China Go Abroad (9th issue)

How will Chinese enterprises navigate new challenges when "going abroad" under the new global trade landscape?

October 2019

Building a better working world

Content

Foreword

Unprecedented challenges with hidden opportunities

Albert Ng
Chairman, China
Managing Partner
Greater China

The global investment climate faces severe challenges in 2019, with cross-border investment regulations becoming increasingly stringent. In 2018, global outward direct investment (ODI) flow decreased by approximately 30%, reaching its lowest level in ten years[1], mainly resulted from the US tax reform which drove US multinational corporations to repatriate profits earned overseas. On the other hand, the globalization historically leaded by developed countries is undergoing significant adjustment while the trend of deglobalization is spreading, coupled with trade protectionism and tense geopolitical dynamics all lead to increased uncertainty in the global investment outlook.

During four decades of economic reforms, China has continuously pushed for opening up and innovation, which provide favorable opportunities for ODI. From "bringing in" to "going abroad", from China's admission to the World Trade Organization (WTO) to the launch of the Belt and Road Initiative (BRI), China has demonstrated resilience and enthusiasm amid unstable geopolitical context.

In the future, Chinese companies will vigorously improve their investment quality, increase competitive advantages in international cooperation to achieve mid to high end in the global value chain. Despite increasingly stringent regulations and conflicts between globalization and protectionism in Europe and the US, the BRI has spurred new international cooperation. Multiple developing countries have launched complementary initiatives or policies to align with the BRI, including Russia ("Eurasian Economic Union" strategy), Kazakhstan ("Bright Road" Initiative), Pakistan (China-Pakistan Economic Corridor) and ASEAN (Master Plan on ASEAN Connectivity 2025). Concurrently, developed countries are participating in the BRI via third-party market cooperation, putting the principles of shared growth and collaboration into practice and creating momentum for shared development. Although Chinese companies may occasionally face resistance while investing overseas, economic globalization is an irresistible trend and economic flow between countries will become more orderly and diversified.

As 2019 draws to a close, the global investment climate continues to face challenges and opportunities which are unprecedented in both size and scope. With the assistance of EY's professional services, I hope this issue of *China Go Abroad* can inspire Chinese companies and investors to adapt to market dynamics and take advantage of new opportunities.

[1] Source: United Nations Conference on Trade & Development (UNCTAD), EY Analysis

In this issue, we have analyzed regulatory measures for monitoring foreign direct investment (FDI) in major international markets. We hope that our analysis will allow Chinese enterprises to better understand the global investment regulatory climate and adapt to challenges adroitly.

In 2018, China ranked **no. 2** worldwide in terms of ODI flows and **no. 3** in terms of ODI stock

In H1 2019, China's ODI reached

US$57.4billion

Down 8% YoY*

In H1 2019, the value of newly-signed Engineering, Procurement, and Construction (EPC) contracts by Chinese companies in Belt and Road (B&R) countries reached

US$63.6billion

Up 33.2% YoY

Accounting for 60.1% of the total

In H1 2019, the announced value of China overseas mergers and acquisitions (M&A) totaled

US$20.0billion

Down 61.4% YoY

The announced deal volume was **257**

Down 39.2% YoY

In 2018, China's goods trade was worth

US$4.6trillion

Up 12.6% YoY

Ranking no. 1 globally

Service trade grew to **US$791.9billion**

Up 13.8% YoY

Ranking no. 2 globally

In 2018, China's **top 5** trading countries were the US, Japan, South Korea, Germany & Australia, whose trade with China accounted for

14%	7%	7%	4%	3%
US	Japan	South Korea	Germany	Australia

respectively

* YoY: year over year

Source: UNCTAD, Ministry of Commerce of The People's Republic of China (MOFCOM), WTO, and General Administration of Customs of China (GACC); ThomsonOne, Mergermarket, including data from Hong Kong, Macau and Taiwan and the deals that have been announced but not been completed; EY analysis.

Note: The China's ODI mentioned in this report refers to ODI of Mainland China only, which is aligned with the release of MOFCOM

Executive Summary

Consolidate advantages and face challenges courageously

Loletta Chow
Global Leader
China Overseas
Investment Network

In H1 2019, China outbound investment faced increasing resistance, and Chinese companies became more prudent when "going abroad". The announced value of China overseas M&As reached its lowest level in the past seven years, standing at US$20 billion, down 60% YoY. By region, Asia and Oceania surpassed Europe and North America to become the most favored destinations for China overseas M&As. By sector, they were mainly concentrated in the technology, media & telecommunications (TMT), consumer products, health & life sciences, advanced manufacturing & mobility, and mining & metals sectors[2]. EY predicts that China outbound investment will exhibit five major trends in the future:

1. "Going abroad" and "bringing in" will form a virtuous cycle and refashion the role of Chinese enterprises in the global value chain
2. The BRI development will further contribute to China's export-oriented economy
3. Seize the development opportunities in the era of the digital economy and accelerate the expansion of foreign investment
4. Promote a green approach in going abroad and maintain the sustainable development of foreign investment
5. Enterprises urgently need to develop a talent strategy that matches their international development

Furthermore, as economic connections between countries deepen, any deglobalization or protectionist behavior will cause spillover effects to previously unaffected countries due to global economic ties. In 2018, global cross-border investment regulations became increasingly stringent. Many developed countries implemented regulatory measures to limit foreign investment, resulting in profound impacts toward international investment and trade markets. In this issue, we examine the FDI regulations implemented by major countries over the past two years, in order to help Chinese companies better understand the global investment regulatory environment and adapt to new challenges. Moreover, we believe that investment and trade are two important drivers of economic development that stimulate and guide each other. In light of recent trade conflicts, we have analyzed in detail the effects of the new global trade landscape on Chinese companies:

Both of China's imports and exports are highly concentrated in a small number of industries, with the top five categories of both accounting for around

75%[3]

of the total

We suggest that Chinese companies keep an eye on the following:

- Investment opportunities related to mechanical and electrical products, industrial chemical products and instruments and apparatus in Taiwan (China), South Korea and Japan
- Investment opportunities related to mining & metals in Australia, Russia and Brazil, to further secure supply chains of strategic natural resources
- Investment opportunities related to automotive and transportation in the US, Germany and Japan, to deepen companies' roles within the value chains of the sector

the main destination for all top five categories of China's exports is the US

China's exports remain relatively reliant on the US market, which is the main destination for all top five categories of China's exports[3]. In order to reduce reliance on individual market and vulnerability to geopolitical risks, Chinese companies should continue to expand their operations to other overseas markets, while examining and improving supply chains regularly

In the future, EY will continue to assist Chinese companies to "go abroad", enhance their level of investment and operation, and improve their risk management capabilities, thereby allowing Chinese companies to navigate challenges for future success.

[2] Sources: ThomsonOne, Mergermarket, including data from Hong Kong, Macau and Taiwan and the deals that have been announced but not been completed; EY analysis

[3] Source: GACC, EY analysis

1 Review of China outbound investment in H1 2019 and outlook

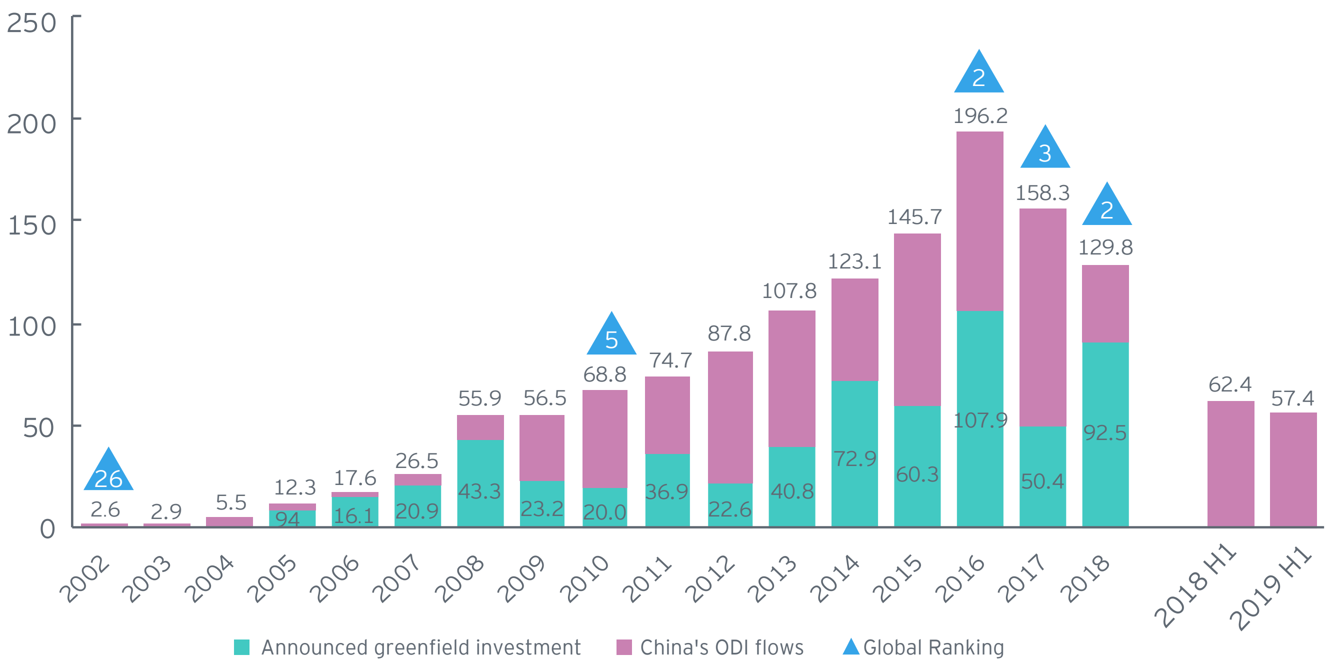
1.1 The structure of China's ODI remained optimized and diversified

