The national policy—"One Belt One Road"—has created a conducive environment to make state-owned enterprises (SOEs) more global; and SOEs should take advantage of the policy impetus to become internationally competitive.

"One Belt, One Road" The Internationalization of China's SOEs

By / Norman Sze, Flora Wu

Decades have passed since China's state-owned enterprises (SOEs) started their internationalization. Many impressive achievements have been made, yet there is still room for improvement. On September 13, 2015, the Central Committee of the CPC and State Council published a top-level government policy paper entitled "Guidelines to Deepen Reforms of SOEs" , in fact a de-facto blue-print for the further reform of SOEs. The guidelines stated that SOE reforms aim to achieve a socialist market economy and improve the modern enterprise system. What this means, in effect, is that SOEs, especially larger SOEs, should compete in global markets, allocate resources across the world, and increase operational efficiency. Step by step, China is implementing its national strategy for a new era of economic development and opening up to the outside world, i.e. the Silk Road Economic Belt and the 21st-century Maritime Silk Road ("One Belt, One Road" or "OBOR") Initiative. These initiatives have created more favorable external conditions for SOEs to invest abroad and thus ushered in a new age of internationalization. It is also likely that the internationalization of SOEs will change focus from mere expansion to improving operations management and enhancing global competitiveness by taking advantage of the OBOR Initiative. Through surveys of middle and senior-level SOE managers, we obtained insights into SOE participation in the OBOR Initiative as well as learning about the challenges they face. This paper presents several representative solutions to such challenges, and aims to offer some new ideas on how Chinese SOEs can successfully internationalize.

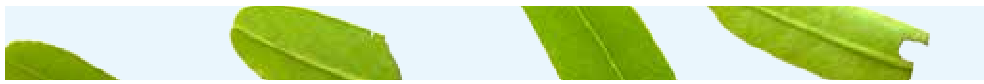
Part One: A Historical Review of SOEs' "Going Global" Strategy and an Analysis of the OBOR Initiative.

1.1 By "going global", SOEs have grown, but managerial skills need improving

China's SOEs began "going global" in the mid-1990s. After China became a WTO member, more and more SOEs expanded their businesses abroad, carrying out international operations, overseas investments, and M&As. After the 2008 financial crisis, many SOEs jumped into the overseas market looking for bargains, and entered into an increased number of overseas investments and M&As. In China's Top 100 Multinational Enterprises 2014 published by the China Enterprise Confederation, there were 84 SOEs - 50 were central SOEs holding overseas assets of RMB4.5 trillion and 34 were provincial SOEs holding overseas assets of RMB 500 billion. China's state-controlled financial institutions possessed even larger amounts of overseas assets. According to the China Banking 2013 Corporate Social Responsibility Report issued by the China Banking Association, by the end of 2013, the total amount of overseas assets owned by 18 Chinese banking financial institutions had reached RMB7.45 trillion. Currently, China's government holds overseas assets totaling over RMB12 trillion. According to statistics published by the Ministry of Commerce, in 2014, Chinese enterprises made direct overseas investments of US$116 billion, which exceeded that of foreign direct investments in China, making China a net capital exporter. SOEs have played a vital role in China's overseas investments and deserve much of the credit for this historic breakthrough.

By "going global", SOEs have allocated resources across the world, expanded into broader markets, achieved economies of scale, by-passed barriers to international trade, and increased capital flexibility and arbitrage opportunities --- all of which has profoundly impacted not only international economic structures, but also China's own domestic economic reforms, and the upgrading of its' industrial structure. A measure of their success in the last two decades is the fact that, with SOEs as the main driving force, Chinese enterprises have leapt into the Fortune Global 500. As of July 2015, 106 Chinese enterprises (84 of which were SOEs) were listed as Global 500 companies, further closing the gap with the United States (128 enterprises)[1]. Such impressive achievements notwithstanding, China's SOEs still face many challenges and risks on the road to globalization. In a nutshell, China's SOEs have grown phenomenally but are still not strong enough, and need to learn how to run multinational operations. Compared with top global companies, China's SOEs have a long way to go to gain experience and enhance risk control capability.

China's SOEs have used specific methods to achieve internationalization. These include import and export trading, project contracting, greenfield investment, and overseas M&A. But each strategy poses unique challenges:



- Import and export trading: low value-added goods, such as textiles, still make up the bulk of China's exports; The export of high value-added goods and services such as high-speed rail and nuclear power has just begun.
- Contracting and greenfield investment: understanding of local environments is insufficient at the bidding stage, the risk control mechanism is unsound at the construction stage, and post-construction management is weak; in the future, Chinese enterprises may consider BOT (build–operate–transfer) or PPP (public–private partnership) models for more projects to marry the interests of host countries with those of Chinese enterprises, following more international market practices and taking sustainability into account.
- Overseas M&A: pre-M&A due diligence is insufficient, risk control ability is weak during M&A, and post-M&A integration capacity is low.
- From a commercial and financial perspective, many overseas investments and M&As fail to live up to expectations.
- Many of China's SOEs have merely expanded abroad but do not yet possess the strategic perspective and abilities needed to manage a multinational enterprise.
- Only a few of China's SOEs have international competitiveness and global brand recognition.

