

The Dream Goes On

Rethinking
China's Globalization

Synopsis

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In 2010, KPMG launched a special report entitled *World Class Aspirations: The Perceptions and Reality of China Outbound Investment*. We found that while Chinese companies had made progress towards their goal of becoming global players, they still needed to do more to realize their “world class” aspirations.

In 2012 we conducted a second survey and in-depth interviews with Chinese companies and overseas respondents to understand the developments since our last report. Based on the results of these interviews and our knowledge and experience, KPMG and our collaboration partners have jointly launched an updated report: *The Dream Goes On: Rethinking China's Globalization*. This document is a summary of the key findings and perspectives in the report. The full report can be accessed through the link provided at the end of this document.

Since the turn of this century, China's rapid economic growth and a deepening reform and opening-up program have propelled a large number of stronger Chinese companies to pursue a “going out” strategy to expand into new markets, secure resources, and enhance their core competitiveness. Against this backdrop, China's “12th Five-Year Plan” calls for combining “bringing in” with “going out,” placing equal importance on inbound and outbound investment, and enhancing China's ability to utilize foreign and domestic markets and resources in a safe and efficient manner. In addition, all enterprises, regardless of ownership structure, will be guided to invest and cooperate in overseas markets based on market-oriented and independent decision-making principles. As a result of the economic forces driving the internationalization and globalization of Chinese companies, we expect to see another boom in outbound investment activity, further integrating the Chinese economy into the global economic landscape.

By reviewing the history and analyzing the current state of China's outbound investments, we can acquire a full and accurate understanding of the current stage of Chinese corporate globalization, and the challenges that need to be overcome. This understanding is also fundamental in our efforts to chart the future course of globalization by Chinese companies.



Reviewing the past, looking into the future

China's outbound investment has gone through three stages:

- Stage I: Initial stage from the late 1970s to the mid-late 1980s
- Stage II: Transition period from 1991 to 2003, marked by the establishment of offshore procurement and sales channels
- Stage III: Rapid development from 2004 to present, China's outbound investment has developed quickly, stimulated by a series of positive factors, including the fundamental business need for Chinese companies to expand overseas, favorable policies and regulations, massive foreign exchange reserves, and the appreciation of the RMB against international currencies.

In 2012, the total value of outbound investments made by China's non-financial enterprises reached USD 77.2 billion, representing a remarkable 44.3% compound annual growth over the period since 2003. China's outward direct investment has already reached the same level as the average outward direct investment of six of the G7 countries (i.e. Great Britain, France, Germany, Japan, Italy and Canada). However, looking behind these impressive statistics we see that China's outbound investments are still imbalanced in terms of investment regions and industries, and exhibit a tendency to invest in projects at the lower-end of the value chain.

Although Asia remains the leading investment destination for Chinese enterprises, Europe and North America have shown noticeable growth over the last few years. At the same time, Chinese investment has diversified across a wider representation of industries. Recently, outbound investment in manufacturing has experienced an uptick but resource acquisitions remain the dominant sector. Average deal size has come down as a result of an increasing number of Small and Medium Enterprises ("SMEs") and Privately Owned

Enterprises (“POEs”) beginning to participate in outbound investments, as well as a growing number of transactions outside of the natural resources sector where the deal sizes are typically larger.

The key sectors for Chinese outbound investment have been overseas engineering and contracting projects, energy and mining, household appliances, automotive, and financial services. Looking forward, we expect that agriculture and food products, renewable energy, real estate, and high-end manufacturing will emerge as new hot sectors. Based on our review of the history and drivers of Chinese outbound investment, the current status and problems encountered, the objectives of future investment and challenges to achieving those objectives, we conclude that Chinese companies should pay attention to the following five areas so they can avoid pitfalls and overcome challenges to smoothly implement their internationalization and globalization strategies:

1. Overseas investment decisions should support the company's overall strategy
2. Risk management systems are essential to support the implementation of an overseas investment strategy
3. Successful completion of post-deal integration will be key in determining whether a project is successful
4. Chinese enterprises should increase their efforts to establish a positive image abroad
5. POEs should be encouraged and supported to “go out”



Having a clear strategy to guide overseas investment

Outbound investment decisions must be consistent with a company's overall development strategy and the overseas business operations should be an integral part of a company's overall business operations. So when companies are developing their international business operations, decision makers must ask several key questions: What are the strategic goals of this outbound investment? How will the investment help us achieve our overall strategic objectives? What role will the overseas operations play in our company's overall business? And, how should we go about deciding where to invest, in what industry, in what company, and through what means so as to realize the objectives of our overseas investment strategy?