The structure of ODI remained optimized, with greenfield investment expected to maintain growth momentum

Despite adverse global investment conditions, China's ODI maintained an optimized structure and orderly development. In H1 2019, China's ODI reached US$57.4 billion, down 8.4% YoY, with non-financial ODI dominated by the leasing and business services, manufacturing, wholesale and retail and mining, information transmission, software and IT services sectors, representing 30.3%, 18%, 9.5%, 8.4% and 8.1%, respectively. China's ODI in manufacturing, information transmission, software and IT service sectors increased by 7.3% YoY and 31.7% YoY, respectively[4].

Although China's ODI has declined for two consecutive years and exhibited downward trends in 2019, greenfield investment rebounded in 2018, growing by 84% YoY[1]. This indicates that as trade frictions increase and FDI screening becomes more stringent, greenfield investment is becoming increasingly favored among Chinese companies. EY expects that overseas greenfield investment will continue to grow, driven by the development of the BRI.

Figure1: China's ODI flows and announced greenfield investment from 2002 to H1 2019 (US$ billion)



Source: MOFCOM: China's ODI flows
World Investment report 2019, UNCTAD: Announced greenfield investment, Global ranking

[4] Source: MOFCOM

B&R cooperation presents fruitful results and exhibits broad prospects

In H1 2019, Chinese companies made non-financial ODI worth US$6.8 billion in 51 countries along the B&R, representing a decrease of 8.1% YoY and accounting for 12.6% of total ODI over the same period. Singapore, Vietnam, Laos, United Arab Emirates, Pakistan, Malaysia, Indonesia, Thailand, and Cambodia became major investment destinations. Newly-signed overseas EPC contracts by Chinese companies increased significantly, and the total value of new EPC contracts reached US$63.6 billion in H1 2019, growing by 33.2% and accounting for 60.1% of the total over the same period[4].

> "We need to pursue open, green and clean cooperation, and try to pursue high standard cooperation to improve people's lives and promote sustainable development.
>
> **Xi Jinping**
> Keynote speech at the Second Belt and Road Forum for International Cooperation (BRF)

EY believes the BRI will create new opportunities in the next five years. Firstly, the "third-party market cooperation" model will involve developed countries in B&R construction and bring in high-quality capital, technology, experience and talent. Secondly, in a volatile global economic climate, developing countries need to forge closer mutual ties in order to protect themselves against the risks of deglobalization and trade frictions, thus accelerating their involvement with the BRI.

1.2 China's ODI demonstrates resilience and possesses significant growth potential

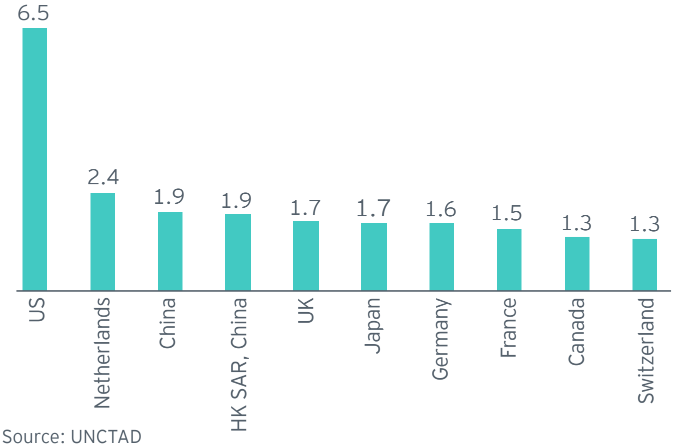
In 2018, China became the world's second largest outward investor and the third largest economy in terms of ODI stock

In recent years, China's ODI flows have continued to rise in global rankings. In 2018, China became the world's second largest outward investor afterJapan, although it experienced a decline of 20% in ODI flows. Moreover, the US was no longer within the top 20 outward investors, as it posted negative growth in ODI flows arising from 2017 tax reforms which stimulated the repatriation of overseas earnings of American multinational companies[1]. In contrast, China experienced stable development in ODI flows, indicating that China remained positive about economic globalization and that China's contributions to the global economy increased steadily.

In terms of ODI stock, China ranked third globally after the US and the Netherlands in 2018, accounting for 6.3% of the total stock worldwide compared with 1.2% in 2008. Moreover, China's ODI stock amounted to 30% and 80% of the US and the Netherlands, respectively, overtaking developed countries such as Japan, Germany and the UK. As of 2018, US ODI stock represented one fifth of the total stock worldwide[1].