1.2 "One Belt, One Road" will initiate a new era of internationalization but China's SOEs must interpret the policy based on their individual economic conditions.

Under the OBOR Initiative, the internationalization of China's SOEs will enter a new era. Having learned their lessons from "going global" in the past, in the next 5 to 10 years China's SOEs should be able to advance beyond the stage of "feeling their way" with untested, short-term strategies to a more mature long term view. If they are to learn from past experience, China's SOEs must do more than simply increase in scope and size, they need to concentrate on delivering better management. With the broader stage and strong support provided by the OBOR Initiative, improving internal management capabilities and truly becoming large enterprises with international competiveness will be both feasible and a priority for China's SOEs.

When Chinese President Xi Jinping visited Central Asia and Southeast Asia in September and October 2013, he announced the initiative of jointly building the Silk Road Economic Belt and the 21st-Century Maritime Silk Road. The announcement attracted attention worldwide. On March 28, 2015, Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road ("Vision and Actions") was jointly issued by the National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of China; this document provides the framework for the implementation of the OBOR Initiative.

A close study of the document reveals the following points.

Though the OBOR Initiative is based around Afro-Eurasia and its surrounding bodies of water, it is not tied to a geography or place. The Chinese government has repeatedly stressed the inclusiveness and openness of the OBOR Initiative. Therefore, while the interpretation of "the plan spanning 65 countries along the OBOR" has been widely cited, we understand the OBOR Initiative to be a global strategy, welcoming any countries willing to participate. Moreover, the influence of the OBOR Initiative is not limited to the 65 countries along to road, but can reach across the globe. Norway, for example, does not lie along the geographic OBOR route, but that did not stop the country from joining the Asian Infrastructure Investment Bank ("AIIB"),and participating in the OBOR Initiative as an AIIB founding member.

The OBOR Initiative promotes economic and cultural cooperation among countries, suggesting five major goals of policy coordination, facilities connectivity, unimpeded trade, financial integration, and interpersonal connections.[2] Many countries along the Belt and Road have poor transportation and energy infrastructure yet are richly endowed with natural resources, so their demand for infrastructure construction is huge. For instance, Indonesia is one of the most important economic entities in Southeast Asia, and also has the largest population among ASEAN members. However, according to the Asian Development Bank and International Monetary Fund's report, the lack of infrastructure development signals barriers to growth and overall development for Indonesia. Statistics show that Jakarta's traffic congestion raises business costs and reduces quality of life by US$3 billion annually[3]. Another country on the Silk Road, Mongolia, has rich coal, copper, iron, and phosphorus resources, but poor transportation and communication infrastructure. Investors wanting to invest or establish factory or mining operations in Mongolia are forced to solve transportation, water, electricity, and communication issues on their own, increasing investment costs immensely. This lack of infrastructure prevents Mongolia from receiving FDI and developing its economy.

Development in many other countries in Southeast Asia, South Asia, Central Asia, and North Africa are similarly hindered by varying degrees of lack of infrastructure, and these countries eagerly await investment to upgrade current systems. Chinese enterprises have accumulated a wealth of overseas construction experience in recent years, with projects including highways, high-speed railways, ports, harbors, airports, oil and natural gas pipelines, and power lines. In a written bulletin Premier Li Keqiang highlighted the role of international cooperation in production capacity and equipment manufacturing in promoting China's economic growth. Boosting such cooperation is essential to halting economic slowdown, achieving medium-to-high speed growth and a medium-to-high level of development, further integrating into the global economy, and having win-win outcomes in cooperation with other countries.[4]

Besides infrastructure, countries and regions involved with the OBOR Initiative will witness cross-border trade and industry investment reaching new heights. Jointly built industrial parks, such as free trade zones and cross-border economic cooperation zones, will be established within these countries and regions, reducing numerous cross-border trading costs and barriers; new commercial activities—such as cross-border e-commerce—will also develop within industry zones. We forecast extensive opportunities for Chinese companies in the OBOR regions in agriculture, forestry, animal husbandry, and fisheries, agricultural machinery manufacturing, farming, marine-product farming, deep-sea fishing, aquatic product processing, as well as in the areas of seawater desalination, marine bio-pharmacy, ocean engineering technology, and environmental protection. Opportunities for Chinese SOEs will also arise in processing technology, equipment, and engineering services in areas such as hydropower, nuclear power, wind power, solar power and other clean and renewable energy sources. There will also be greater government to government cooperation in the surveying and development of coal, oil, gas, metal and mineral deposits, and other conventional energy sources.

