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Demystifying Chinese Investment in the United States

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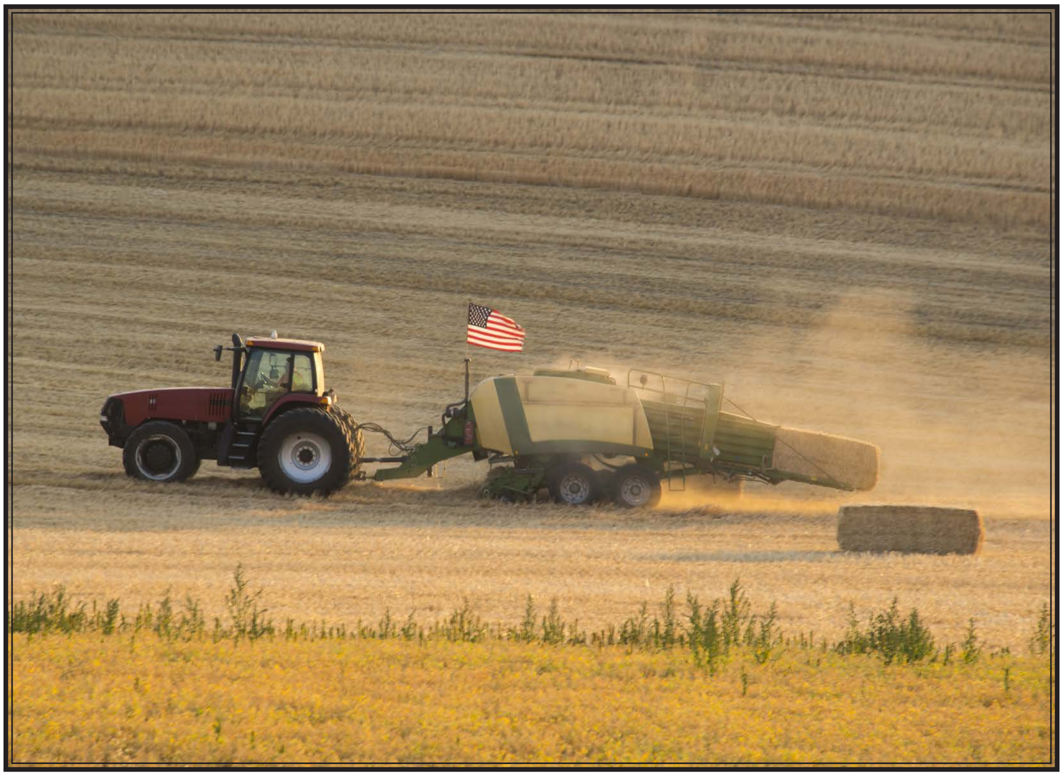

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About the Author

Henry M. Paulson, Jr.

Henry M. Paulson, Jr., is a businessman, China expert, conservationist and author. He is the founder and chairman of the Paulson Institute, and co-chairman of the Latin American Conservation Council of The Nature Conservancy and the Risky Business Project.

Paulson served as the 74th Secretary of the Treasury under President George W. Bush, from July 2006 to January 2009. Prior to that, he had a thirty-two year career at Goldman Sachs, serving as chairman and chief executive officer beginning in 1999. Earlier in his career, he was a member of the White House Domestic Council as well as a staff assistant at the Pentagon.

Today, he serves as chairman of the Paulson Institute at the University of Chicago, which aims to advance sustainable economic growth, a cleaner environment and cross-border investments in the United States and China. A "think and do" tank founded in 2011, the Institute's work is comprised of programs, advocacy and research with partners around the globe.

A lifelong conservationist, Paulson was Chairman of The Nature Conservancy Board of Directors and, prior to that, founded and co-chaired the organization's Asia-Pacific Council. In 2011, he founded and continues to co-chair the Latin American Conservation Council, comprised of global business and political leaders.

Paulson co-chairs the Risky Business Project, which focuses on quantifying and publicizing the economic risks of climate change in the United States, with former New York mayor Michael Bloomberg and former hedge fund manager Tom Steyer. The non-partisan initiative aims to spur action to mitigate the effects of climate change before the worst potential outcomes occur.

In his best-selling book, *On the Brink*, Paulson describes his experiences as Treasury Secretary fending off the near-collapse of the U.S. economy during the Great Recession. His new book, *Dealing with China*, details his career working with scores of China's top political and business leaders and witnessing the evolution of China's state-controlled capitalism.

Paulson graduated from Dartmouth College in 1968 and received an M.B.A. from Harvard University in 1970. He and his wife, Wendy, have two children and four grandchildren.

Cover Photo: Getty Images/Joanna McCarthy

Introduction

For almost 40 years, the US-China economic relationship has been defined by rapidly growing bilateral trade, and it is only recently that Chinese foreign direct investment (FDI) in the United States has begun to make a strong mark. These investments are likely to grow significantly, establishing another important and often beneficial economic linkage that, at its best, will support and even create American jobs. Moreover, by linking the two economies more directly, investment can also serve as ballast for what is becoming an increasingly important but more difficult and fraught relationship between the two countries.

Although bilateral trade and the success of US businesses in China have conferred substantial economic benefits onto both nations and are an important linchpin of the relationship, this economic interdependence is not without controversy and real points of friction. This is due to regular trade spats and, especially in recent years, to Chinese government policies that have restricted market access and made it harder for some US firms to compete in China. But it also reflects a lack of public understanding of the enormous economic benefits that trade in general, including trade with China, provides to Americans.

Direct investment reflects a vote of confidence in the American market and its workers and a belief in the long-term resilience of the US economy.

Trade, it is true, *does* result in very real and serious job losses, while its benefits are spread more broadly over the entire US economy. Yet many job losses are not a result of trade; they are actually driven by productivity gains related to rapid advancements in technology, a powerful force disrupting labor markets globally and affecting numerous countries, including the United States and China.

