China Outlook 2016: Synopsis

Key words: China business outlook; China outbound; Chinese ODI; Chinese overseas M&A; foreign investment in China; Chinese inward FDI

Today KPMG's Global China Practice released its much anticipated, flagship publication: ***China Outlook 2016***. Amidst all the headlines, commentary and discussion about China's transition from an investment-intensive, export-led model of growth, to one driven by consumption and innovation, this report looks at the implications of this process on inward foreign direction investment (FDI) and outward direct investment (ODI). Global Chair of KPMG's Global China Practice, Vaughn Barber said: "properly understanding the objectives of China's economic development, the policy settings which are being implemented to steer this transition, and the progress which has already been made are all key to understanding the drivers, trends and outlook for Chinese investment overseas, and for foreign investment in China."

While 6.9 percent gross domestic product (GDP) growth in 2015 represents a 25-year low for China, it is still one of the highest among the world's largest economies. The incremental economic output generated by China's 6.9 percent growth today is much higher than in the years when China was experiencing double-digit growth. Indeed, according to forecasts prepared by the IMF, China is expected to continue being the largest contributor to world GDP – in purchasing power parity terms – and is expected to account for nearly 20 percent of world GDP by 2020, compared to 15.5 percent for the European Union and 14.9 percent for the US.

China's transition to an innovation-driven, service-oriented and consumption-led economy has led to the emergence of a two-track economy. One track – in basic manufacturing and traditional industries – is experiencing significant headwinds; while a second track – in services, advanced manufacturing and consumer markets – is exhibiting strong growth potential. Understanding the objectives for development of these industries helps explain policy settings and identify opportunities for foreign firms investing in China and Chinese firms investing abroad.

Indeed, according to Thomas Stanley, Chief Operating Officer of KPMG's Global China Practice, China's economic restructuring "is taking place in a slower-growth environment, which taken together with other competitive and market factors is presenting significant challenges for business. At the same time, we see new growth opportunities in sectors whose development will assist in China's economic transformation, and the government is channelling investment into these areas."

The services element of the economy has presented robust growth, offsetting the impact of the industrial slowdown. The resilience that the service sector has shown amid the global and domestic slowdown helps to underline its importance for China's long-term growth, and explains why its development is among the Chinese Government's top policy priorities.

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Contribution from consumption as a percentage of GDP in China has been rising steadily and still has considerable potential to grow. We expect Chinese consumers will become one of the main drivers of China's growth in the future, especially given the country's current rapid urbanisation rate. E-commerce is turning into a pillar of growth: reducing costs and other barriers to entry, increasing competition, driving down prices, and unlocking new demand. E-commerce has become a dominant feature in the consumer spending landscape in China with online retail sales recording a 37.2 percent year-on-year increase to reach RMB 3.8 trillion in 2015, and this is forecast to almost double by 2018.

Over the course of 2015, the Chinese Government introduced a number of major policy initiatives to facilitate the country's transition into a high value-added economy, tackling issues such as overcapacity, increasing the productivity and international competitiveness of China's traditional industries, and promoting innovation and entrepreneurship. Importantly, rather than focusing on the speed of growth, these initiatives place importance on the quality of growth, in order to achieve a more balanced level of development that is conducive to long-term prosperity. We expect this to continue being a feature of China's policies in the next few years, especially following the release of the 13th Five-Year Plan in March 2016.

