

# MyConsultant

NEWSLETTER FEBRUARY 2015



**Anne Kuleshova**

## Consultant

Anne Kuleshova (BCom (Honours), AIAA, SA Fin) is a Consultant in JANA's Direct Investments Unit and a member of the Infrastructure and Private Equity Research Teams.

Anne is an experienced financial professional, having worked in Mergers and Acquisitions (M&A) at Macquarie Capital and in M&A and Valuations at Deloitte Corporate Finance. She is an Associate of the Institute of Actuaries of Australia (AIAA) and Senior Associate of the Financial Services Institute of Australasia (SA Fin).

Anne is Director of Partnerships and Relationships, Australia-China Youth Dialogue, the premier track-two dialogue for early career leaders, which is supported by the Australian Government.

Anne is also Chair of Financial Services Institute of Australasia's (Finsia) Young Finance Professionals Committee in Victoria and Director of People and Networks, Australia-China Young Professionals Initiative. She speaks fluent Russian and basic Mandarin.

## Chinese Foreign Direct Investment

### Opportunities and challenges for Australian institutional investors

The China Australia Free Trade Agreement (ChAFTA) was signed in November 2014; what could this mean for Australian investors? This article discusses some of the political and financial developments in Australia's largest trading partner, and identifies key challenges and opportunities for Australian investors, including superannuation funds.

Australia has been seen as an attractive investment destination for Chinese investors for many years, attracting over \$10 billion of Foreign Direct Investment (FDI) per year, and ranking second only after the United States.

But firstly, what exactly do we mean by FDI? Simply put, FDI indicates any investment that is made by a company based in one country (e.g. China), directly into assets based in another country (e.g. Australia). Importantly, FDI tends to be associated with investments where some degree of control over the asset can be achieved, as distinct from indirect investments, such as investments into equities listed on a nation's stock exchange (such as the ASX), particularly minority and portfolio investments. In practical terms, Chinese FDI into Australia has typically been in the form of Chinese companies buying stakes in Australian mines and farms and, increasingly, infrastructure assets.

There is little doubt that Chinese investment into Australia will accelerate with the current changing political landscape in China. But what are the implications for Australian investors?

This article examines how China's new financial reforms will impact both Chinese investment into Australia, as well as the potential for Australian funds to invest in China, in sectors such as infrastructure.

However, before we look at the likely implications of the new Chinese reforms, it is important to understand both why

these reforms are happening and President Xi Jinping's broader political strategy.

### How China's political landscape is shaping financial reforms and outbound investment

China's changing political landscape is the main driver behind its financial reforms and FDI policy. Many consider President Xi to be the most powerful leader since Mao Zedong and he has embarked on the most ambitious reforms since Deng Xiaoping, Mao's successor who developed China into one of the fastest-growing economies over the last 35 years.

Since coming to power two years ago, President Xi has introduced significant reforms which have been underscored by centralisation of power and an anti-corruption campaign. This has allowed President Xi to consolidate his power base, remove people opposed to his reforms, and improve the image of the Chinese Communist Party. Further, President Xi's new doctrine, the so-called "Chinese dream", coupled with his strong stance on international relations (particularly towards disputes with Japan and in the South China Sea), have appeared to evoke a sense of patriotism in China's population.

With this political context, we can now examine the reforms that President Xi is implementing.

China is at the early stages of a multi-decade move from a largely export-led manufacturing economy to a consumer-led services economy; this shift has had and will continue to have a significant impact on urbanisation.

President Xi knows that in order to maintain power, he needs to provide economic growth and stability to minimise social unrest. This has culminated in unprecedented financial reforms, including:

- Requiring state-owned-enterprises (SOEs) to partially privatise themselves;
- Lessening the power of the National Development and Reform Commission (NDRC) making it easier for Chinese firms to invest overseas. Under the previous regime, the NDRC was the ultimate decision-making body on Chinese outbound investments as well as the internal economy, such as overseeing China's \$650+ billion stimulus package in 2009 post the GFC;
- Liberalising the stock exchange to encourage private sector investment; and
- Easing controls on capital flows and the yuan exchange rate.

Whilst there are plenty of 'China Bears' in the West, President Xi's financial reforms appear to have inspired confidence in the Chinese people. For example, in December 2014 the Shanghai Stock Exchange's main market Index reached 3,000 points for the first time since 2011 and sentiment is strong for activity to pick up in 2015.

Many Chinese believe that if President's Xi's reforms succeed, it will be another golden era for China. But a more objective view sees both opportunity and risk.