Capital flows between the two countries are already substantial. But in the past, the vast majority of Chinese capital flows into the US market were paper transactions involving the purchase of securities, particularly US Treasuries, not direct investments that involved the hiring of US workers or the building of plants and other physical assets. Indeed, cross-border direct investments generally flowed from the United States to China rather than the other way around. And these were largely one-way US corporate investments designed to help them enter and compete in the China market.

But that is now changing. China's outbound direct investment globally has been increasing for a number of years and, where much of this investment once went to Africa and Latin America, for example, it is now increasingly

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directed at advanced Western economies. That has meant that Chinese direct investment in the US market is ramping up rapidly from a low base.

As a result, Chinese investments have begun to sustain or have created local jobs across the United States. In some instances, Chinese investors can be a source of growth capital to help US firms expand capacity. In other cases, establishing a strategic partnership with a Chinese investor can lead to new market opportunities in China. And for innovative American startups, China is, after all, a market that has both the scale and capacity to commercialize new products rapidly and lower the cost of nascent technologies. Chinese investment could, in this sense, benefit small and medium-sized American firms, manufacturers, and startups, as well as farmers and ranchers, all of which are facing intense global competition.


Photo: Flickr/Steve Beshear

On a broader level, as the US-China relationship becomes ever more challenging, bolstering and sustaining cross-border investment can set a new tone. Chinese direct investment can provide stronger and more enduring economic linkages—in some ways more permanent than bilateral trade—while also supporting American growth. Direct investment reflects a vote of confidence in the American market and its workers and a belief in the long-term resilience of the US economy.

Of course, many other factors can affect the ebb and flow of investments, not least of which is what happens in the Chinese economy, including currency movements and capital controls. Still, such cycles are normal and unlikely to affect the overall trend. Plenty of Chinese investors, much like their counterparts from Europe, Japan, and elsewhere, continue to view the United States as one of the most stable and dynamic markets in the world.

There are good reasons to believe this trend will persist. First, macroeconomic conditions are changing rapidly in China, and its current growth model is leading to diminishing returns and limiting attractive opportunities for Chinese investors in their domestic market. Second, many Chinese companies have reached a point where their success in the home market has naturally led them to pursue global expansion and attempt to build global brands. Third, Chinese investments are shifting from natural resource and commodity plays in developing countries toward the consumer, enterprise technologies, services, and high-tech markets.

These factors indicate that Chinese investment has the potential to grow rapidly, but whether it actually does will depend equally on the ability and willingness of the United States—federal, state, and municipal governments, as well as US firms—to capitalize on these dynamics and continue to embrace foreign investment. This requires the creation of an investment climate that welcomes global capital, including Chinese capital. The eventual completion of a US-China Bilateral Investment Treaty (BIT) would go a long way toward that end by making the rules and institutions that govern investment more predictable.

To keep direct investments flowing also requires the United States to compete with other advanced markets, such as the European Union.

To keep direct investments flowing, the United States will also have to compete with other advanced markets, such as the European Union. It is no secret that competition for Chinese capital is fierce from Asia to Europe.[1] Great Britain and Australia, too, have been favored destinations of Chinese investment, although politics in both countries have, as in the United States, begun to yield a backlash. The United States will not fully benefit from Chinese capital if it fails to maintain an environment that attracts, rather than spurns, foreign investment in general and Chinese investment in particular.

To be sure, while direct investment can bring enormous opportunities, it also comes with a daunting set of practical and execution challenges. Simply having demand for foreign capital or the desire to make an investment is insufficient. Above all, a prospective deal has to make economic sense, providing the investor with adequate returns and the recipient with new opportunities. The United States is a comparatively open and transparent market, but identifying and executing on transactions is still a complex process. It involves complying with a thicket of federal and state regulations, accepting some level of political risk, accommodating local stakeholders, and addressing corporate culture mismatches, among other considerations.

All these factors matter even more when it comes to the United States and China, where differences in culture, legal and regulatory regimes, basic understanding of the respective markets and opportunity sets, political dynamics, and information asymmetry amplify these challenges. As a result, some investments will invariably fail to be consummated for various economic, legal, and political reasons. And many deals, once consummated, will turn out to not be economic and commercial successes.

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Although the level of Chinese investment remains relatively modest, some of the larger deals have already raised national security and related concerns about the nature and intent of those acquisitions, particularly when they are concentrated in high-tech sectors. That fear is often unwarranted, and stems from a common misunderstanding of how investments work.

Foreign investors, Chinese or otherwise, tend to seek stable environments in which to put their capital and typically look for steady, long-term returns. When it comes to physical assets, such as plants, manufacturing facilities, and property, the identity of the investor may change, but the actual assets almost never leave the country. The upside is that the United States, in the meantime, potentially stands to gain an important new source of capital.

Moreover, on balance, Chinese investors, whether state-owned enterprises (SOEs) or private firms, have largely behaved like other international investors in the US market: they are looking to diversify their portfolio with good assets and deploying capital into sectors that have complementarities with the Chinese economy and can meet domestic demand.

The next sections of this paper aim to demystify Chinese investment in the US market in greater detail by examining some of the basic rationales that motivate such investment and addressing the key challenges associated with it. The central purpose is to offer general principles and common sense advice that may be useful for both policymakers and potential investors.

Overview: What Is Taking Place and Why It Is Happening

China is already one of the largest investors in the world. In 2014, China's outbound investment flows totaled $116 billion, inching ahead of Japan to take the number-two position, behind the United States.[2] It was not until this decade, however, that the focus of Chinese investments began to diversify from emerging and frontier markets to advanced economies. That shift resulted from changes in the Chinese economy.

For the better part of the previous decade, Chinese outbound investment had often been characterized as state-driven mercantilism aimed at "locking up" natural resources in developing countries. Although the reality is more complicated than this simplified account suggests, there is some truth to that view because Chinese overseas investment at the time was indeed predominantly state-led. Beijing had backed a "going out" strategy of foreign acquisitions, with central SOEs leading the charge.

Savvy Chinese investors have sought to get ahead of the curve by investing in assets and technologies that align with the next stage of Chinese economic growth.