While the OBOR Initiative is a national strategy, the market itself should still be the deciding factor for SOEs in deciding which projects to take up. And the government should only provide necessary support services. Enterprises should first evaluate their own strengths and weaknesses and then decide whether and how to participate in the OBOR Initiative. Management of enterprises carrying out OBOR projects should concentrate upon how to avoid or control risks, increase profits, and maintain sustainable growth.

The OBOR Initiative has no public project list, only a public list of economic corridors. The "Vision and Actions" document issued by the National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of China, also emphasizes that the Belt and Road Initiative is a systematic project, which will be "jointly built through consultation to meet the interests of all, and efforts should be made to integrate the development strategies of the countries along the Belt and Road". In other words, projects will be negotiated and decided jointly by China and involved countries. Although the OBOR Initiative is a global strategy, we understand that the majority of future major infrastructure construction projects and industry investment projects will be implemented in the following economic corridors:

- Overland: international economic cooperation corridors such as a new Eurasian Land Bridge corridor, the China-Mongolia-Russia corridor, the China-Central Asia-West Asia corridor, the China-Pakistan corridor, the Bangladesh-China-India-Myanmar corridor, and the China-Indochina Peninsula.
- By sea: one route from China's coast through the South China Sea to the Indian Ocean and to Europe, and another from China's coast through the South China Sea to the South Pacific.

However, with respect to specific economic collaboration projects, the market itself should still be the deciding factor with enterprises playing the leading role. It is China's SOEs' social responsibility to undertake the OBOR projects.They are certainly capable of such an undertaking given that SOEs, especially central SOEs, comprise the majority of enterprises that have "gone global." As the OBOR Initiative continues, the internationalization of SOEs will further develop in both depth and breadth.

In the new era of internationalization, China's SOEs should not blindly follow trends. Instead, they ought to consider whether and how their operations and development strategies are related to the opportunities brought by the OBOR Initiative. China's SOEs should stick to a market-oriented perspective and strong commercial practices, and carefully study local needs, balancing them against all possible innovation, cooperation, and investment models. Presented with an opportunity such as the OBOR Initiative, China's SOEs, especially the 84 SOEs among the Global 500, should they wish to truly become multinational companies with global competitiveness, brand influence, and international management capability, need to grow stronger internally, in particular, by grasping top-level design thinking.

There are different ways to achieve internationalization, none of which applies universally, and enterprises will have to make strategic decisions in light of their own needs, capabilities, economic strengths and weaknesses. Internationalization strategies include import & export, multi-domestic, global standardization, and geographical diversification strategies. Different strategies correspond to different kinds of advantage, product types, scope of competition, standards for site selection, and standards for designing organizational structure.

Figure 1 Internationalization strategies commonly adopted by enterprises

Strategic Situation	Description
Import and export	This strategy is mostly adopted by commodity trading companies. From a cost point of view, these companies can increase arbitrage chances by becoming internationalized. Generally, these companies are headquartered domestically with subsidiaries all over the world so they can take advantage of price differentials, profiting by buying low and selling high.
Multi-domestic	Companies adopting this strategy usually offer lifecycle-based products. They can expand their product portfolio through internationalization. Subsidiaries are responsible for profit in each country. Instead of setting mandatory requirements, headquarters only offer advice, in order to give local subsidiaries room to maneuver. Global best practices are not used company-wide, instead, companies let subsidiaries operate independently and achieve profits according to local market environments. Company structure is based on geographic location. Example: Groupe Danone.
Global standardization	Companies offering standardized global products and services usually adopt this strategy. They compete in global markets by achieving economies of scale through internationalization. These companies unify local constituents through globally-shared business objectives, values, and principles, and design their organizational structures based on business units instead of geographical locations, and are capable of mobilizing managers globally. Example: Procter & Gamble.
Geographical diversification	A geographical diversification strategy is a combination of the two aforementioned strategies, suitable for companies with platform-based products. This strategy applies global best practices in certain regions and aims at building a globally unified brand and establishing a matrix organizational structure, allowing local management to have independent decision making authority on certain matters but not all. Example: L'Oréal Group.
Regional internationalization and intergration	Compared to complete globalization or localization, regional internationalization can coordinate different countries' needs within the region, reducing the impact of differences between countries. Usually, these companies will not integrate business across different regions. Example:Unilever.

No Internationalization strategy can be judged as inherently good or bad. While different enterprises are internationalized to different degrees, adopting a particular strategy depends on the objectives and advantages that a company wants to achieve through internationalization. A company on its way to internationalization needs to make key decisions on products, competition, site selection, organizational structure design and in the ultimate analysis, strike a balance between maintaining a unified internationalization strategy within the group and efficiently executing global operations.

Every outstanding enterprise boasts sustainable and profitable growth. One tried and tested way to achieve sustainable and profitable growth is entering new markets through internationalization, expanding product portfolios, adjusting organizational structure, and improving internal capability.