Chinese Overseas Direct Investment (ODI)

At USD118.02 billion, Chinese non-financial outbound investment hit a record high in 2015, recording a 14.7 percent year-on-year increase. Chinese outbound M&A activity recorded a 40 percent increase over the same period to reach USD 87.7 billion. Given this rapid growth, Chinese outbound M&A may be on track to surpass the USD 100 billion mark this year. Indeed, with a staggering USD 74.8 billion of deals being announced in the weeks up to 18 February, this activity shows no signs of abating. Consistent with our predictions last year in ***China Outlook 2015***, three trends characterised China's outbound M&A in 2015:

- First, China's outbound M&A activity continued to be focused on 'quality growth', with not only more but also larger deals being announced in high value-added and consumption-related sectors. For instance, 2015 saw 99 deals in the computer and electronics sector up from 57 in 2014, with their total disclosed value increasing from USD 9.0 billion to USD 11.8 billion.
- Second, and consistent with the first trend, Chinese companies did more deals in developed markets in 2015 compared with prior years. This translated into 408 deals or 81.3 percent of the total, with a value of USD 67.8 billion in 2015, up from 277 deals with a value of USD 52.3 billion in 2014, and 225 deals with a value of USD 33.3 billion in 2013.
- Third, more deals were announced by privately owned enterprises (POEs), accounting for 75.9 percent of the total number of deals in 2015, which was up from 68.0 percent in 2014 and 55.1 percent in 2010. State-owned enterprises (SOEs) are still doing the majority of the largest deals.

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Chinese outbound M&A – Key Statistics for 2015	
Top 3 countries and regions (by number of deals)	US – 113 deals Australia – 42 deals South Korea – 38 deals
Top 3 sectors (by number of deals)	Computers and electronics – 99 deals Healthcare – 54 deals Real estate (including hotels and restaurants) – 35 deals
Top 3 countries and regions (by deal size)	US – USD 14.4 billion Italy – USD 10.6 billion Australia – USD 8.4 billion
Top 3 sectors (by deal size)	Financial services (including insurance) – USD 18.1 billion Computers and electronics – USD 11.8 billion Utility and energy – USD 10.2 billion

Source: KPMG's China Outlook 2016

Looking forward

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

- **Sectors**: We expect that Chinese ODI will continue to be undertaken across more sectors. Key drivers include:
  - Acquiring experience, technology, brands and human capital to become more competitive, and support China's transition towards an advanced economy, which will benefit countries which are strong in sectors such as advanced manufacturing and information communication technology
  - Accessing high-quality products and services that can be deployed in China to meet its evolving consumption needs, which will benefit sectors such as agriculture and food production, healthcare and eldercare services

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- Creating new sources of demand for products and services affected by overcapacity issues in the domestic market
- Sourcing investments which allow Chinese companies to diversify their portfolio risk and earn more stable returns
- Building a credible track record that facilitates expansion into new markets, particularly in developed economies.

- **Types of investors**: More Chinese companies will make investments overseas, and POEs will feature increasingly in this trend. This is because POEs are active in many of the new sectors where Chinese companies are investing, and because from the perspective of many overseas countries, there is typically less sensitivity around investments by POEs compared to SOEs. This is reflected, for example, in the higher approval thresholds for POEs under the China-Australia Free Trade Agreement (ChAFTA). Financial investors will continue to be a feature of the Chinese ODI landscape.
- **Countries**: More investments will be made in North America, Europe and other developed economies, where there are more high-quality targets which can help Chinese companies upgrade, transform and improve their competitiveness. More projects and investments will be undertaken along the 'Belt and Road', as the objectives come to be better understood and the mode of implementing this initiative continues to evolve over the coming years.
- **Partnerships**: We will continue to see more win-win cooperation between Chinese and foreign companies, with partnership and building trust lying at the heart of these collaborations. Deals will often be struck on the basis of the Chinese partner providing one or more of the following advantages: access to China market demand, funding, a strong balance sheet, cost-competitive inputs to the production process, and/or unique expertise that can help the foreign company expand its business locally and/or in third countries.