But that strategy was largely dictated by a spectacular decade of rapid growth and massive industrialization, as well as a ballooning trade surplus that led to accumulation of foreign exchange reserves. Therefore, Chinese demand for economic inputs, whether oil from Africa or copper from Latin America, drove many of these outbound investment decisions. That phase of Chinese investment saw capital flowing primarily between developing countries.

That phase has given way to a more complex set of Chinese strategies. The "One Belt, One Road" infrastructure investment initiative, if realized, will continue to keep Chinese money flowing to emerging and frontier markets, especially in Asia. But this strategic initiative should not obscure the reality that Chinese investors, especially firms rather than policy banks or state investment funds, now increasingly target advanced economies such as the United States and European Union. Not only have the target markets become more diverse but the composition of Chinese investors has evolved as well. Investors are no longer mostly SOEs, as private sector players are increasingly playing a larger role.

China continues to invest far more in its own Asia-Pacific neighborhood, but its investments in the United States have started to climb significantly in the last few years. Still, Chinese FDI in the United States pales in comparison to that of the other Asian economic powerhouse: Japan. As of 2012, Japan had invested about eight times more in the United States than China, even though the Chinese economy in nominal terms is about twice as large.[3]

And Chinese capital is also finding its way to the European Union. In fact, since 2007, Europe has consistently outpaced the United States as a major recipient of Chinese money. For example, Chinese investments in Europe in 2012 were 50 percent higher than in the United States, and reached a new record of about $23 billion in 2015.[4]

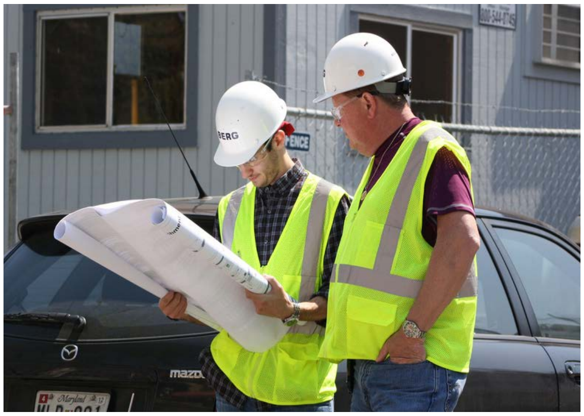

Photo: Flickr/Elvert Barnes

The United States has not been attracting its share of Chinese capital. But the upside is that this means Chinese investment in the United States is likely to rise significantly over the next decade, driven by specific trends to be discussed below. This potential can only be fully captured, however, if an open investment climate is maintained and the United States proactively competes with other markets for Chinese capital.

Shifting Macroeconomic Drivers

Chinese policymakers recognize that their growth model is running out of steam and is in serious need of rebalancing away from growth predicated on investment in fixed assets, exports, and energy-intensive industrialization. In its place, they seek to continue building a middle-class and consumer-oriented economy by climbing the value-added and technological ladder and letting services play a much larger role in the economy.

This economic transition, which was initiated during the 12th Five-Year Plan (2011-2015), began to change the type of global investments and assets that Chinese investors sought. The industrialization phase of Chinese growth is yielding to a new era focused on efficiency, innovation, and consumption. The new mindset among Chinese investors also reflects the recognition that while China is no longer a capital scarce country, it is still a relatively technology-scarce economy.

As a result, savvy Chinese investors have sought to get ahead of the curve by investing in assets and technologies that align with the next stage of Chinese economic growth. These fall into three basic categories, all of which center on consumers: services, high-end manufacturing, and technology.

Recent Chinese investment patterns bear this out. From 2011-2014, China's

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outbound investments in sectors such as healthcare, entertainment, and information technology (IT) have seen robust growth.[5] At the same time, investment in industries such as mining and construction dropped precipitously. These patterns reinforce the fact that Chinese investors view outbound investment as a key vehicle to support the creation of value-added industries and facilitate the transition of the domestic economy.

Such a transition also means that private sector players, many of which have been purely domestic operators, are beginning to look beyond the home market as well. Unlike energy and commodities, which were and still are dominated by state sector giants, consumer-based and innovative companies are concentrated in the private sector. This trend has been especially pronounced in recent years. Chinese private equity firms, venture capital funds, and traditional institutional investors, which have proliferated over the past decade, are shifting from their focus on the home market to proactive pursuit of opportunities beyond China.

Another rationale behind the investment push is China's accumulation of foreign exchange reserves, which peaked around $4 trillion in 2014. Rather than parking the reserves in safe but low-yield assets such as US Treasuries, the Chinese government decided to diversify its portfolio. It has re-capitalized its sovereign wealth fund China Investment Corporation (CIC) and permitted certain SOEs to use foreign exchange reserves to invest abroad in assets with higher potential returns. Moreover, China has created specialized funds focused on outbound investment, including one specifically targeting the semiconductor industry (a source of growing tension with industry groups in the United States).[6] Finally, at least until the end of 2014, the Chinese currency had been strengthening against the US dollar, which further bolstered the rationale to seek buying opportunities abroad. More recently, as the market continues to expect downward pressure on the Chinese currency, volatility and currency depreciation has also led to capital outflows.

Supply Chains and Know-How

Other factors are also steering Chinese investments toward the US market. For instance, given rising labor costs in China and relatively expensive transportation costs, in a number of industries, there is a strong economic rationale for establishing manufacturing hubs and supply chains closer to the end-user and consumer markets. And Chinese companies, quite obviously, want to continue selling their products to what is by far the largest and one of the most vibrant consumer markets in the world.

In fact, to remain competitive, many Chinese firms need to reevaluate their strategies, which typically view the

United States primarily as an export destination. It increasingly makes little commercial sense to locate certain supply chains and manufacturing capabilities in China—it is often more economical to site some facilities in the United States instead, where supply chains are already integrated, and then export the products back to China. This process will likely become even more efficient as e-commerce platforms grow, with companies such as Alibaba aiming to connect Chinese consumers to American products.

