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China M&A Round-Up

Cross-border investment trends

What's the Deal?

China's Belt and Road Initiative: Impacts and Opportunities

Reshaping Value Chains

In mid-May of 2017, China organized the first Belt and Road Summit in Beijing, an event attended by over 100 national representatives from a broad, global swath of potential Belt and Road counterparties. Around the same time, trade tensions were rising between the US and China, and a frequent conversation among onlookers was about China's growing influence, especially among emerging economies, as the US appeared to be stepping back from international engagement. China's Belt and Road Initiative (BRI) has moved forward, and the second summit has been announced for September 2019, under the theme of "The Digital Silk Road," an event in Hong Kong projected to have over 5000 government and business leaders attending.

As significant rounds of tariffs have been introduced in 2018, frictions between the US and China in trade and investment have brought into focus the high level of interdependence that the US and China have developed over the last few

decades. Both sides are making moves to reduce that level, China by diversifying its sources for commodities and its targets for exports, the US by dual sourcing or sourcing relocation of manufactured goods up and down the value chain. Many US companies that have depended on sole sourcing from China are taking steps to diversify their supply chain locations, a process that was already underway for lower value, higher labor products that began moving out of China a decade ago as China's labor costs rose.

There is an interesting confluence of impacts of the trade frictions and China's Belt and Road Initiative that is likely to change a number of current value chain structures and investment patterns, market opportunities, and organizational arrangements. We believe that there are both imperatives and opportunities for multinational corporations (MNCs) working to expand their global presence.

What has been accomplished in BRI

The major tranches of Belt and Road investment from China and cooperating entities are focused on infrastructure, much of it related to cross-border ports and logistics and port-to-inland access. In 2017, investment totaled US$26.9 billion and construction totaled US$40 billion. In terms of sector, investment went 37% into logistics, 31% into energy, and 19% into transport. Construction likewise focused 45.8% on transport and34.8% on energy. Not surprisingly, the 2019 summit is being subtitled "What's Next for Belt and Road After Infrastructure."

Of course, many projects are yet to be finished, and some have been slow to start. And for comparison purposes, it is useful to note that in direct ODI to BRI countries China invested US$14.4 billion, while fixed asset investment (FAI) on the Mainland for 2017 was US$2072.7 billion.

Among some of the most visible, successful projects are the Piraeus port in Greece, new major rail links in Kenya, and port and rail projects in Djibouti. New trade relations have been established with countries like Mali, giving China access to critical energy and mineral resources. Some of the more challenged projects are the ones nearby, in Southeast Asia. Sri Lanka, Malaysia, Myanmar, and Thai projects are moving slowly, and some have been reopened to explore new terms and arrangements. The Gwadar port project in Pakistan is being reviewed for both security and commercial viability, and after Prime Minister Mahathir Mohamad reassumed power in Malaysia, he traveled to Beijing to review the entire China-Malaysia BRI portfolio. After his five-day visit, Mahathir announced the cancellation of three major BRI projects: the East Coast Rail Link and two gas pipelines, the Multi-Product Pipeline and Trans-Sabah Gas Pipeline.

The pipeline projects may be particularly interesting because they can provide insight into some of China's motivation in pursuing BRI projects and the strong resolution to see them through. China has been open in expressing concern about energy security and the potential for a damaging blockade in the narrow Straits of Malacca, a 550-mile choke point between the Malaysian Peninsula and Indonesian Sumatra. This national security concern is a focal point of China's deep-water navy buildout and its territorial claims in the South China Sea.

One of the earliest BRI successes is the Kabala terminal in Myanmar, a project spearheaded by China National Petroleum Corporation (CNPC). Crude delivered there is stored at Kyaukphyu and then transported by a pipeline that has been operational since April 2017 to a refinery in China's Yunnan province. To date, 80 million barrels have been loaded. This Kabala terminal provides China with a "west coast," an oil import channel from the Middle East that avoids the Straits of Malacca and blockade risks. It also greatly improves energy logistics into China's relatively undeveloped southwest provinces.

MNC impacts and opportunities

We foresee three major strategic and operational issues for MNCs with Asia sourcing and market development interests.

At the same time as major MNCs are looking to diversify supply chains, BRI is improving global logistic efficiency, increasing options, and opening up new potential inland pools of low cost labor in Southeast Asia, South Asia, Africa, and Latin America. Many of these newly opening locations are officially classified as Low Income Developing Countries (LDCs) and are exempt from duties by developed countries.