In our survey, we asked respondents, "What are the most serious mistakes that Chinese enterprises make in the process of investing overseas?" The most frequent response was that Chinese companies "Did not formulate clear investment plans and goals". While, "Did not choose the best investment target" ranked third. These results are consistent with our own observations. Some Chinese enterprises "go out" for the sake of "going out" following the footsteps of other mainland firms that have ventured overseas. Other firms are enticed by relatively cheap valuations in the wake of the global economic downturn and the European debt crisis and do not seriously consider how the acquired asset will enable synergies to be realized and help the company to achieve its overall strategy.

Successful outbound investors will determine their overseas investment strategy after fully examining their current stage of development and business needs. Decisions about where to invest, in what company, and through what means will be made based on this strategy.

Investment destinations will continue to diversify as Chinese firms pursue a broader range of investment objectives. Decisions will be driven by factors such as Chinese firms' desire to operate in developed countries with mature market systems and learn advanced management techniques, the existence of free trade agreements and the opportunities which are available in emerging markets. The security situation and attitude towards Chinese investment in the host country should also be considered when deciding where to invest.

Chinese enterprises should be flexible in their choice of how to make overseas investments. Companies may consider forming joint ventures with local partners, not insisting on acquiring a controlling stake, partnering with experienced financial investors, or "going out" together with other Chinese enterprises. Such tactics could significantly reduce host market resistance to a potential investment project, diversify investment risks, enhance the investment experience that can be drawn upon, and raise the probability of the investment being a success.

When choosing potential targets, Chinese companies should think about how to generate synergies from potential investment targets and properly assess the difficulties associated with post-deal integration.

Having an international talent pool is a prerequisite to the successful implementation of an outbound investment strategy. Companies must think about how to source qualified leaders and build a strong management team for the new overseas business when they are preparing to make the investment.

Risk management

Risk management systems are a necessary safeguard for the smooth implementation of an outbound investment strategy. Over more than a decade of rapid growth in overseas investment activity, Chinese enterprises have learned lessons and accumulated a certain amount of practical experience. Many enterprises have established risk management systems, particularly risk management frameworks to address overseas investment risks. However, for many companies these systems are not comprehensive enough and various problems arise during implementation. Examples include an emphasis on form rather than substance, risk management controls are not fully integrated into management processes, lack of checks and balances between risk management functions performed by different departments, employees' reluctance to perform risk management responsibilities, and insufficient or ineffective oversight of effectiveness of risk management functions.

We found that Chinese enterprises undertaking outbound investments often take external risks more seriously than internal ones. Internal risks include those relating to financial matters, labor disputes, and operational management. When examining external risks, companies often underestimate political risks outside their control, and lack real-time monitoring and risk-avoidance and response plans or mechanisms. Furthermore, Chinese firms have a tendency to evaluate the potential difficulties of overseas projects based on their domestic experience, without fully understanding the complexities of the overseas market. Examples of this are seen in unfamiliarity with foreign labor markets, inadequate attention to contract terms, and an overestimation of the influence of foreign governments.

A comprehensive risk management system is needed to successfully manage risk. The risk management objectives must be specified and mechanisms created by which risks are identified, assessed, and addressed with appropriate responses and controls. There should also be protocols and procedures regarding information gathering and communication, and ongoing risk monitoring.