A case in point is in the agriculture sector, which saw one of the largest single Chinese deals in the US market to date: Shuanghui's acquisition of Smithfield Foods in 2013. This multi-billion dollar acquisition did not lead to the Chinese taking over the US pork industry or overhauling the supply chain, nor has it threatened national security or US food security as some critics of the deal alleged. Instead, Smithfield has, at the time of writing, continued operating its business as usual and maintained its US-based farm supply chains. Smithfield's pork exports to China increased by some 45 percent in the first half of 2014, on the back of Chinese demand for high quality pork products.[7] In this instance, the "Made in the USA" label is an enormous asset because of serious concerns over domestic food safety among Chinese consumers.

Over time, such knowledge transfers may well lead Chinese companies to converge toward global best practices.

Shuanghui's investment underscores another rationale behind Chinese FDI: acquiring managerial and technical expertise. China consumes roughly half of the world's pork, yet its hog farming operations are small-scale and prone to the spread of diseases. As China is poised to undertake major reforms to move toward industrial-scale production, Smithfield, the world's largest hog processor, was viewed by its Chinese acquirer as having the kind of management know-how required to scale up while maintaining product quality and meeting food safety standards.

These types of knowledge transfers can be valuable for Chinese investors, who are learning how to manage global operations in companies that have been mostly domestic players. Over time, such knowledge transfers may well lead Chinese companies to converge toward global best practices.

Building Brands and Enhancing Innovation

Establishing global brands and strengthening innovation capacity, including human capital, have long been factors behind China's outbound investment strategy. But these factors have become ever more pressing and important for Chinese investors, as China realizes that it faces a global branding deficit.

Branding and marketing for consumer products and services are much more important than in commodities and energy, which are generally undifferentiated goods. From Lenovo's acquisition of IBM's PC division and Geely's buyout of Sweden's Volvo to Haier's takeover of GE's appliances division, Chinese investors tend to view these acquisitions as not only buying a value-added product, but also purchasing a valuable brand.

Globalizing a brand is difficult and requires years of consumer validation, especially since the "Made in China" label still carries negative associations for the average American consumer. This is not so dissimilar from the paths that Japanese and Korean products took, both of which managed to elevate what were once perceived as cheap and shoddy goods to reputable, high quality global brands.

A major aspect of globalizing Chinese brands is to overcome the innovation hurdle. Chinese companies are still largely viewed as followers rather than pioneers in innovation, imitating US products to sell them at lower cost. Consequently, American consumers tend to hold negative views of Chinese products. This is why Chinese entrepreneurs and venture capitalists seek to invest in the US innovation engine, whether it is in novel startups or research and development (R&D) capacity.

Many Chinese investors believe that the environment for R&D and innovation is superior in the US market, not least because of the diverse pool of human capital that can be tapped and the strong, legal protection of intellectual property (IP) in the United States.

Unrealized Potential: Challenges and Barriers to Chinese Investment

These macroeconomic drivers play to America's strengths in services, innovation, and consumer-oriented products. In other words, the US market has many complementarities to a Chinese economy in transition. This underlying reality suggests that the incoming wave of Chinese capital could grow significantly over the next 5-10 years and has the potential to eclipse Japanese investment in the United States.

While it is impossible to predict the future growth of Chinese direct investment, it has certainly risen significantly over the last several years, with Chinese FDI flows up over 60 percent from 2011 to 2014.[8] New Chinese investment in the United States in 2015 rose to nearly $16 billion, with acquisitions leading the way but also with an uptick in greenfield projects.[9]

Despite these positive trends, challenges and barriers—some unavoidable, some imposed by the US government in its national interest, and some counterproductive—prevent Chinese direct investment from reaching its full potential. The impact of these barriers and obstacles should not be lightly dismissed. Some of those key challenges include the following.

Perception Gaps: Not Seeing Eye-to-Eye

One fundamental challenge is mutual misperception, which over time can sour the general investment climate in both countries. This is an unsurprising problem, since the US market is not well understood by the vast majority of potential Chinese investors, especially smaller private players. Indeed, because of their unfamiliarity with processes and norms in the US market, the rare instances of blocked deals have taken on outsized influence in shaping the overall Chinese perception that America is somehow "not open for business."

One fundamental challenge is mutual misperception, which over time can sour the general investment climate in both countries.

In some ways, this is ironic, since the United State has in fact maintained a consistent approach to foreign investment: all sectors are open with the exception of a very few that are specifically prohibited by a so-called "negative list." Until recently, China's approach to foreign investment was just the opposite: virtually everything has been *prohibited* for foreign investment unless specifically approved.

The United States has long held an open attitude toward foreign investment. Very few sectors are wholly prohibited to FDI, although transactions in sectors tied to national security—those deemed as "critical infrastructure and technology"—

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usually require a review by the federal government (see discussion below). In practice, this does mean that acquisitions in certain sectors that affect US national security may very well be unappealing from a commercial perspective, due to the need for compliance with mitigation agreements and other measures.

But even when they acknowledge that the US market welcomes foreign investment, many Chinese investors are too often convinced that their transactions receive "more scrutiny" than those from other countries. In practice, that is highly dependent on specific circumstances and not generalizable across all Chinese investments. A number of attempted Chinese acquisitions in high-tech industries, such as semiconductors, have raised concerns over motives and the implications for US national security. These concerns are more pronounced when it comes to Chinese SOEs both because of their real or perceived relationship to the Chinese government—which raises the level of scrutiny from intelligence, defense, and homeland security professionals—and because of their pivotal roles in China's expansive industrial policies. Moreover, the sectors in which Chinese SOEs are concentrated are often more significantly restricted for foreign investors.

A number of attempted Chinese acquisitions in high-tech industries have raised concerns over motives and the implications for US national security.

Chinese investors should be cognizant of the fact that the American public generally does not "like" foreign investment in the abstract sense. In fact, no public anywhere likes the idea of foreigners buying up domestic assets, particularly if those assets happen to be well-known companies and brands. For example, Chinese investments in high-end real estate, such as hotels and resorts, have led to heightened concerns similar to those when Japanese investors bought iconic properties such as New York's Rockefeller Center or California's Pebble Beach, the renowned golf course that has hosted the US Open tournament.