In the new round of internationalization promoted by the OBOR Initiative, China's SOEs bear the responsibility of carrying out the national strategy, but this brings its own set of challenges. In order to stand out as internationalized enterprises, China's SOEs should first consider the following issues:

- How to integrate the OBOR Initiative with the enterprise's own long-term strategy?
- How to adjust the company's industry and product portfolios?
- Which countries or regions should be targeted as priority areas for internationalization?
- Which approach should be taken to enter the target market?
- What kinds of difficulties will the enterprise encounter? How can these be overcome?
- How can the company comprehensively manage risks? How can it establish a system of crisis management, including early warning and post-crisis feedback mechanisms?
- Which internal and external abilities need to be improved?
- Which kinds of organizational and systematic protection are necessary?

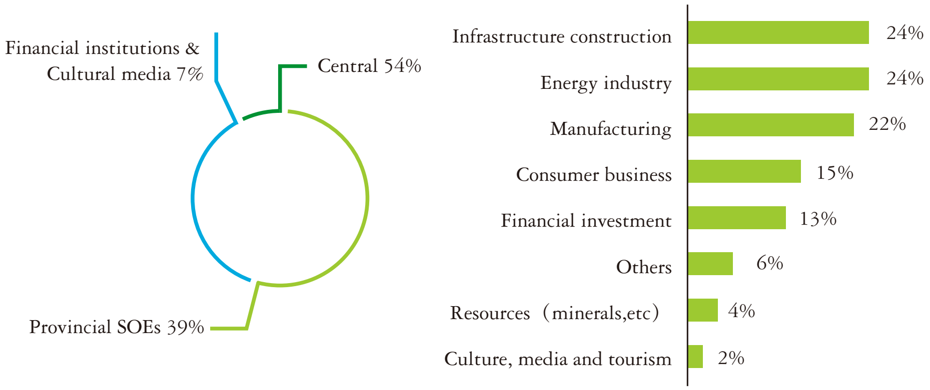
Part Two: Survey and Key Findings - Internationalization of China's SOEs and the OBOR Initiative

In order to provide insights into the above issues, we need to first understand the current status of the internationalization of China's SOEs and their intentions and difficulties in participating in the OBOR Initiative. By surveying middle and senior-level SOE managers regarding the internationalization of China's SOEs and the OBOR Initiative, we discovered the following:

1. The category and industry distribution of interviewed SOEs tallies with our analysis of which industries stand to gain the most from the OBOR initiative.

In total, we received 54 valid surveys, of which, 54 percent were from central SOEs, 39 percent from provincial SOEs, and 7 percent from state-owned financial institutions and cultural media. Such distribution is consistent with the composition of SOEs participating in the OBOR Initiative: central SOEs take the lead, provincial SOEs play a major secondary role, and state-owned financial institutions and cultural media are also active participants. As for the industry distribution, infrastructure construction (including telecommunications) and energy are the two industries in which the majority of interviewed SOEs are located, each accounting for 24 percent, with manufacturing (22percent) and consumer business (15percent) coming next. Enterprises in the top four industries constitute 85percent of the interviewed SOEs. This percentage tallies with our analysis of which major industries stand to gain the most from the OBOR Initiative.

Figure 2 Category and industry distribution of interviewed SOEs



2. Overall, the proportion of total revenue coming from overseas operations for China's SOEs is significantly lower than that of leading multinational companies in the Global 500, and lower than that of Chinese private enterprise in the Global 500 as well

The survey shows that for 43 percent of China's SOEs, their overseas revenue currently accounts for less than 5 percent of their total revenue; for 60 percent of China's SOEs, the proportion is less than 10 percent. This demonstrates that the majority of China's SOEs are still in the early stage of overseas market development and their overseas revenue potential has yet to be realized. However, for a minority 20 percent of the interviewed SOEs (11 out of 54) overseas revenue accounts for more than 30 percent of total revenue. Of these 11 SOEs, 73percent (8) are central SOEs. By industry distribution, about 40 percent are in the infrastructure construction industry, with the energy and manufacturing industries coming next. These results again show that central SOEs are the "going global" pioneers, with SOEs in the infrastructure construction, energy and manufacturing industries leading in internationalization.

According to the China Enterprise Confederation and China Enterprise Directors Association's 'China Top 500 Enterprises Analysis Report 2014' , 272 enterprises among the top 500 have provided their overseas revenue data (most of which are SOEs); for these companies overseas revenue accounts for 10.9 percent of the total revenue, which is essentially consistent with the results from our survey. However, for some leading multinational companies, overseas revenue accounts for more than half of the total revenue demonstrating that for these select companies the overseas market has become an integral part of their market. These same five Fortune Global 500 companies ranked in the Top 50 by profits[5].

Figure 3 Overseas revenue proportion of notable Fortune Global 500 companies

Company Name	Ranking in Fortune Global 500 in 2015	Overseas Revenue Proportion
Exxon Mobile	5	62%
Chevron	12	59%
GE	24	52%
IBM	82	55%
P&G	100	67%

Compared to many of China's SOEs in the Global 500, Lenovo and Huawei are ahead of the curve regarding overseas revenue proportion. In the fiscal year 2014 – 2015, the proportion of Lenovo's overall revenue coming from overseas earnings reached 68 percent and Huawei's was about 62 percent[6]. These numbers are comparable to many leading multinational companies.