What is missing in the wake of infrastructure investment is investment capital for manufacturing capacity and training and management. Some Chinese manufacturing companies are lined up to follow the infrastructure investment being made under BRI, but financial constraints are challenging, and the key markets for products appropriate for this kind of relocation are North America, Western Europe, and Japan, markets that China has been serving from the Mainland. A likely scenario then is for BRI to open new potential manufacturing centers in LDCs, supply them with basic materials like fabrics, molded and other prefab components, electronic components and sub-assemblies, but do so in cooperation, perhaps equity joint ventures, with major MNCs embarking on supply chain relocation. This could redirect investment flows, incentivize new forms of cooperation, and stage a new era of competitive manufacturing and sourcing to help depressurize the existing trade impasses and de-risk MNC supply chains.

Then for some MNCs there is growing opportunity to participate in basic BRI projects, as material and equipment suppliers and as financiers. More capital is likely needed across the board, as well as more innovation in project finance structuring. Known global brands of equipment needed for ports, rail, power distribution and the like can enhance receptivity to project proposals. And although the commercial calculus behind some BRI investments is challenging, where investment is scheduled to run far ahead of returns, more familiar investment models than some of those used in the earliest stages of BRI might also smooth the path for project launches.

Finally, the progress of BRI could be a trigger to rethink Asia organizations, which for many MNCs are fragmented into at least three pieces, a Japan/Korea organization, a China organization, and an AsiaPac or Southeast Asia organization. For many MNCs, it was clear as China reforms progressed, that the

demands of operating in China were so different from their existing Japanese presence, that a completely separate organization and different kind of presence was required. While there has been a growing intra-Asian investment and trade trend for many years, BRI is an accelerant of that trend, and it could be good to rethink the way existing pieces of Japan, China, and Southeast Asia operations are organized. Global shared service centers are one example catching on quickly but there are many additional productive ways that strategy and operations from Northeast to Southeast Asia can be coordinated if not actually consolidated in the coming years.

[1] http://www.beltandroadsummit.hk/en/index.html
[2] AEI and The Conference Board
[3] https://globalriskinsights.com/2018/06/pushback-belt-road-initiative-southeast-asia/
[4] https://thediplomat.com/2018/08/malaysias-canceled-belt-and-road-initiative-projects-and-the-implications-for-china/

Trends to watch

US-China trade war: worst yet to come for Chinese economy, say analysts, South China Morning Post, 11/14/2018
Billion-dollar tech startups hold promise for China's economy, Nikkei Asian Review, 11/9/2018
China challenges foreign firms to a race to win its consumers, Bloomberg, 11/6/2018

Outbound M&A from China

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eCargo goes on an Australian shopping spree, to acquire a Metcash business and Jessica's Suitcase, Business News Australia, 11/9/2018
Citychamp snaps up luxury watch brand, InsideRetail.Asia, 9/20/2018

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Elix Polymers sold to China's Sinochem, CHEManager, 10/18/2018
Barrick announces agreement with Shandong Gold for cross shareholding of up to $300 mln, MarketWatch, 9/24/2018
HK-listed United Energy to buy Kuwait Energy for $651 mln, Reuters, 9/23/2018

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FWD Group to acquire Indonesian life insurance unit from CBA, Reinsurance News, 11/14/2018
CCCC's HK subsidiary to buy 51% in US real estate investment unit, Xinhua, 9/28/2018

Technology, media & telecommunications

China's Tencent invests $180 million in Brazil fintech Nubank, Reuters, 10/8/2018
Shunwei leads new funding round in social networking platform ShareChat, VCCircle, 9/19/2018

Inbound M&A into China

Consumer business
BMW to buy control of China venture in 'new era' for foreign carmakers, Reuters, 10/11/2018

Financial services
Hunter Maritime to merge with Chinese fintech company, World Maritime News, 10/8/2018
Alternative investment firm PAG offers to buyout Hong Kong real estate trust Spring Reit for $670 mln, South China Morning Post, 9/26/2018

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Shunfeng signs MoU to sell solar manufacturing unit for $684 mln, Renewables Now, 10/1/2018

China domestic M&A and industry consolidation

Consumer
Chinese toothpaste giant Yunnan Baiyao to take over company holding group, Yicai Global, 11/2/2018
Household appliance giant Midea to merge with washing machine maker Little Swan, National Business Daily, 10/24/2018
China Evergrande to pay $2.1 bln for minority stake in Guanghui Group, Reuters, 10/23/2018

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GCL Intelligent Energy plans reverse merger with Xiake Color Spinning to list, Yicai Global, 11/6/2018

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