Much more troubling for the future of the climate for foreign investment is the growing public sentiment in the United States, vocalized and reinforced by some politicians in both major parties, that because the Chinese government does not grant market access for US companies or play by the rules, the US government should impose strict reciprocity on Chinese companies that want to access those same sectors in the American market.

The notion that "China cheats" has gained traction. And a litany of issues, including currency manipulation, IP theft, regulatory bias favoring Chinese domestic firms, barriers to US firms' market access, and implicit and explicit support for SOEs, are commonly cited as examples of problematic Chinese policies. Many of these charges are warranted; some are not.

Take currency as an example. It is often an issue that is misunderstood or debated without proper context. Monetary policy is a complex issue. And China's monetary policy choices have played out in US domestic political debates for the better part of the last decade. But a more market-determined currency in China, which is what the US government has promoted, could lead both to appreciation or depreciation. Indeed, the Chinese government spent much of 2015 and 2016 trying to *prop up*, not drive down, the value of its currency and limiting volatility.

By calling for appreciation while ignoring the possibility of two-way currency movement in a more flexible currency regime, the US political debate ignores principle in favor of a particular outcome. It is certainly true, however, that many of the other areas of US concern, including IP theft, market access, and in particular, extensive policy and fiscal support for SOEs, remain serious issues and must be addressed by more extensive reforms in China.

Subsidies for SOEs, for instance, will continue to receive scrutiny in the US transaction review process when those entities invest in the United States, especially when it comes to mergers and acquisitions. And the fact that the Chinese government uses state-backed vehicles, including powerful policy banks like the China Development Bank, to support SOE investments abroad simply *reinforces* the view that state firms do not operate commercially and receive direct government backing.

Separate and apart from ties to the state, both SOEs and private Chinese firms have been caught up in cases where attempted acquisitions inexplicably fizzle because the Chinese party turns out to have insufficient capital and a shaky balance sheet.[10] The mere fact that companies with questionable finances still attempt to pursue a US acquisition reinforces the overly simplistic impression that the Chinese state is subsidizing all such firms' investments. These kinds of bad deals can set an unwelcome precedent that further muddies the investment climate and complicates matters for future Chinese investors.

But the fact is, these negative perceptions, unfortunately, can and will increasingly shape the mood and political attitudes in both countries, creating obstacles before *any deal takes place.*

But the fact is, these negative perceptions, unfortunately, can and will increasingly shape the mood and political attitudes in both countries, creating obstacles *before* any deal takes place. As adverse as today's politics are, the reality is that almost *every* foreign direct investment has had a political dimension. Indeed, it is becoming increasingly important for the parties involved on both sides of a prospective deal, particularly those involving Chinese investors, to address and mitigate the politics. Chinese investors certainly have a learning curve to climb in managing not just political issues at the federal level but also grassroots politics at the local level where the investment occurs.

This is no easy task, and there is simply no one-size-fits-all solution. The US market is complex, regulations differ across states, and local politics are diverse. So for any Chinese investor, it is necessary, as a basic precondition, to adhere to a high standard of transparency and faithfully comply with the legal processes and norms to complete a transaction. In fact, much of the perception challenge for Chinese firms stems from confusion over regulations and misunderstanding of processes, as well as the difficulty in sorting out the relationship between the federal and state governments.

Investment Regulations Affect Both Markets

China

The Chinese government has not fully liberalized the country's capital account, which means the transaction costs for Chinese investors to move money out of their country remains higher than it would or should be. Eliminating that impediment alone could lead to greater Chinese capital flows to other markets, not least the United States. Even though the Chinese government has pledged to lift capital controls, Beijing will likely continue to be cautious on this front, especially if uncertainty persists over China's growth prospects and economic fundamentals.

Moreover, China's outbound investment approval process remains cumbersome, although that is improving gradually. For instance, the State Council in 2013 effectively abolished many of the administrative controls that had restricted overseas investment.[11] Essentially, investments under $2 billion and in non-sensitive markets and sectors can now use a streamlined process based on registration rather than direct approval by the Ministry of Commerce or the National Development and Reform Commission, China's state planner, thereby cutting bureaucratic red tape.[12] In addition, China's foreign exchange regulator, the State Administration of Foreign Exchange (SAFE), also relaxed rules to allow Chinese firms to get foreign currency faster via banks rather than having to apply directly with SAFE.[13]

If this approval regime continues to be streamlined, it would give the firms themselves greater control and decision power over their investments, and reduce reliance on the Chinese government per se. And as noted above, the completion of a US-China BIT would not only introduce more competition into the China market, it would also bolster confidence on both sides by sustaining an affirmative economic agenda.

Despite the fact that more private Chinese investors are pursuing overseas investments, both access to financing and the general policy environment (accessing foreign exchange reserves, for example) still favor SOEs. The large central

SOEs have numerous means of receiving financing for their investments abroad and tend to "crowd out" the private sector players. In addition, the state-owned banks are more willing to lend to SOEs because they are viewed as less risky—a result of the government serving as their backstop.

Although the Chinese government has clearly articulated its intent to address unequal access to financing and incentivize lending to the private sector, this will not change overnight. The problem is that in practice, the state banks continue to believe the government stands firmly behind their loans to SOEs for the reasons noted above. Meanwhile, midcap companies that want to invest overseas are still hampered by their inability to get the necessary capital.