3. About 90 percent of Chinese SOEs have established either a centralized or decentralized structure for internationalization, but they still have to adjust the limits of authority for different units within the company, improve responsibility and increase management efficiency according to their own internationalization strategy.

On the organizational structure side, nearly 60 percent of interviewed SOEs have established an "international" department to centrally plan and manage overseas business, about 24 percent of the SOEs have their overseas business management personnel placed in each business unit, and 6 percent leave overseas subsidiaries to handle this independently. It is worth mentioning that about 10 percent of interviewed SOEs have no specific department to handle their overseas business, which can lead to an unstructured, somewhat disorganized management of overseas business. These companies need to further refine their organizational structure.

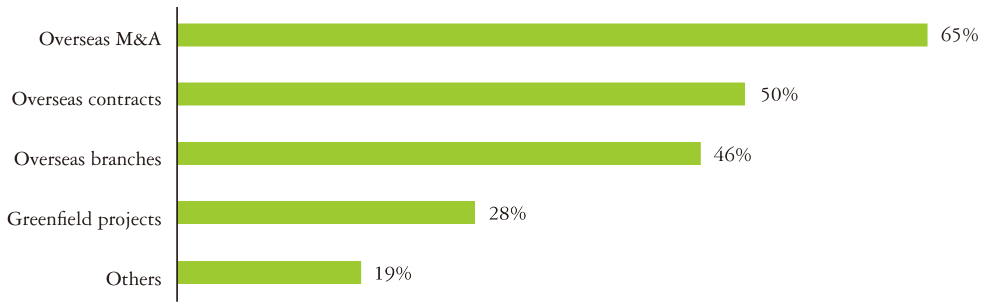
As mentioned above, there are no "good" or "bad" internationalization strategies. An organizational structure needs to be designed in correspondence with an internationalization strategy. There is no single 'right' answer to whether centralized management or decentralized management is better. However, further analysis of decentralized management shows that a multi-domestic strategy corresponds to an organizational structure based on geographic locations, while a global standardization strategy corresponds to an organizational structure based on business units. In the next stage of internationalization, China's SOEs will need to adjust their organizational structure according to their respective internationalization strategies, and more importantly, define the bounds of authority and responsibility between different departments and improve internal rules and regulations. The ultimate goal is to increase management efficiency within the company and thus operate efficiently on a global scale.

4. With the implementation of the OBOR Initiative, China's SOEs have adopted diversified forms of internationalization and the number of Greenfield projects will increase.

Amongst the SOEs who were surveyed, overseas M&A was the most widely adopted method of internationalization, followed by overseas construction contracts and establishing overseas branches to advertise and promote domestic business products. For overseas M&A, most SOEs preferred whole ownership or being the controlling shareholder, while only a few accepted to acquire a minority interest. Some SOEs also chose overseas trading or cooperation with foreign institutions as their preferred method of internationalization.

Greenfield investment is a form of investment where a parent foreign company establishes a new enterprise in the host country; this new enterprise must abide by the host country's laws, with partial or whole assets belonging to the parent foreign company. While it is true that Greenfield projects have a longer time cycle compared to M&A, and thus require higher management capability from the investors when compared to a simple construction contact, entering target markets with greenfield investment allows Chinese investors to retain the monopoly advantage and have better risk control. If the host country is a developing country, the investment project will usually come with policy support, reducing costs and increasing investor profits. Many OBOR projects will adopt the PPP model (Public Private Partnership, where the host country government collaborates with the Chinese enterprise), with China's SOEs investing or carrying out investment and construction simultaneously in the host country, hence it is very likely that the number of greenfield projects will increase substantially.

Figure 4 Internationalization forms adopted by interviewed SOEs



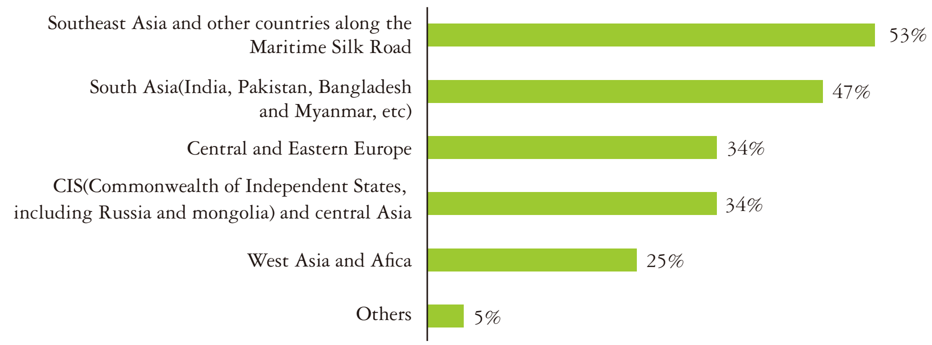
5. About 40 percent of interviewed SOEs indicated that their internationalization directions would not lean towards the OBOR Initiative, demonstrating maturity and independence in making investment decisions.