EY believes that in the short term, although enterprises in developed countries such as the US will continue to dominate economic globalization and participate in the division of global industrial chain, the rise of protectionism in developed countries creates opportunities for the internationalization of Chinese enterprises - when the US withdraws its capital and focuses on its domestic market, Chinese capital will become one of the major sources of foreign investment in many overseas countries. Thus, Chinese enterprises should seize investment opportunities with a well-prepared strategy and deep understanding of the market, actively seek for continuous optimization in industries, supply chains and investments, and effectively prevent and control geopolitical risks.

Figure 2: Top 10 countries /regions worldwide ranked by ODI stock in 2018 (US$ trillion)



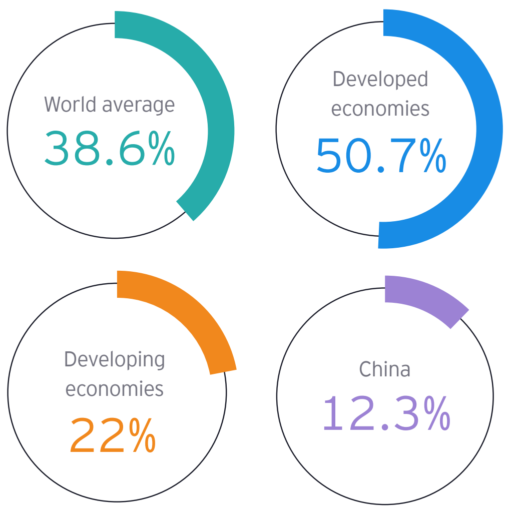
Source: UNCTAD

China will continue to see potential growth in ODI stock due to its small share of GDP

China is now one of the world's top countries by ODI stock and the world's second largest economy. However, its proportion of ODI as a share of GDP remains relatively low given its role in the global economy. In 2017, the average ratio of ODI stock to GDP worldwide, in developed economies and in developing economies were 38.6%, 50.7% and 22%, respectively; China's ratio of ODI stock to GDP was only 12.3%, less than one third of the world average and far less than that of developed economies[1].

EY believes that economic globalization is irreversible, and China will continue to see an increase in outward investment driven by its growing capital. It is also expected that outward investment will stimulate China's economy and create a "virtuous cycle".

Figure 3: The proportion of ODI stock to GDP in 2017 (%)



Source: UNCTAD

1.3 Overseas M&As focused TMT, with Asia-Pacific being the preferred investment destination

Since 2018, significant changes have taken place in the global outbound investment environment as regulations have become increasingly stringent and many developed countries have issued FDI-related regulations. Confronted with more challenges when going abroad, companies from regions such as mainland China, Hong Kong, Macau and Taiwan have become more prudent in their overseas M&As. In H1 2019, the value of announced China overseas M&As amounted to US$20.0 billion, down nearly 60% YoY, the lowest of the past seven years, while the number of announced M&As dropped nearly 40% YoY to 257.

China overseas M&A activities focused high growth sectors, concentrated on the high end of the value chain

As China's industrial structural adjustment deepens, sectors that support structural adjustment, reform and upgrading are becoming increasingly favored among Chinese investors for overseas M&As. As a result, Chinese companies are moving upward in the global value chain. It is expected that high-tech and high value-added emerging sectors, high-end service industries and the consumer products sector will continue to be the focus of overseas M&A activities. Meanwhile, Chinese companies may face bigger challenges investing overseas due to increasingly stringent regulations and restrictions imposed by developed countries on foreign investment.