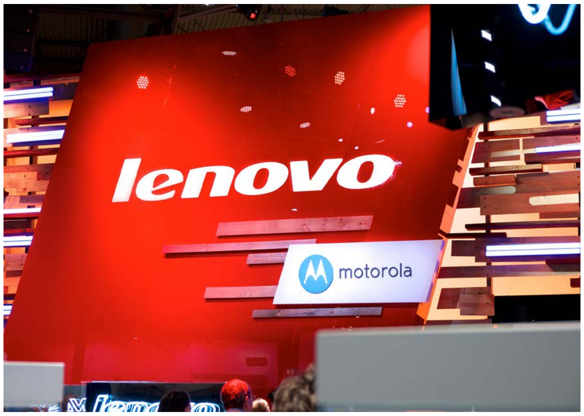

Photo: Flickr/Kārlis Dambrān

United States

National Security Review of Foreign Investment

Chinese investors, as well as the Chinese government, regularly point to the US government's invocation of national security reviews as a significant impediment and complicating factor to attempted transactions. The statutory vehicle for doing so is the Committee on Foreign Investment in the United States (CFIUS) process, which is chaired by the Department of the Treasury but managed through an interagency process that includes the State Department, Department of Commerce, Department of Defense, Department of Justice, and Department of Homeland Security, among others.

Regulating foreign investment is hardly unique to the United States. Many countries, including France and Australia, have such national security reviews for foreign investment. In fact, China, too, has recently implemented its own national security review for inbound FDI, which is modeled on the US process.

Technically speaking, a CFIUS review is triggered only if the investment leads to foreign *control* of a US entity and *also* poses a national security risk. However, neither "control" nor "national security" is specifically defined in this process and both are construed broadly. In practice, this means that the US government can initiate the CFIUS process if there is simply a *perceived* national security threat.[14] To further complicate matters, the US government is sometimes opaque and slow to raise national security concerns, which leads to the pernicious effect of not giving the investors a sufficient or appropriate opportunity to address them within the timeframe of the review. There can also be political pressure from the US Congress and other agencies in the executive branch that oppose a given foreign investment, particularly from China and other countries that are not US allies.

Unlike some countries, such as France, that have excluded specific strategic sectors from foreign investment, CFIUS does not specify sectors. But it is generally well known that anything considered to be critical infrastructure and critical technology, which includes areas such as energy, telecommunications, information technology, and defense, will likely trigger CFIUS review. The ownership identity of the foreign firm matters in this process. That is because CFIUS requires an extended and more intensive review of SOEs, Chinese or otherwise.

It is also important for foreign investors to be aware of the emerging "doctrine of proximity." That is, the acquisition of US assets near military bases or sensitive installations is likely to be subject to CFIUS review. For instance, the Chinese-owned Ralls Corporation had to divest its holdings in a wind farm in Oregon because it was located near a naval base. Similarly, although ultimately approved, CFIUS also scrutinized the Shuanghui acquisition of Smithfield Foods because some of the assets were near military bases. Finally, in what could be the largest Chinese investment to date, the ChemChina/Syngenta deal was also affected by this doctrine.[15] As of this writing, however, the deal has cleared CFIUS review.[16]

Because of the large size of China's state sector and SOEs' increasing focus on technology-intensive acquisitions in the US market, Chinese investors will need to be especially sensitive to this process. From 2012-2014, for example, China's filings with CFIUS accounted for 19 percent of the total, followed by the United Kingdom at 15 percent, Canada at 11 percent, and Japan at 10 percent.[17] While the higher rate for China in part reflects a rise in overall Chinese investments, it is also likely because of the *type* of investments being pursued (e.g. semiconductors).

Even though CFIUS reviews rarely lead to wholesale blocking of the deal (some are voluntarily withdrawn)—only a *single* transaction out of 627 total notices filed since 2009 has led to a presidential decision—investments from Chinese SOEs will be scrutinized more carefully under the law than those by wholly private firms. This is generally the case for all foreign firms with state ties because it is often difficult to untangle the ownership structure of SOEs, even though the factors that matter more are not ownership but *control* of the firm and whether such a firm operates based on commercial principles. A firm may have majority state ownership but conduct itself strictly in a commercial manner. On the other hand, some firms that have minority state

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ownership are actually controlled by government bureaucrats and tend not to behave as a private firm would.

When there is doubt and uncertainty, however, CFIUS usually defaults to a more *expansive* interpretation of what transactions need to be reviewed, particularly those perceived to have foreign government involvement. The prudent behavior for any foreign investor, particularly Chinese investors, is *not* to seek to circumvent the process or hope to fly under the radar undetected. Just the opposite: the proper course of action is to deal with it transparently and follow standard operating procedures.

The prudent behavior for any foreign investor, particularly Chinese investors, is not to seek to circumvent the process or hope to fly under the radar undetected.

Just as important, Chinese investors need to identify potential national security issues related to an attempted acquisition early in the process and conduct thorough due diligence, particularly in an environment in which the scope of the CFIUS review appears to be more expansive. To appropriately handle the process in an open manner, it will be necessary to hire experienced legal advisors who understand both the national security implications and Washington, DC political dynamics, including how to work with relevant Congressional committees.

Dealing at the Sub-National Level

In the decentralized US system, governors of states (and to a lesser extent, mayors of cities) can be important players in attracting investment, but they do not wield the same authority as Chinese local governments. US governors and mayors can offer tax incentives, cut through some bureaucratic red tape, and may even be able to help find sites for greenfield investments. In most cases, governors and other local politicians do not become directly involved in a deal nor can they marshal substantial state resources for investment projects. Provincial party secretaries and governors in China, in contrast, have the power to directly approve or axe a project; they can offer land by fiat because it is a state-owned asset in China; and they generally do not need to account for the interests of diverse constituencies when deciding on projects. In other words, Chinese local governments are more powerful and their support is necessary to successfully execute any major investment project.

US governors and mayors, however, can be important allies to foreign investors and can serve as strong advocates and cultivators of local support for a particular project. This is especially true when a particular foreign direct investment creates or keeps jobs in the local economy. Just as important, they can often act as a bulwark against the politicization of a particular transaction at the federal level. For instance, they can help ensure support (or lack of opposition) among US Senators and

Representatives whose states or districts are involved, making political controversy in Washington less likely.

This is why it is crucial for Chinese investors to identify and work with state and city officials *and* other local stakeholders, because it may be the first Chinese investment in that particular community. The American public is naturally inclined to be skeptical, rather than be supportive, of foreign investment. Only when foreign investment can demonstrate tangible benefits to the economy will local support coalesce.