Concerning the intention to participate in the OBOR Initiative and the changes in foreign investment scales, nearly 60 percent of interviewed SOEs stated that their short-term internationalization would rely on the OBOR Initiative while the remaining 40 percent indicated that it would not. This latter figure shows that a large number of SOEs can independently plan future development rather than blindly follow trends. At the same time, 70 percent of interviewed SOEs stated that their future internationalization direction relied on the OBOR Initiative. Among SOEs willing to participate in the OBOR Initiative, 78 percent anticipated that the overall scale of future overseas investment would become larger than in recent years. Under the guidance of the OBOR Initiative, China's SOEs, especially central SOEs, are likely to unleash a new wave of overseas investment in the coming years.

6. The most favored investment destinations are Southeast Asia and South Asia.

Southeast Asia and South Asia were the regions most commonly picked as favorable investment destinations by interviewed OBOR SOEs, followed by Central and Eastern Europe, CIS, and Central Asia. Southeast Asian countries, with their geographic closeness to China, frequent economic and trade exchanges, relatively high degree of development, and huge need for infrastructure improvement, are the most favorable investment destinations for SOEs. South Asian countries have large populations and huge market potential. Priority regions for the OBOR Initiative include the Bangladesh-China-India-Myanmar and China-Pakistan economic cooperation corridors, and these regions should see many projects in the near future. For this reason, South Asia has received attention from China's SOEs.

Figure 5 Favorable investment destinations for SOEs



7. SOEs need to upgrade four kinds of capabilities: long-term strategy, financing, risk control, and international talent.

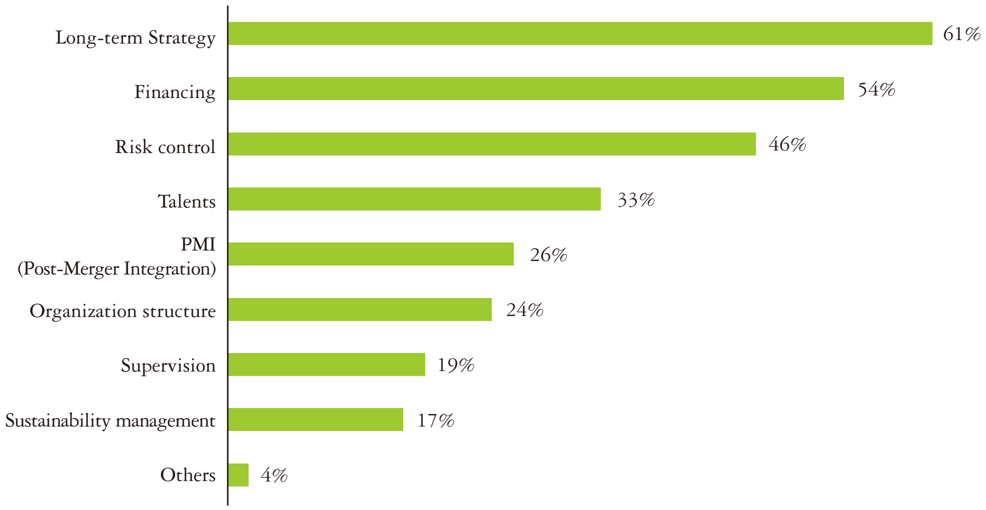
When asked what were the three most important changes that need to be made in the company for successful internationalization or participation in the OBOR Initiative, the following were most common answers:

- Up to 61 percent of interviewed SOEs indicated that during overseas investment and expansion, the enterprise itself has to form a clear, long-term strategy which takes the entire group into account, and to avoid impulsive investment (done without an exploration of market potential) and other short-sighted actions.

- 54 percent of interviewed SOEs chose "increase financial support for enterprise's internationalization by government, financial institutions, or social capital".
- 46 percent of interviewed SOEs selected "improve capabilities for evaluating, preventing, and responding to various risks, such as political, legal, tax, cultural (religious) risks of the investment host country".
- 33percent of interviewed SOEs chose "create a reserve of international talents capable of comprehending local laws, regulations, and culture, as well as management and operation".

The results show that the difficulties encountered by China's SOEs during internationalization mainly concerned four aspects: strategy, finance, risk control, and talent. In addition, post-investment management, such as "PMI (Post-Merger Integration)" and "sustainable management enhancement of overseas greenfield projects/contract constructions", was also regarded a big SOE shortcoming. 24 percent of interviewed SOEs chose the category "reasonable construction/organization of enterprise's management structure to enable headquarters to better manage overseas branches/projects", reflecting that SOEs also need to improve their organizational structure and control system building. In addition, some enterprises mentioned their need for support in seeking suitable projects, as well as their hope that the Chinese government would take measures to avoid unhealthy competition in the international market among SOEs in the same industry.