These three drivers will have a positive impact on Chinese ODI in 2016 and beyond:

- **Government initiatives:** China is advancing a new paradigm of international cooperation through its ‘Belt and Road’, ‘International Production Capacity Cooperation’ and ‘Third-country Market Cooperation’ flagship initiatives. According to Vaughn Barber, “A key feature of the ‘new normal’ for China’s relations with the rest of the world is ‘cooperation’ and ‘collaboration’, both in China and in markets outside China, to the mutual benefit of China, the partnering countries and the third-country markets.”
- **New funding sources:** in addition to the emergence of financial investors on the China outbound stage, Chinese financial institutions and companies have announced over USD 1.1 trillion of funding for ‘Belt and Road’ projects. This is in addition to the USD 100 billion authorised capital for the Asian Infrastructure Investment Bank (AIIB) and the USD 100 billion of authorised capital for the BRICS New Development Bank. In January 2016, China became a member of the European Bank for Reconstruction and Development (EBRD) which opens the way for the EBRD to support ‘Belt and Road’ projects in member

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countries. We expect that other investment funds and financing platforms will be established to support these initiatives.

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

Agriculture and food, infrastructure, high end manufacturing and real estate will continue to be important sectors. ICT, healthcare and transportation are new "hot" sectors to watch in 2016.

Foreign Direct Investment (FDI)

In 2015, China saw another year of steady growth in FDI, which increased 6.4 percent year-on-year to reach an all-time high of USD 126.3 billion. There were fewer but larger inbound M&A deals, representing an increase in average deal size as higher value, more expensive Chinese companies were acquired: the total value of announced deals increased 75 percent year-on-year to USD 25.2 billion, and the total number of deals dropped to 202 from 248 the previous year.

In line with the emergence of a two-track economy in China, the service sector represented 61.1 percent of total FDI in 2015, while FDI into manufacturing accounted for 31.4 percent of the total. As a comparison, in 2006, 63.6 percent of total FDI went into the manufacturing sector, while 31.1 percent went into the service sector. Growing investment in China's service sector indicates that international investors are increasingly viewing China as an 'end-destination' market, rather than a source of low-cost labour.

Also, manufacturing firms are shifting away from the production of lower-cost goods for export, and are increasingly producing goods that are higher in quality and designed to meet the demands of the Chinese consumer. FDI into high-tech manufacturing, for instance, has grown rapidly over the past years, and it currently represents almost a quarter of total FDI into manufacturing.

Chinese inbound M&A – Key Statistics for 2015	
Top 3 countries and regions (by number of deals)	Singapore – 44 deals US – 41 deals Japan – 36 deals
Top 3 sectors (by number of deals)	Computers and electronics – 33 deals Professional services – 16 deals Agribusiness and food – 15 deals

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Top 3 countries and regions (by deal size)	Japan – USD 10.6 billion Qatar – USD 5.0 billion US – USD 3.1 billion
Top 3 sectors (by deal size)	Holding companies/conglomerates – USD 10.4 billion Oil and gas – USD 5.0 billion Real estate (including hotels and restaurants) – USD 2.1 billion

Source: KPMG's China Outlook 2016

Looking forward

A clear-eyed analysis of the opportunities for foreign investors in China indicates some dramatic shifts in the areas of need being emphasised by the China Government. These present significant opportunities for companies with targeted, well-positioned value propositions that deliver against emerging customer needs while simultaneously delivering a strong value proposition to the government's development goals.

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

Below, we list some of the most important drivers behind China's near-term growth priorities:

- **Recognition of the need for foreign technology, knowhow and capital in the service sector as the economy tries to keep up with the growing demands of China's expanding middle class** – This will generate FDI opportunities in areas such as healthcare, logistics, e-commerce, computer technology and consumer goods. While China will certainly continue its drive to develop a more localised IT industry, global advancements will continue to be recognised by China market participants and create ongoing partnering opportunities.
- **Strong aspirations for a cleaner, healthier and more inclusive society** – Government spending will pivot to the 'lean, clean and green' categories that seek to improve healthcare coverage, reduce environmental impact, strengthen food safety and security, and ameliorate pollution conditions. We expect this to bring opportunities in sectors such as elder care, new energy vehicles, environmentally friendly technologies, food processing and cold chain logistics.