When it comes to greenfield investments where a new plant is being erected, it is much easier to generate local support for obvious reasons. But even here, community outreach is necessary because it is helpful to explain the investor's plans to localize the operations, the impact on the local community, and how these plans fit into the parent company's broader business operations and vision. In terms of an acquisition, especially when it involves the takeover of a longstanding, successful local employer, priority should be placed on how to keep or increase jobs because the local community's key concern will be the impact on their job security.

Finally, dealing with a proactive, free, and sometimes combative press is problematic for Chinese investors who have little experience handling independent and private media. Multi-billion dollar deals will invariably attract attention and headlines, especially in local media markets. The default tendency for many Chinese investors is to stay silent rather than engage, hoping the press eventually loses interest, but that is usually not an effective strategy.

A thoughtful and proactive communication strategy needs to be in place throughout the entire deal process to explain the intent of the investment and how it will be integrated into, and benefit, the local economy. Of course, this should not be relegated to only the local level. A similarly robust communication strategy needs to be simultaneously deployed at the federal level to maintain transparency and mitigate potential politicization of transactions that should not be politicized.

Best Practices and Principles for Chinese Investment

Despite these challenges, powerful underlying economic rationales and complementarities will encourage Chinese capital to continue seeking investments in the US market. And in many, if not most, cases it will be in the interest of the United States to be a recipient of Chinese capital. But to truly tap this potential, the United States needs to compete vigorously with other advanced markets for Chinese capital and maintain an investment climate that is open and welcoming, irrespective of the political winds at any given moment.

Stronger bilateral investment ties, as opposed to just trade linkages, can inject new energy into the increasingly complex US-China economic relationship.

This trend affords major opportunities for local economies across America. At a broader level, stronger bilateral *investment* ties, as opposed to just trade linkages, can inject new energy into the increasingly complex US-China economic relationship.

To that end, both governments, as well as market participants, will need to work toward creating an environment to sustain this trend. This is no easy task, as direct investments are inherently more difficult to execute. Moreover, it is fundamentally the capital markets, rather than governments, that play the leading role when it comes to deal transactions.

But constructive policy at the national level can help to set the tone and overcome the perception gaps in both countries. Both the US and Chinese governments would do well to:

- Maintain an open economy and embrace foreign investment even in the face of political pressure from their respective domestic constituencies and interest groups.

- Avoid carving out sectors that are entirely off limits to foreign investment and apply national security reviews in a fair and transparent manner. For both governments, this means ensuring that neither the US CFIUS process nor China's new national security law is arbitrarily expanded for protectionist purposes that are unrelated to national security.

- Prevent the slide toward tit-for-tat actions on investments. Reciprocity may sound reasonable in the abstract, but in reality, there are no good mitigation mechanisms to prevent these actions from escalating into serious market access problems and creating a debilitating environment.

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- Continue to support the completion of a BIT so that two-way investments become normalized under a proper framework and transparency is enhanced.

Mergers and acquisitions are difficult to complete for many reasons, but largely because it takes a willing buyer and seller to reach a mutually agreeable price. And even after the deals are consummated, many prove to be unsuccessful either because the underlying economic rationale is flawed, insufficient due diligence results in unpleasant post-acquisition surprises, or the acquired business cannot be successfully integrated and run due to management issues or lack of cultural fit. The degree of difficulty is greater, and the success rate lower, when it comes to cross-border investments, particularly when the foreign investor seeks to take control of a company.


Photo: Flickr/Roger Smith

To increase the chances of a successful investment, it is helpful to keep these principles in mind:

- All acquisitions, but particularly takeovers by a foreign investor, have a political dimension, so it is always beneficial and often necessary to get buy-in from all stakeholders/communities in which the new acquisition or new plant operates.

- No foreign acquisition of any healthy US company is politically popular. In addition, the American public is generally resistant to government ownership/control even if it is by its own government. Acquisition by a Chinese SOE will receive extra scrutiny.

- In addition to being as transparent as possible, foreign investors would be well served to retain high quality financial, legal, and communication advisors. This would also include an experienced Washington, DC law firm to deal with any transaction where the possibility of a national security review by CFIUS, or political scrutiny, arises. It would be prudent to engage such a legal firm as the deal is being negotiated rather than after it has been signed. Relatively minor adjustments in deal terms can often significantly improve chances for swifter and successful regulatory approval. And it is always harder to reopen a completed deal than it is to consider these changes while the deal is being structured.

- Acquisitions tend to be easier for any selling company or domestic politician to support if they save or create jobs in the local economy (there will often be concern or the perception that the Chinese acquirer is only interested in buying US technology and technical know-how and will subsequently move jobs out of the country post acquisition).

- Chinese businesses and acquisitions operating in the US market will be the window through which many Americans view China. Hence operating success, employment practices including compensation and training, social responsibility, and community involvement enhance their reputation with local stakeholders. Therefore, it is just as important to ensure the use of best practices in the post-investment operating environment as it is in completing the transaction itself. In short, the reputation of the Chinese investor in the US market is an extension of the reputation and image of the nation of China writ large.

Finally, any foreign *buyer* of a US company must bear in mind these two general precepts:

1. Ground your acquisition in economic reality: do not over pay

Too often, buyers, and particularly foreign investors, make the mistake of being overly optimistic and paying too much for a particular asset. This primarily benefits the selling shareholders and the investment banks but works to the detriment of the acquiring entity. Not only does it hurt the buyer, it can also undermine the economic health of the acquired company and disadvantage its employees, customers, and the communities in which it operates.

The best acquisitions provide real synergies that allow the buyer to increase the growth of the US business and employees—for instance, by offering new market opportunities and/or access to the buyer's home market. In other instances, the investor is viewed as injecting growth capital to give the acquired entity more capacity to grow its existing business. Buying an unrelated business where the buyer brings little else other than capital to the table is often a recipe for failure.