Figure 6 Major challenges perceived by internationalized SOEs



8. China's SOEs lack sufficient understanding of local risks in host countries and therefore are unable to respond adequately. More than 60 percent of SOEs have not set up related in-house risk control positions nor attempted to engage professionals to help them reduce risk.

The overseas operations of China's SOEs, particularly in the projects related to the OBOR Initiative, are exposed to all kinds of risks, including natural risks, political risks, social risks, and legal risks, to name a few. But Tax risks were singled out as being the single most worrisome. Our survey results below enumerate the three biggest tax-related challenges relating to participating in the OBOR Initiative:

- 90 percent of interviewed SOEs indicated that "they are unfamiliar with host countries' tax system, tax collection and management; overseas projects involve relatively high tax risks".
- 78 percent of interviewed SOEs stated that "host countries of overseas projects generally impose strict regulation on Chinese enterprises".
- 67 percent of interviewed SOEs have encountered "difficulties due to lack of experience in responding to local tax authorities' inspections or tax disputes".
- 55 percent of interviewed SOEs felt "host countries of overseas projects frequently change tax regulations while Chinese enterprises have limited resources to gain relevant information in time".
- 43 percent of interviewed SOEs do not have experienced tax management staff for overseas projects.

69 percent of interviewed SOEs do not have a complete tax risk management system or specific risk control positions. Compared to the advanced and full-fledged tax management systems in leading multinational companies, the majority of China's SOEs still have much room for improvement. Chinese enterprises should give due attention to tax risk management in overseas investment and operations, otherwise it will become a constraint on their ability to compete globally and stop them from becoming truly modern multinational enterprises.

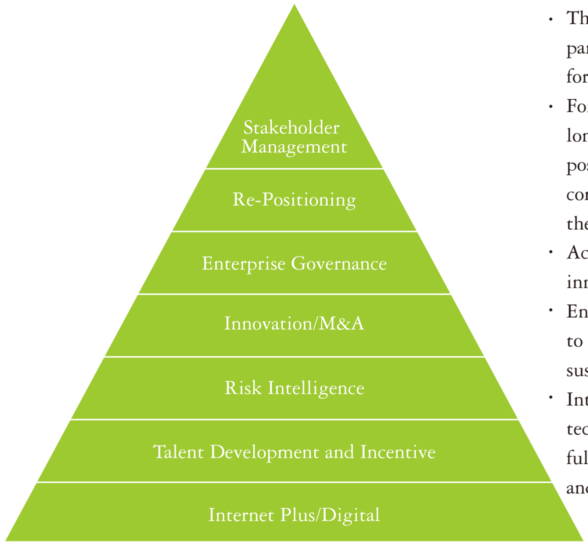
67 percent of interviewed SOEs have never employed tax advisers to evaluate the tax environment, collection and management systems, and tax risks in the host countries, nor arranged appropriate tax optimization for overseas projects. This shows clearly that China's SOEs have not paid enough attention to reducing tax risks in the operation of overseas projects, nor have they tried to utilize globalized professional institutions to develop strategies for optimizing their overall tax burden.

Part Three: With the OBOR Initiative, the Internationalization of China's SOEs will Reach New Heights.

SOE reform focuses on three areas - "Marketization, specialization, and internationalization". China's SOEs interpret internationalization as the ability to compete successfully in the global marketplace, and in the process become more professional by improving various internal capabilities. In other words, the success of the internationalization of SOEs hinges on the improvement of internal capabilities.

Based on its research, Deloitte now proposes a conceptual framework for SOE reform, covering various internal capabilities of enterprises. This framework can act as a guideline for individual companies who want to design their own blueprints for successful internationalization under the OBOR Initiative.

Figure 7 Conceptual framework: SOE reform



- The reform of SOEs affects various interested parties, requiring comprehensive considerations for its top layer design
- Formulating and implementing medium and long-term planning by carrying out strategic positioning and enterprise governance to ensure companies'sustainable and profitable growth and the increase in shareholders' value
- Achieving organic and inorganic growth by innovation and M&A respectivdly
- Enhancing risk control and talent development to guarantee the driving forces for companies' sustainable development
- Introducing Internet plus and digital technology and solidifying reform process to fully implement the measures for innovation and reform

Before undertaking an OBOR sponsored project, SOEs should carefully evaluate their position with regard to the key aspects of our conceptual framework: strategy, finance, risk identification and control, talent, and control systems.

Long-term strategy: Where most SOEs were concerned, the lessons of the past with regard to short-sighted or impulsive investment have been well learnt. More than 60 percent of interviewed SOEs stated that "formulating a clear, long-term strategy" is one of the most demanding challenges in the new era of internationalization. First of all, as part of the group's overall business activities, the strategic planning of overseas investment and operations must serve the group's overall strategy. Next, to effectively implement its overseas investment strategy, the strategy must be broken down into different components such as positioning, strategic targets, execution, quantitative indices, and risk control.