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- **A desire to increase the productivity and international competitiveness of China's manufacturing sector, as shown by the release of the 'Made in China 2025' and 'Internet Plus' plans** – This will drive opportunities in advanced manufacturing and automation for foreign participants. We also expect the manufacturing aftermarkets to begin to mature more rapidly in China.
- **Need for advanced technology and expertise in highly specialised fields within traditional sectors in order to reduce operating costs** – This includes the development of non-conventional energy resources and technologies that provide for more efficient, cleaner utilisation of current energy sources.
- **The government's capacity to provide public goods is being strained by the high local debt levels and the country's rapid urbanisation rates** – This will drive significant opportunities for foreign capital to participate in social infrastructure projects including healthcare and education, among other areas. China has also signalled a willingness to encourage foreign investment through public-private partnerships (PPP) to meet these challenges, and we expect these efforts to accelerate in 2016 and to be highlighted in the forthcoming release of the 13th Five-Year Plan.

Some of the most important policies and initiatives by which Chinese authorities are and will continue encouraging FDI are:

- **Increasing market openness.** Both the *Report on the Work of the Government* and the *Plan for National Economic and Social Developmen*t, which were released during the third session of the 12th National People's Congress in March 2015 affirm that authorities will continue opening the service and advanced manufacturing sectors to foreign capital, while also loosening restrictions in the finance sector. Policies that will assist in this process include 2015's revised *Catalogue Guidance of Foreign Investment Industries*; China's FTAs with Australia and South Korea; and the establishment of new Free Trade Zones (FTZ) in Guangdong, Fujian and Tianjin, and the expansion of the Shanghai FTZ. Based on historical experience we expect some fits and starts in the process of experimentation associated with incremental market opening.
- **Urbanisation and private-public partnerships.** The Chinese Government has stated that it intends to increase the percentage of the population in urban centres to 60 percent by the end of 2020, and issue 100 million urban *hukous* in the process. Likewise, authorities are pushing forward the implementation of a number of regional development plans which will lead to the emergence of new urban centres, such as the 'Beijing-Tianjin-Hebei Coordinated Development Plan', which looks to develop a megacity cluster by combining Beijing's high-tech industries with Tianjin's port facilities and Hebei's traditional industries.

  It is expected that cities will require significant utility system upgrades to address current and future capacity gaps in the next five years. To finance these upgrades, government agencies have already begun implementing a range of pilot PPP programmes to determine financial feasibility. Authorities have already implemented a series of policies to provide clarity regarding the responsibilities of contracted parties and strengthen the rights of private corporations to arbitrate disputes, in order to attract foreign participation into PPPs.

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- **SOE reform.** Since the mid-1990s, China's SOEs have undergone a steady series of reform and modernisation initiatives, gradually opening previously protected sectors to foreign companies through direct investment and partnership with state-owned asset entities. In September 2015, authorities issued a guideline to deepen the reform process of its state-owned companies which, along the 13th Five-Year Plan, is expected to further open areas of the economy currently closed to private and foreign investment.

  The deepening of China's SOE reform should lead to more acquisition targets for, as well as wider market access to, foreign companies. Smaller branches of central SOEs will likely be sold off, or allowed to accept equity shared ownership. In this way, foreign companies should be able to enter additional markets that are currently still under state control.

- **'Made in China 2025' and 'Internet Plus' plans.** These plans set out a path for China to move up the value chain in the next decade by leveraging the latest advances in information communication technology, advanced manufacturing and automation technologies to increase the productivity of the country's traditional industries. This will bring opportunities to foreign investors in sectors such as pharmaceuticals and biotechnology, automotive, and aerospace. FDI will also be channelled to support China's efforts to modernise its agricultural industry, as well as the level of automation and sophistication of robotic technologies in lower-value industries.

The service sector will continue to grow, with e-commerce and logistics driving FDI opportunities. High-tech manufacturing will be another important sector, while the healthcare and environment sectors are areas to watch in 2016.

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