## China's outbound FDI – implications for Australian investors

China has amassed a large pool of savings from over a decade of current account surpluses. For example, China has the world's largest stockpile of foreign-exchange holdings, estimated at \$4 trillion. A large portion of these are held in US government bonds, which are paying very low yields. Therefore, the Chinese government is diversifying away from this low yielding debt and tilting towards real assets, such as infrastructure, property and agriculture. Already, we are seeing energy and power investments account for 64% of the value of China's outbound investment globally, (Figure 1). As such, China is planning \$500 billion in foreign investment into real assets over the next five years. As highlighted earlier, Australia has historically attracted a large portion of China's FDI, only slightly behind the US.

Chinese investment into Australia has already shown signs of shifting from mining assets to infrastructure and utilities, including:

- State Grid's \$5 billion acquisition of SP Ausnet's assets in 2014;
- State Grid's \$500 million acquisition of 41% of ElectraNet in 2013;
- China Merchants' \$1.75 billion purchase of Port of Newcastle, with Hastings;
- Shanghai Electric planning to build a \$120 million demonstration plant in Victoria to process coal into briquettes;
- PowerChina setting up headquarters in Melbourne in 2014 to 'bid for investment and partnership opportunities in major infrastructure projects'; and

- China Southern Power representatives visiting Australia in late December 2014, allegedly to explore interest in bidding for upcoming privatisations.

At the same time as these reforms encourage Chinese firms to look overseas, the Australian Government has rolled out the red carpet to foreign investors, spurred on by the slowing Australian economy and the funding gap of c. \$300 billion in Australia's infrastructure requirements. As part of this strategy, Australia has signed the China-Australia Free Trade Agreement in 2014. The agreement sets out improved investment terms and less onerous regulatory restrictions.

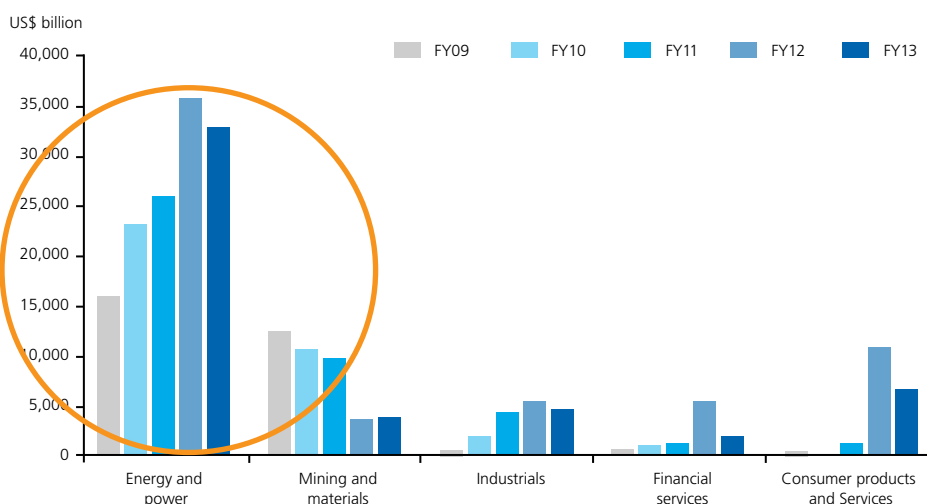
An increase in Chinese FDI, particularly into infrastructure, will undoubtedly present challenges for local investors, including increased competition for assets. In practical terms, this could mean that some Australian superannuation funds could be outbid by Chinese investors in proposed privatisations of NSW's electricity transmission and distribution assets, and ports in Victoria. But given the attractiveness of the sector in the current low yield environment, we would expect these assets to be hotly contested by any number of foreign investors, and not just Chinese investors.

In addition to increased competition for 'brownfield' (mature, operating) assets, the new Chinese reforms may also increase competition for 'greenfield' projects. The Chinese government is providing (partial) debt funding for projects where Chinese companies are awarded the Engineering, Procurement and Construction (EPC) contracts. This policy is in place to encourage Chinese EPC contractors to develop projects overseas, as well as to promote the use of Chinese equipment. Chinese companies that have already provided this funding structure in the Australian mining sector include:

- China Metallurgical Group Corporation (MCC);
- China Nonferrous Metal Industry's Foreign Engineering and Construction Co. Ltd (NFC);
- China Machinery Engineering Corporation (CMEC).

At the same time, the Australian Government has offered more flexible labour arrangements for development of large infrastructure projects under ChAFTA. In effect, Chinese labourers will be more freely allowed to work on infrastructure projects, as determined on a case-by-case basis.

**Figure 1 – China outbound deals by target sectors (globally)**



Source: 'Trends in M&A – China outbound deals: 2013 review and 2014 outlook', PwC.