Finance: To provide funding for SOEs participating in the OBOR Initiative, China has initiated the Asian Infrastructure Investment Bank (AIIB) and established the Silk Road Fund. However, AIIB will have only US$100 billion and the Silk Road Fund US$40 billion, and so more funds will need to be found to make OBOR projects a reality. Greenfield investment is one good way of attracting finance. By establishing a joint venture project company in the host country with contributions from the host country's government, other "going global" SOEs, third party enterprises, and financial institutions, the SOE in question should succeed in obtaining financing. In addition, grouping its interests with those of the host country and third parties will reduce project risk.

Risk control: China' SOEs, particularly OBOR projects, will quite likely encounter numerous risks during the process of internationalization - political risk, legal and compliance risk, operational risk, and of course financial risk. The capacity to evaluate, respond, learn from and hence prevent these risks will determine how successfully China's SOEs internationalize.

Talent Development: Investing in talented personnel is the foundation stone of successful SOE internationalization and reform. Talented personnel include not only Chinese management personnel acquainted with local laws and culture but also local management personnel and staff. Interpersonal relations play an important part in the implementation of the OBOR Initiative. The success of OBOR projects depends on gaining the trust and support of local people. In some recent cases, newly-elected host country governments have been unwilling to proceed with projects, however, with support from local people and employees, Chinese enterprises have managed to convince the governments to complete the projects. Many OBOR projects are obliged to hire local employees, and therefore communicating with various local parties, sharing corporate culture, and establishing a corporate image in a market radically different from the domestic market politically, economically, and culturally, will test SOEs' "soft power", i.e. their cultural sensitivity, during the internationalization process.

Financial control: A major goal of internationalizing SOEs is to achieve effective operations on a global scale under the guidance of an integrated and clear development strategy. Effective operation requires the establishment of a control system with well-defined authority and responsibility boundaries and risk control functions, a management system which measures performance, an application sharing mode to achieve intensification of operation, and management standardization for quick worldwide implantation of operational models. As proven by the practices adopted by world leading multinational companies, the construction of a shared financial service center increases the integration of operations and finance allowing management to react quickly and efficiently to opportunities and problems that arise during the execution of the project.

Tax planning: In recent years, with Chinese enterprises "going global" and participating in bigger projects in OBOR countries, local governments and tax authorities at all levels have begun scrutinizing the management and tax compliance systems of Chinese enterprises much more closely. Often local tax authorities target the operations and construction projects of local Chinese enterprises, conducting regular or irregular tax inspections and audits of Chinese enterprises. Many enterprises have been involved in tax disputes and even some tax-related litigation with local tax authorities in their "going global" projects. Therefore we believe that before signing project agreements, enterprises must consider potential tax risks in relation to transaction structures and contractual term. They should actively communicate and negotiate with local tax authorities during the implementation of the projects, and invoke tax exemption clauses and cases to reduce fines and/or resolve tax disputes.

Internationalization is the only way for China's SOEs to grow in size and strength, to reform and develop. While the OBOR Initiative can create unprecedented opportunities in the coming decades, it will also throw up unprecedented challenges. Looking to the future, we would like to make the following suggestions:

- Every outstanding enterprise boasts sustainable and profitable growth. SOEs should conduct comprehensive feasibility studies and predictions before investing in overseas projects or carrying out international operations and focus on long-term profits and return on assets.
- Enterprises should not blindly follow trends or make impulsive investments. Investments should be consistent with the enterprise's overall strategy, giving due attention to risk factors and due diligence, Managers must have the courage to vote against unfeasible projects.
- The OBOR project countries have different political and economic systems and diverse cultural backgrounds. Legal, tax and other risks abound. Instead of turning a blind eye to risks or exaggerating risks to the extent of not daring to move forward, enterprises should correctly identify and keep themselves updated on risks, actively manage risks and carefully plan the mechanism and measures to respond to risks.
- Where organizational structure is concerned, an enterprise's overseas investments or operations require a specific department for overall planning and management as well as well-defined authority and responsibility boundaries for each department and post.

China's SOEs should seize the opportunity presented by the OBOR Initiative to improve internal capabilities, grow through internationalization, and become world-class companies with international competitiveness and globally-recognized brands.

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Note

1. *The Fortune Global 500 by July 22, 2015*
2. *On March 28, 2015, Vision and actions on jointly building Silk Road Economic Belt and 21st-Century Maritime Silk Road, issued by Xinhua News Agency with State Council authorization.*
3. *http://money.163.com/14/0529/07/9TD617IV00252C1E.html, Investment in Southeast Asia: low price with poor infrastructure, risks and opportunities coexist*
4. *The instruction was sent to a meeting on central SOEs' participation in the Belt and Road Initiative and international cooperation on production capacity and equipment manufacturing. The meeting was held on June 18-19 in Beijing.*
5. *Source of Information: the Fortune Global 500 by July 22, 2015 and annual reports of relevant companies*
6. *Source of Information: financial results published by Lenovo and Huawei*