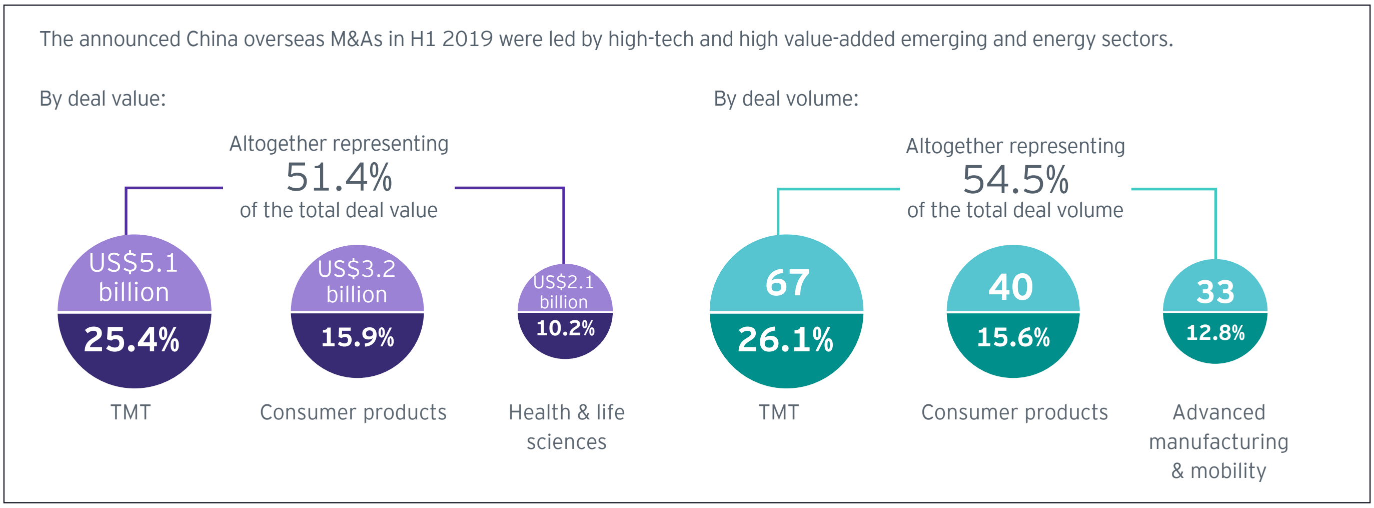


Figure 4: Announced China overseas M&As deal value by sector, H1 2019 and H1 2018 (US$ billion)

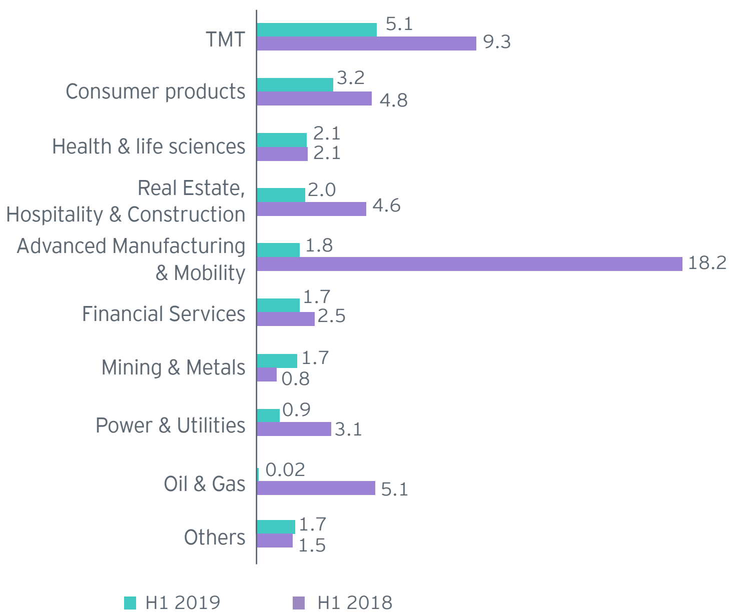
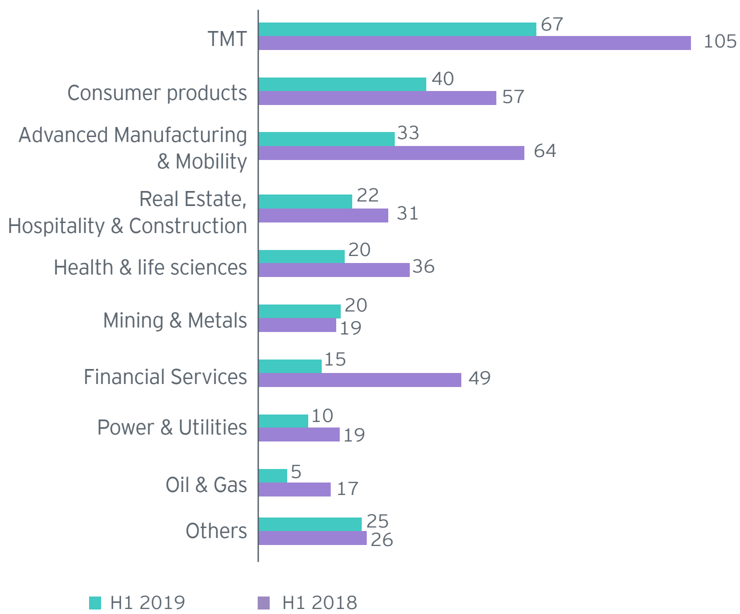


Figure 5: Announced China overseas M&As deal volume by sector, H1 2019 and H1 2018



Source: ThomsonOne, Mergermarket, including data from Hong Kong, Macau and Taiwan and the deals that have been announced but not been completed; EY analysis

Overseas M&As in Asia-Pacific increased despite contracting trends, making the region the top destination for Chinese investors

As investors became more prudent in their overseas M&As, Chinese companies changed their preference in investment destinations, with Europe and North America no longer being the top regions for Chinese investors. By deal value, Asia and Oceania overtook Europe and North America to become the most popular destinations for overseas investment among Chinese companies. Respective China overseas M&As posted double-digit growth despite a sharp decrease in overall deal value.

