrigation techniques, and environmental conservation, to animal husbandry and organic farming practices.

14 University of Sydney China Studies Centre

15 For full analysis of the potential for Australia-China partnerships in agribusiness, see: *Australia and China: Opportunities in agribusiness, food and beverages – KPMG 2011*

16 IMF data

17 Deutsche Bank research, 2010

18 Australia and China: Opportunities in agribusiness, food and beverages – KPMG 2011

Renminbi internationalisation and the financial services sector

A significant opportunity in a world where the Renminbi is progressively internationalised lies in foreign exchange trading. After Hong Kong and Singapore, Sydney or Melbourne is the next logical location for a Renminbi global trading centre given the prominence of Australia's trading relationship with China and the regional reach of its sophisticated financial services sector.

The expansion of Chinese corporate investment in Australia also suggests the potential for Australian and Chinese banks to develop partnerships to build Renminbi settlements and payments capabilities. Chinese banks dominate the Chinese corporate market and they tend to follow their clients overseas, developing their international payments clearing capabilities in the process. Australian companies with Chinese dealings will need to buy Renminbi and related currency hedging services – the benefit of paying in Renminbi is the potential for reaching more companies in China, lifting trade.

Australian banks are already partnering with local Chinese banks in China to provide enterprise finance and other financial services. On top of that, Australian banks' experience and expertise in areas such as corporate governance, credit risk evaluation and organisational structures are among the specialised skills Chinese banks are keen to acquire, to assist their development and expansion in both global and domestic markets.

Infrastructure

Chinese participation in the success of Australia's infrastructure projects would provide valuable capital to much-needed rebuilding and new construction of our infrastructure, especially in the resources sector. Potentially, Chinese investors could build ports, railways, roads and other critical resources infrastructure, operate them for an agreed number of years until their investment pays out, and then transfer ownership fully to Australian companies[19].

China's experience in Africa, central and South America and Australia has demonstrated its increasing willingness to move beyond controlled buy-outs or pure resource purchase contracts towards partnering with local companies and communities to build infrastructure, often at relatively low costs. These are increasingly operated by local management and employees with oversight from a number of Chinese executive board members. Spreading risk through partnership arrangements, such as syndicated international loans, is a prudent move and also an option for Australia.

In order to facilitate Chinese investment and capitalise on evidence of Chinese interest in Australian infrastructure projects, the leaders of Australian companies must initiate and lead discussions with Chinese counterparts, explaining the longer term mutual benefits of combining strengths, as well as accessing new, previously unreachable resources and markets together.

Australian companies also need to maintain responsibility for educating and lobbying key stakeholders along the way. An honest and transparent process of communication is vital in dealing with any hurdles in such projects.

'China's Ministry of Agriculture estimates that China has more than 6,000 organic food producers – the market is expected by some observers to grow at around 20 percent a year in coming years.'

19 For full analysis, see Australia & China: Future Partnerships 2011 – a joint report by KPMG Australia and the University of Sydney China Studies Centre

Practical engagement

An approach that has proven extremely effective in attracting and facilitating Chinese investment is the role of a government in actively connecting with the Chinese Government and reaching the right type of potential Chinese investors. Chinese businesses adhere to their government's guidance in the investigation and assessment of new investment opportunities abroad.

Australia needs to utilise multiple influencing parties at all levels of government – federal, state and local government bodies – to speak to China's central, provincial and municipal governments respectively, as well as other stakeholders and businesses about investment opportunities in Australia.

To promote business interaction, we need to define a powerful, consistent and persistent marketing and confidence- building role for Australian governments in there dealings with Chinese counterparts.

The initiation of government-to-government arrangements for routine consultation between Australian and Chinese authorities would facilitate the examination of competition, corporate governance and financial transparency issues. This would have the practical effect of strengthening understanding and the framework for Chinese investment over time.

The more Chinese investors participate in the Australian market, the more they gain vital experience with the disciplines of robust and well-governed market institutions.

'The more Chinese investors participate in the Australian market, the more they gain vital experience with the disciplines of robust and well-governed market institutions.'

KPMG and the University of Sydney China Studies Centre have formed a strategic relationship to publish research and insights on doing business with China. The first product of the relationship was *Australia & China: Future Partnerships 2011*, published in September this year. We hope you enjoy this specialist, supplementary report, *The Growing Tide: China outbound direct investment in Australia.*

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KPMG's China Practice

KPMG's Global China Practice is a network of 41 countries providing high quality, consistent services to China inbound and outbound investors globally. The Global China Practice allows KPMG to maximise the opportunities emerging from China's rise as an economic superpower, and provides a sustainable competitive advantage for KPMG around the world.

In Australia, KPMG's dedicated China Practice acts as a priority gateway advising on inbound and outbound investment transactions between Australia and China. We assist our clients to develop truly regional strategies to help mitigate risk, improve performance, create value and most importantly capitalise and realise the business and investment opportunities arising from China's growth.

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THE UNIVERSITY OF SYDNEY
CHINA STUDIES CENTRE

University of Sydney China Studies Centre

The China Studies Centre was established by the University of Sydney in 2011 as a major initiative of the University's 2011-2015 Strategic Plan. The China Studies Centre represents a commitment by the University to cross-disciplinary research and public education including cooperation with external partners. The Centre's open research architecture facilitates interaction between Australian researchers working on China, Chinese academics and external partners with specific expertise.

The Centre's China Business Development team works on projects concerned with new and changing markets emerging from China's deepening marketisation and privatisation of public services and state monopolies. These projects anticipate new trends and create new knowledge for Australia China cooperation.

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