With respect to building an internal risk management structure and procedures, Chinese enterprises need to establish a scientific, open and efficient decision-making process and foster a positive risk management culture. They should establish an autonomous and vertically-integrated organizational framework for risk management to manage and undertake real-time monitoring of each category of risk. Companies should have a comprehensive risk management system and procedures to manage risks associated with overseas investment and place due emphasis on the legal compliance issues associated with this activity.

Undertaking a proper feasibility analysis is the first step to understanding and managing potential sources of risks. For many projects the problems are often already present when the agreement is signed. At the due diligence stage, Chinese enterprises should fully identify all possible risk areas and seek to include risk-prevention measures and appropriate compensation terms when negotiating agreements. When unable to fully mitigate identified risks in the deal agreement, Chinese enterprises should evaluate the potential impact that identified risks may cause, and prepare an appropriate action plan, or even walk away from the deal. Chinese enterprises should allocate more funds, spend more time and involve more people in this important stage of the investment process.

The following measures can also help Chinese companies to minimize the risks associated with proposed overseas investments:

- Using policy credit insurance products
- Seeking the support of experienced intermediaries
- Improving government information and support services
- Utilizing international or multilateral organizations.

Creating value through post-deal integration

Signing off on a deal is far from being a guarantee of success. Only after integration of the target has been completed can it be determined whether the acquisition has created value.

Post-deal integration problems can arise from all aspects of operations. Respondents to our survey believe that “creating synergies” is the biggest challenge in the post-deal integration process, followed by “cultural conflicts” and “formulating a vision and strategy for the new company”. Many Chinese enterprises do not have a clear integration strategy for overseas merger and acquisition (“M&A”) projects, and do not know how they will carry out the integration to achieve the envisaged objectives of the acquisition. After completing overseas M&A deals, Chinese firms frequently have difficulty achieving business synergies, resulting in chaotic operations, loss of customers, and low (or no) cooperation from suppliers and/or business partners. Complicating this situation are the distinct differences between Chinese enterprises and their foreign peers in terms of working styles, values, business practices, and behavioral norms. If handled inappropriately, these issues can lead to damaging cultural conflicts. Other problems include difficulties integrating the workforce and underestimating the time required to complete the integration process.

Chinese enterprises should boost their efforts to deal with problems that arise in post-deal integration by:

- Being clear about the objectives of an M&A project and the integration strategy, and choosing an appropriate management method to achieve these objectives

- Fully utilizing the capabilities and resources of local management teams so as to be able to more effectively operate in the overseas market
- Establishing a dedicated integration team which is involved in the entire project cycle to ensure there is no disconnect between the acquisition and integration phases
- Optimizing the use of both domestic and foreign market advantages by introducing new products, technologies, and brands to the China domestic market and leveraging domestic resources to promote overseas business expansion
- Approaching cultural integration challenges with an open mind
- Winning the recognition and loyalty of local staff based on quality communication.



Integrating with local markets and establishing a positive image

In our survey, the overseas respondents were neutral in their assessment of the success and image of Chinese companies operating in their countries. In their opinion, the overseas operations of Chinese companies exhibit several problems, of which the most frequently mentioned were “consumer’s concern about the quality of products,” “a lack of understanding of local business practice” and “the negative impression of the general public towards Chinese investment”. These results reflect that Chinese enterprises have considerable room to improve in terms of strengths and competitive advantages, corporate social responsibility, and public relations management.

Survey feedback shows that Chinese enterprises need to build their strengths and increase investment in branding, product quality, and technology. When making investments and then operating overseas, Chinese firms do not think enough about building an image as a good corporate citizen and may fail to make sufficient investments in long-term and sustainable social and economic development in host countries. Adding to this, Chinese companies do not disclose much information about their overseas operations and are not adept at public relations management and media communications. This has led to a lot of misunderstandings about the intentions of Chinese firms towards investing and operating in overseas markets.

Chinese enterprises should take concrete actions to reduce resistance towards their overseas investments. Specifically, it will be to the benefit of Chinese companies to:

- Build capabilities and develop core competitive advantages centered on technology, brand, quality, and service to become internationally competitive

- Comply fully with local regulatory requirements, paying particular attention to corporate social responsibility related issues including environmental protection and local welfare and philanthropic activities
- Promote workforce localization and seek to align corporate objectives with long-term development of local economy and society
- Improve public relations management, information disclosure and media communications
- Have more exchanges with local people about their culture and beliefs, learning how to interact effectively with local people and ultimately becoming a “local” company in the eyes of the local community.