Figure 6: Announced China overseas M&A deal value (US$ billion) and volume by destination, H1 2019

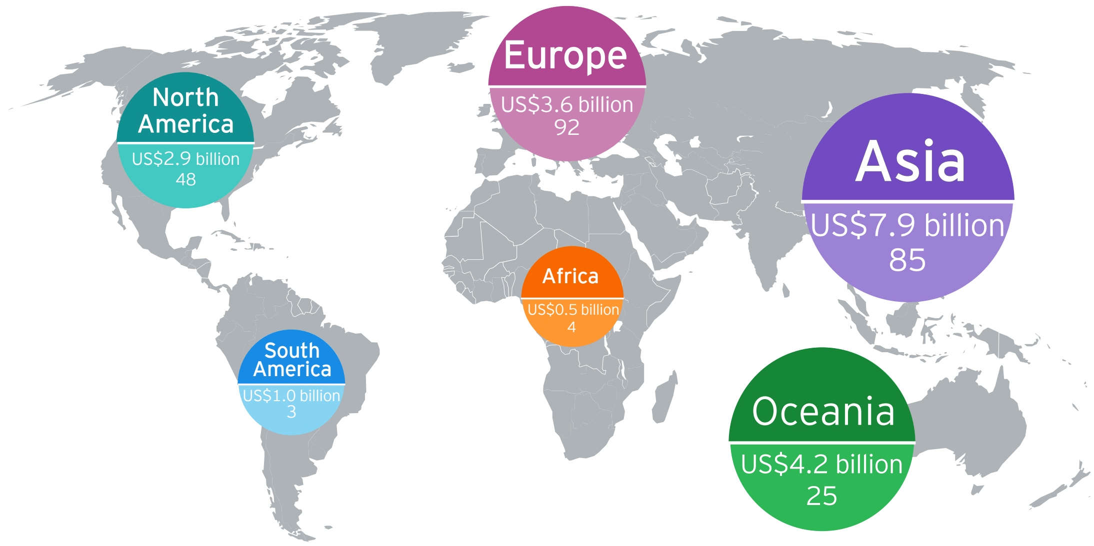


Figure 7: Top 10 destinations of announced China overseas M&As, H1 2018 and 2019 (by deal value, US$ billion)

	H1 2019		H1 2018	
1	Australia	3.8	Germany	9.7
2	India	2.3	US	9.1
3	US	2.2	UK	6.3
4	Singapore	2.0	Chile	4.1
5	Japan	1.9	Spain	3.8
6	UK	1.5	Australia	3.0
7	Sweden	1.1	France	2.0
8	Korea	1.1	Switzerland	1.9
9	Brazil	0.8	Saudi Arabia	1.2
10	Canada	0.7	South Korea	1.1

Source: ThomsonOne, Mergermarket, including data from Hong Kong, Macau and Taiwan and the deals that have been announced but not been completed; EY analysis

Asia

Ranked first, focused TMT and consumer products

GDP of emerging markets in Asia are expected to grow by 6.3% in 2019, making Asia the most economically active region worldwide[5]. In H1 2019, announced China overseas M&A deal value in Asia grew by 21.9% YoY to US$7.9 billion, representing nearly 40% of the total M&A value, making Asia the world's largest destination for Chinese investors. This shows that Chinese investors are confident in the future development of Asia. In H1 2019, the favorite sectors of Chinese investors by deal value were TMT, consumer products, financial services and mining & metals, while India, Singapore and Japan became the favorite investment destinations. EY expects that Chinese companies will continue to increase their investments in Asia, driven by the BRI and robust regional economic growth.

Oceania

Deal value grew by nearly 40% despite adverse conditions while health & life sciences became the favorite sector

In H1 2019, announced China overseas M&A deal value in Oceania rose by 38.3% YoY to US$4.2 billion, led by the health & life sciences, real estate, hospitality & construction sectors. Australia became the largest destination for China overseas M&A activities in H1 2019. In recent years, Australia has become favored among Chinese investors due to its advanced technology in health & life sciences and well-established elderly healthcare system. EY expects that with the increasing healthcare demand driven by growing China's middle class and aging population, respective investment targets in Australia will remain favored among Chinese companies.

Europe

Deal value suffered the largest ever setback, decreasing over 80%, overseas investments as a result tended to be prudent

Due to uncertainties regarding Brexit and increasingly stringent FDI screening in European Union (EU) countries, the announced Chinese overseas M&A activities recorded the largest ever decline in deal value, decreasing 86.6% YoY to US$3.6 billion in H1 2019. M&A deals by Chinese companies were mainly focused in the advanced manufacturing & mobility, consumer products and financial services sectors; only two European countries (UK and Sweden) were ranked among the top 10 M&A destinations for Chinese companies.

