KPMG's Global China Practice commentary on FDI outlook

Breaking news, 4 March 2016: Draft Foreign Investment Law expected to ease access for foreign investors

Despite foreign direct investment (FDI) into China hitting a new high in 2015, mergers and acquisitions (M&A) represented a relatively small proportion of total FDI activity. A number of factors – such as restrictions on foreign participation in some sectors, lack of suitable investment targets, and challenges in deal process – have contributed to a perception that many foreign investors are cool to the prospect of new M&A activity in China.

As with many areas of the Chinese economy, signals from leadership and policy initiatives have a significant impact on practical investment matters and the interpretation of 'facts on the ground'. For this reason, the recent statement from China's Ministry of Commerce (MOFCOM) regarding foreign M&A in China is significant.

The content below includes a summarised translation of MOFCOM's press release, which was issued in relation to the press conference held in Beijing on 2 March 2016. We also provide commentary from KPMG's Global China Practice to provide context and analysis for what this may mean in practice, and what to watch for going forward.

Key developments

Cross-border M&A

At MOFCOM's press conference held on 2 March 2016, spokesman Shen Danyang was asked about MOFCOM's views on the wave of foreign M&A in China, especially foreign investors' participation in state-owned enterprise (SOE) reform through M&A.

In his response, Shen stated that cross-border M&A is an important form of global FDI, citing statistics from the United Nations Conference on Trade and Development (UNCTAD) which show that active cross-border M&A can lead to substantial growth of international capital flow. This was illustrated by the example that in 2015, the growth of global M&A (61 percent) contributed to global FDI growth of 36 percent.

While global cross-border M&A accounted for 38 percent of global foreign investment in 2015, investment from foreign investors to China through M&A (USD 17.8 billion) only accounted for 14 percent of the aggregate foreign investment into China last year. Although foreign investment via M&A has been increasing steadily in China in recent years, he said the scale and proportion of the total foreign investment are still far lower than the international level.

Shen added that he believes MOFCOM should support China's SOE reform initiatives by encouraging foreign investment through M&A. In light of the country's limited energy resources, this investment could help better explore and access existing energy supplies, drive industrial transformation and upgrading, introduce advanced foreign management experience, and further promote SOEs' international competitiveness by encouraging foreign capital M&A.

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FDI

China saw another year of steady growth in FDI in 2015, and Chinese leaders have continued to signal that China will actively encourage the use of foreign capital in key sectors. The media has reported that MOFCOM is planning how to further introduce and utilise FDI.

In this regard, Shen said that the scale of FDI in China increased 30 percent during the 12th Five-Year Plan period compared to that in the 11th Five-Year Plan period. In addition, an UNCTAD survey shows that China has continued to be listed as the most attractive investment destination for 2016 and 2017. FDI is a key part of China's opening up policy, and Chinese leaders, including President Xi and Premier Li, have often stressed that China will continue efforts to attract more FDI in an increasingly diversified list of sectors.

Policy measures under consideration

According to Shen, MOFCOM is studying specific policies and measures to increase the scale and quality of FDI utilisation. MOFCOM's initial views include the following:

- China will continue to improve the investment environment and further enhance foreign investors' confidence in investing in China.

- China will integrate the utilisation of FDI with goals underlying the country's economic transformation, industrial upgrading and regional coordination objectives, by actively introducing foreign capital, talent and technology.

- China will strengthen its legal system for foreign investment, particularly in two areas:

  1) Accelerating the revision of the *Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures*, the *Law of the People's Republic of China on Foreign-funded Enterprises* and the *Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures*

  2) Drafting the *Foreign Investment Law* and trying to submit the draft to the National People's Congress for approval in 2016.

- China will further lower the threshold for foreign investment and encourage foreign companies to invest in sectors including high-tech, environmental protection and cutting-edge services, in order to supplement the insufficient supply of products and services in these areas.

Viewpoint from KPMG's Global China Practice

This statement from MOFCOM came just ahead of the important *Lianghui* ("Two Sessions") meetings that started on 3 March 2016 in Beijing. *Lianghui* comprises two important policy discussion meetings over a two-week period – the key annual meeting of the Chinese People's Political Consultative Conference (CPPCC) and the National People's Congress (NPC).

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The press conference underscores the importance of FDI in China's economic transformation effort in specific sectors of the economy. These initiatives and the focus on specific sectors are consistent with the conclusions in our recently released *China Outlook 2016* report, where we stated that "…China's SOE reform should therefore create two opportunities for private and foreign investors: 1) Smaller branches of central SOEs will likely be sold off, or allowed to accept equity shared ownership; 2) By taking equity stakes in SOEs targeted for 'mixed ownership', foreign companies should be able to enter additional markets that are currently still under state control. This mechanism may require patience and an incremental approach, but should result in the progressive opening of additional sectors if initial cooperation initiatives prove fruitful."

We will continue to monitor the measures to introduce foreign participation in the SOE sector as they progress. It is notable that this topic was discussed at length in a prominent public setting, demonstrating the importance the government ascribes to the topic.

It is not unusual that there are few specifics at this stage. While the comments are directional in nature, there are some clear indicators about MOFCOM's view on its role in further enabling FDI into specific sectors. We believe the legal and regulatory updates are important but will not have a significant impact in the short term. Further, it is interesting to note that the role of the free trade zones (FTZs) is not specifically mentioned, although we expect that FTZs will play an important role in piloting new policies.

In addition, looking to the example of the role of the China-Australia Free Trade Agreement in further clarifying opportunities for healthcare sector foreign investment, we expect that future FTAs will serve to codify areas that are explored more generally in initial central government comments.

Lastly, we note that while shared ownership is increasingly promoted by the central government as a practical reform instrument, many foreign investors are not overly attracted by the opportunity for minority stakes. This is an area where we expect further evolution of the spectrum of opportunity through experimentation and ongoing dialogue between foreign investors and the China Government.

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