## China's inbound investment opportunity – too big to ignore?

But what about opportunities for Australian investors to invest in China, particularly in infrastructure where the country faces a significant and widening infrastructure gap?

Chinese infrastructure is a large and growing market that is too big to ignore for foreign investors. China's annual infrastructure spending now surpasses that of the United States and European Union. Notwithstanding enormous investment to date, there is still some way to go before China achieves the quality of infrastructure comparable to Japan, South Korea and other advanced economies (Figure 2).

The Chinese government is certainly aware of the need to improve infrastructure. The government's urbanisation plan targets an increase in the urbanisation rate from 54% to 60% by 2020. This implies an additional 100 million people migrating to the cities and an estimated CNY 42 trillion (c. A\$8 trillion) of investment over the next six years.

Where will this money come from? To date, around 85% of infrastructure investment in China has been undertaken by the government. Notwithstanding the large pot of foreign exchange reserves held at the Central Government level, China's fiscal arrangements mean that local governments do not always have the capacity to finance the provincial- and city-level projects. Debt concerns are mounting and the Chinese government has acknowledged that this is not sustainable.

Despite this significant investment opportunity for private investors globally, investing in Chinese infrastructure to date has had mixed success for foreign investors, due to complicated government requirements and associated political risk. Put simply, previous structures were immature and subject to risk of government policy changes.

As a result, last year the government introduced a suite of reforms to encourage private investment into infrastructure through franchises, equity investment and Public Private Partnerships (PPPs).

**Shanghai's financial district of Pudong in 1987 and in 2013 – 26 years of growth**  
Shanghai has more skyscrapers than New York and a more expansive public transit system than London.



Whilst these reforms are comprehensive and ambitious, they will take years to crystallise, and even longer before a credible track record is established in order for foreign investors to be comfortable with deploying significant amounts of capital.

## Conclusion

China is complex and rapidly evolving. The country has attracted a record US\$118 billion in FDI in 2013, and the government is putting in place reforms to attract even more foreign investment.

With respect to China's own infrastructure funding needs, given the historical challenges faced by foreigners investing in Chinese infrastructure, recent reforms are a welcome development; however these will require significant time before direct investment is sufficiently de-risked. At the same time, the size of the Chinese market makes it too big to ignore all together. As such, indirect investment via listed infrastructure, Fund-of-Funds, equities, etc. can provide exposure to China growth, whilst diversifying some of the risks.

Conversely, China's outbound investment story is well known to Australia. This historic trend will continue, with the Chinese government planning to invest \$100 billion per year into real assets. As with the mining boom before, this is likely to result in a flood of cheap capital to Australia that will most likely place upward pressure on valuations of infrastructure, real estate and agricultural assets.

The upcoming \$50 billion+ proposed privatisation of Australian electricity and port assets have already attracted significant interest from overseas investors, including Chinese investors. Having abundant and cheap capital can be an advantage for foreign investors, however the ability to comply with regulatory and local requirements is paramount. As such, the key to successful offshore investment is the same for Chinese companies (looking to investment in Australia) and for Australian funds (looking to invest in China): having the right local partners.

<sup>1</sup> Victorian Government Department of Premier and Cabinet (2014) Business and Investment Outcomes: PowerChina MoU.

**Figure 2 – Selected development indicators by country**

	China	Japan	South Korea	India	US
Gross national income per capita (a)	5,720	47,880	22,670	1,580	52,340
Paved roads (percent of total) (b)	54	78	79	50	98
Reliable access to water (c)	85	94	88	90	100
Reliable access to sanitation	65	100	100	35	100

Notes: (a) 2012, current US dollars; (b) Most recent observation; (c) 2011, per cent of rural population  
Source: 'Infrastructure Investment in China', Reserve Bank of Australia

**Issued by JANA Investment Advisers Pty Ltd (ABN 97 006 717 568) (AFSL 230693).**

Information current as at February 2015. This document may not be copied or redistributed without the prior consent of JANA Investment Advisers Pty Ltd. This document is intended for use only by persons who are 'wholesale clients' within the meaning of the Corporations Act. It is intended to provide general information only and has been prepared without taking into account any particular person's objectives, financial situation or needs. Investors should, before acting on this information, consider the appropriateness of this information having regard to their personal objectives, financial situation and needs. We recommend investors obtain financial advice specific to their situation before making any financial investment or insurance decision. While due care has been taken in the preparation of this document, no warranty is given as to the accuracy of the information. Except where under statute liability cannot be excluded, no liability (whether arising in negligence or otherwise) is accepted by any JANA Investment Advisers Pty Ltd for any error or omission or for any loss caused to any person acting on the information contained in this document.

68544M0215