Encouraging and supporting POEs to “go out”

Although POEs have become an important force in China's offshore investment wave, the extent of their participation does not match their contribution to the national economy. Supporting and guiding private enterprises to carry out orderly and sound overseas investments will not only promote quality growth and enhance core competitiveness of individual companies, it will also be beneficial to improving the structure of the Chinese economy and diversifying the types of entities that are making outbound investments. This will help establish a positive image of China as an economic and investment power and contribute towards Chinese enterprises being able to benefit from a more favorable and fair investment environment where it is easier to obtain approval from local governments.

POEs have certain advantages when it comes to investing overseas. For example, their ownership structure is clear. Their process and procedure of decision-making can be fast and flexible. POEs receive less support from the government in their domestic operations, which makes them more competitive in the market place. POE entrepreneurs' proactive spirit gives their companies the nimbleness needed to quickly adapt to an ever-changing global market. Notwithstanding these advantages, POEs also face many difficulties when investing overseas, including:

- Lack of funding; POEs have fewer fund-raising channels and face more stringent requirements
- Most POEs do not have a long-term corporate strategy and an overseas development plan, and lack experience operating overseas
- Policies and procedures to facilitate POEs' outbound investment are not sufficient
- Many POEs are not strong enough to invest overseas on their own.

That said, the government can play a pivotal role in assisting private enterprises to “go out” by:

- Simplifying, improving and increasing the level of transparency of the project approval process, particularly for SMEs, without compromising the risk control objectives
- Adjusting tax policies to encourage Chinese enterprises to “go out”. For example, replacing the “foreign tax credit” system with an “exemption” system of taxation for foreign-sourced dividends and capital gains
- Accelerating the signing or upgrading of multilateral agreements to protect investments and prevent double taxation
- Establishing an overseas investment insurance system that enhances the ability of private enterprises to manage operational risks
- Providing financial support for POEs to “go out”
- Creating project information sharing platforms for state-owned and private enterprises; orchestrating and facilitating alliances between state-owned and private enterprises to make various types of overseas investments.



Conclusion

Based on the pattern of the growth and development in outbound investment by other economies, the continued growth of China's economy and corporate strength, and the continued implementation of the "opening up" policy will propel China's entry into a new phase of outbound investment where the amount, structure and quality of Chinese outward direct investment will rapidly improve. Many Chinese enterprises have realized that outbound investment is not just a way to achieve geographic expansion or acquire natural resources. Once enterprises have reached a certain stage of development, outbound investment is a way to break through development bottlenecks by utilizing "domestic and international markets and resources" to enhance core competitiveness and improve companies' overall strength.

In other words, China's outbound investment is close to a tipping point. Chinese overseas investment is also exhibiting new characteristics. For example, investments are being undertaken to move Chinese enterprises up the value chain; these companies are increasingly looking to acquire targets in developed markets and undertake transactions to acquire advanced technology and R&D capabilities. The need to improve the structure and quality of China's outbound investments; the complex and dynamic global economic

environment; and the gap in overall strength, resources and experience between Chinese enterprises and mature multinational companies from developed nations all pose challenges for Chinese firms on their “going out” journey.

This is why KPMG’s Global China Practice (GCP) and our cooperation partners have jointly launched this special report: *The Dream Goes On: Rethinking China’s Globalization*. We hope that the report will achieve the following objectives:

- For Chinese enterprises with investments overseas: help them make the necessary preparations to manage risk
- For the Chinese government: provide some practical insights to consider in relation to improving its investment promotion and support system
- For readers outside China: open the door to better understanding Chinese enterprises and culture so as to deepen mutual understanding and trust.

The full report may be downloaded through the following link:
<http://www.kpmg.com/cn/DreamGoesOn>

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