North America

Deal value decreased by over 70% due to increasing geopolitical risk

In H1 2019, Chinese enterprises saw a sharp decrease in the announced M&As in North America, dropping by 71.5% YoY to US$2.9 billion. TMT, mining & metals, consumer products and financial services dominated M&A activities. Announced China M&As in the US declined by 76% in deal value . In 2018, *the Foreign Investment Risk Review Modernization Act* (FIRRMA) was passed in the US, placing restrictions on Chinese investments. As a result, the Committee on Foreign Investment in the United States (CFIUS) rejected multiple Chinese investments targeting the US's high-tech sectors. Although the China-Us trade frictions appear to be directed at existing trade deficits, such frictions actually reflect a greater economic and political competition between the two countries. As increased frictions give rise to political and policy risks, Chinese companies with investment plans have slowed down their pace of investment in the US. However, a peaceful and harmonious bilateral relationship between the two countries will be a win-win situation, while a confrontational one will be a lose-lose one. Thus, it is just a matter of time until China and the US break the deadlock and resume cooperation to achieve win-win results. Although China's investment in the US is unlikely to pick up in the short term, Chinese companies need to look to the future and consider the advantageous position of the US in the high-tech sector and its huge consumption potential.

Source: ThomsonOne, Mergermarket, including data from Hong Kong, Macau and Taiwan and the deals that have been announced but not been completed; EY analysis

[5] Source: *The World Economic Outlook*, April 2019, the International Monetary Fund

1.4 Keep up with the world and forge ahead with aspiration

During the past 40 years of reform and opening up, China outbound investment has experienced three important stages:

The first stage: 1979-2000

The State Council proposed "doing business abroad" in 1979 and thus began the journey of China outbound investment.

The second stage: 2001-2016

The second stage was marked by China's official admission to the WTO in 2001 to expand its international market. In the same year, the "going abroad" strategy was written into the *Outline of the 15th Five-Year Plan for National Economic and Social Development,* and China outbound investment entered the stage of drastic increase. Between 2001 and 2016, the compound annual growth rate of China's ODI reached 25%[1] in 16 years, and marked historical high in 2016.

The third stage: 2017-present

The *Measures for the Administration of Overseas Investment of Enterprises* was released in 2017. China began to comprehensively strengthen the regulatory measures for post-investment management and introduced a negative list system. In 2018, China introduced the *Special Administrative Measures on Access to Foreign Investment (Negative List) (2018 Version)* to curb irrational investment in real estate, hotels, sports clubs, entertainment and other industries, gradually directing the investment structure to be more technology-oriented and developing China's role in the global value chain. This indicates that China's foreign investment is entering a stage of high-quality development. According to the Ministry of Commerce's *China Outward Investment Development Report 2018*, China had more than 39,000 enterprises undertaking overseas direct investment in 189 countries and regions . "Going abroad" has become an important component of China's economic transformation and upgrade, win-win cooperation with foreign markets, and it has accelerated the country's integration into economic globalization.

Looking ahead, EY expects five trends in Chinese outbound investment and management:

1 "Going abroad" and "bringing in" will form a virtuous cycle and refashion the role of Chinese enterprises in the global value chain

Today, greater emphasis has been placed on the quality of China's economic development, and China's "opening up" has entered a new stage. Increasing national power and corporate strength not only support the global distribution of Chinese capital, but also assist many Chinese industries in transforming from being followers to leaders. The goods that are "going abroad" are no longer limited to low-end processed trade products or primary processed goods, but now include high value-added goods and goods involving the entirety of the industry-chain such as telecommunication equipment, electronic products, high-speed rail, nuclear power, and infrastructure. At the same time, China continues its unwavering effort to further open up its economy, attract foreign investment and actively expand imports. This plays an important role in bringing the world's advanced technology, management model and value chain network to China, and promoting the upgrading of China's related industries. After Chinese enterprises invest overseas, they will "bring in" value chain elements such as overseas resources, technologies and brands that they have acquired. This will refashion Chinese enterprises' role in the global value chain more directly and rapidly.

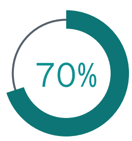
EY believes:

"Going abroad" and "bringing in" are interconnected and can reinforce each other. Only by adhering to the principle of openness and forming a virtuous cycle can we promote quality improvement of industries and thus adapt to the complex and ever-changing geopolitical economic climate.

2 The B&R development will further contribute to China's export-oriented economy

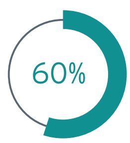
Chinese enterprises accomplished the following performance with countries along the B&R

Jointly developed overseas economic and trade zones accounted for



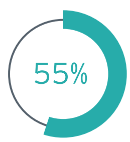
of the total
(As of April 2019)

The value of newly-signed overseas EPC contracts accounted for



of all overseas EPC contracts over the same period
(H1 2019)

The turnover of completed overseas EPC projects accounted for



of the total turnover over the same period
(H1 2019)

Source: MOFCOM, The State Council Information Office

As a result of increased development, the BRI's role in China's export-oriented economy has also evolved. In recent years, developed countries have set off a wave of deglobalization while promoting closer ties between developing countries. The BRI has undergone development during this time and shows four key characteristics: First, the scope of the BRI continues to expand from the countries along the route to the global community. Second, the BRI participants have become increasingly diversified, expanding from developing countries to developed countries, international organizations and regional economic alliances. Third, countries are actively exploring the feasibility of bilateral, multilateral and third-party market cooperation to enrich collaboration. Fourth, the cooperation areas are further expanded from energy and infrastructure to digital technology, finance services and other emerging industries. These phenomena have laid the foundation for the sustainable and high-quality development of the BRI in the future.