2. Closing a deal is not the end of the story: retaining human capital after the acquisition is critically important

When acquiring a company, make sure a plan is in place at the same time for running it after the acquisition. Integrating a new acquisition into existing operations to capture synergies is challenging for any company. This is made all the more difficult for foreign investors because they will invariably have to deal with a different corporate culture, legal system, and regulatory regime in the United States.

It is important to think carefully and comprehensively about how to integrate existing management into the new parent company and how to retain existing talent. For acquisitions in industries other than property or natural resources, human capital will almost always be an essential and valuable asset from the acquisition. Unless a foreign buyer is convinced it can insert its own management team, it will need to develop a plan to keep the existing management, including how best to structure compensation and career advancement opportunities to motivate the management team. Much of the success of an acquisition hinges on the post hoc integration process and the ability to retain human capital.

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The Paulson Institute's Program on Cross-Border Investment

There are compelling incentives for the United States and China to increase direct investment in both directions. US FDI stock in China was roughly $60 billion in 2010, yet a variety of obstacles and barriers to further American investment remain. Meanwhile, Chinese FDI stock in the United States has hovered at around just $5 billion. For China, investing in the United States offers the opportunity to diversify risk from domestic markets while moving up the value-chain into higher-margin industries. And for the United States, leveraging Chinese capital could, in some sectors, help to create and sustain American jobs.

As a nonprofit institution, The Paulson Institute does not participate in any investments. But by taking a sector-by-sector look at opportunities and constraints, the Institute has begun to highlight commercially promising opportunities—and to convene relevant players from industry, the capital markets, government, and academia around economically rational and politically realistic investment ideas.

The Institute's goal is to focus on specific and promising sectors rather than treating the question of investment abstractly. We currently have two such sectoral efforts—on agribusiness and manufacturing.

The Institute's aim is to help develop sensible investment models that reflect economic and political realities in both countries.

The Paulson Institute currently has four investment-related programs:

US-China Agribusiness Program

The Institute's agribusiness programs aim to support America's dynamic agriculture sector, which needs new sources of investment to spur innovation and create jobs. These programs include:

- A US-China Agricultural Investment Experts Group comprised of some of the leading names in American agribusiness. The group brainstorms ideas and helps in the Institute's effort to develop innovative investment models that reflect economic and technological changes in global agriculture.
- Periodic agribusiness-related investment workshops, bringing key players and companies together. The Institute held the first workshop in Beijing in December 2012. Attendees included CEOs and experts. It has since held smaller, sessions in the United States focused on specific technologies or aspects of agribusiness.

- Commissioned studies that propose specific investment models, including for commodities, such as pork, or value chain opportunities, such as collaborative research and development (R&D).

US-China Manufacturing Program

In June 2013, the Institute launched a program on trends that will determine the future of global manufacturing and manufacturing-related capital flows. We aim to identify mutually beneficial manufacturing partnerships that would help support job growth in the United States. The Institute's principal manufacturing programs include:

- Investment papers that the Institute is co-developing with private sector and academic partners.
- Periodic workshops in Beijing and Chicago with Chinese, American and global CEOs and executives, focused on technological change, sectoral trends, and investment opportunities.

Case Study Program

The Institute publishes in-depth historical case studies of past Chinese direct investments in the United States, examining investment structures and economic, political, and business rationales. These detailed studies are based on public sources but also first-hand interviews with deal participants on all sides. They aim to reconstruct motivations and actions, and then to draw lessons learned.

State-Level Competitiveness Program

The Institute works closely with several US governors to help them hone their teams' approach to attracting job-creating foreign direct investment. Our core competitiveness program is a partnership with states in the Great Lakes region, but we work with other governors as around the United States as well.

- Paulson Institute-Great Lakes Governors Partnership: Working closely with the Council of Great Lakes Governors, the Institute is honing pilot strategies to help match the "right" investors and recipients to the "right" sectoral opportunities. Work is also focusing on how to connect Great Lakes/St. Lawrence-based R&D and innovation to foreign deployment opportunities while opening markets in China. The Council includes the governors of Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin, as well as the Canadian premiers of Ontario and Quebec.

- American Competitiveness Dialogues: The Institute convenes an ongoing series of competitiveness forums around the United States. These aim to address the implications of the changing global economy for US competitiveness, opportunities and challenges associated with foreign direct investment.
- R&D+Deployment ("R&D+D"): Working with partners, including McKinsey & Company and a small number of universities, the Institute is exploring new models that would link Chinese investors to the US innovation engine, especially in areas linked to demand-side needs in the China market. The aim is to design fresh models that capture value in both countries but do not sacrifice America's innovation edge or intellectual property protection. Our dialogue in this area aims, ultimately, to lead to a pilot initiative.

About The Paulson Institute

The Paulson Institute, an independent center located at the University of Chicago, is a non-partisan institution that promotes sustainable economic growth and a cleaner environment around the world. Established in 2011 by Henry M. Paulson, Jr., former US Secretary of the Treasury and chairman and chief executive of Goldman Sachs, the Institute is committed to the principle that today's most pressing economic and environmental challenges can be solved only if leading countries work in complementary ways.

For this reason, the Institute's initial focus is the United States and China—the world's largest economies, energy consumers, and carbon emitters. Major economic and environmental challenges can be dealt with more efficiently and effectively if the United States and China work in tandem.

Our Objectives

Specifically, The Paulson Institute fosters international engagement to achieve three objectives:

- To increase economic activity—including Chinese investment in the United States—that leads to the creation of jobs.
- To support urban growth, including the promotion of better environmental policies.
- To encourage responsible executive leadership and best business practices on issues of international concern.

Our Programs

The Institute's programs foster engagement among government policymakers, corporate executives, and leading international experts on economics, business, energy, and the environment. We are both a think and "do" tank that facilitates the sharing of real-world experiences and the implementation of practical solutions.

Institute programs and initiatives are focused in five areas: sustainable urbanization, cross-border investment, climate change and air quality, conservation, and economic policy research and outreach. The Institute also provides fellowships for students at the University of Chicago and works with the university to provide a platform for distinguished thinkers from around the world to convey their ideas.

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