As the joint B&R construction development deepens, EY expects that:

- The B&R development will contribute more to the development of China's export-oriented economy
- Energy, transportation, infrastructure and finance will continue to be the key development areas of the BRI, while investment in the new economic forms such as the internet, telecommunications and cross-border e-commerce will also speed up
- From "following the policy" to "following the market", investment has gradually become a market-driven decision

3 Seize the development opportunities in digital economy era and accelerate the scope of foreign investment

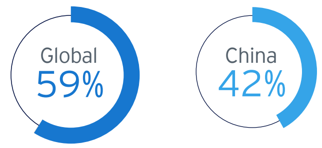
EY research reveals that with the development and application of next-generation digital technologies such as 5G, cloud computing and artificial intelligence (AI), technology-based digital infrastructure construction has become the driving force of global expansion. Technology is accelerating and disrupting the development and cycles of traditional industries, and M&As are the most convenient means for enterprises to achieve digital transformation. With the development of China's technology and the improvement of companies' international competitiveness.

EY expects that cross-industry M&A activities in the areas of Internet of Things (IoT), automotive and transportation will increase due to digitalization.

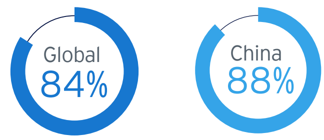
IoT: the smart city market is China's fastest growing IoT market , and technologies such as smart transportation, smart medical care and smart energy management will have considerable growth as 5G, augmented reality/virtual reality (AR/VR) and AI technologies mature.

Automotive and transportation: Digitalization is gradually penetrating the entire automotive industry value chain, leaving a positive impact on operational efficiency, customer experience and business models. Companies need to improve digital capabilities from development to production, from sales to mobility services delivery and integrate them into the new industrial ecosystem[6].

EY's latest edition of the *Global Capital Confidence Barometer* reveals that



Executives expect the companies to actively pursue M&As in the next 12 months



Executives expect an increase in cross-sector M&As driven by technology and digitalization

4 Promote a green approach in "going abroad" and maintain the sustainable development of foreign investment

In recent years, the international community has attached great importance to ecology, environmental protection and sustainable development. Countries have formulated relevant laws and regulations to regulate corporate behavior and guide green investment. China has also actively guided and supervised the investment and the environmental, social and governance (ESG) disclosure of Chinese enterprises. Under the two-way supervision of China and the international community, environmentally-friendly "going abroad" has become mandatory for the internationalization of Chinese enterprises. In September 2018, the China Securities Regulatory Commission officially issued a new version of the *Code of Corporate Governance for Listed Companies*, requiring listed companies to disclose ESG information and incorporate it as an important indicator into their annual financial report. In 2019, at the Second BRF, President Xi Jinping also mentioned that China would support green and sustainable development, build a B&R sustainable cities alliance and an international alliance for green development, and formulate the *Green Investment Principles for the Belt and Road*[7].

EY believes:

Fulfilling corporate social responsibility (CSR) can not only help Chinese enterprises obtain a more stable business investment environment while investing overseas, but also help establish positive corporate image, enhance global competitiveness, and improve local people's livelihood as well as the economic and social environment thereby creating win-win cooperation. Using this as a springboard, the low-carbon and environmental-friendly new energy, renewable energy and green industries are bound to usher in new development opportunities.

5 Enterprises urgently need to develop a talent strategy that matches their international development

In the new stage of the internationalization of Chinese enterprises, talent strategy is gradually becoming the key for business development success. On one hand, talent strategy for internationalization should focus on the cultivation and retention of talent to ensure that talent and knowledge structures meet the developmental needs of enterprises. On the other hand, companies need to ensure that employees meet the legal and compliance requirements of host countries with regard to cross-border mobility and enterprise integration. Apart from selecting and retaining their own international talent, enterprises should also hire and cultivate local employees from host countries. They can actively fulfill CSR by offering jobs in local communities and providing more comprehensive and systematic training opportunities for local employees to enhance the diversity and inclusiveness of their corporate culture.

EY believes that Chinese enterprises could consider the following in the future:

- Cooperate with domestic and overseas universities and professional institutions to explore and establish a talent training system, create an innovative talent training model, and regularly hire more international management and professional technical personnel through targeted recruitment
- Implement "going abroad" recruitment in a more open and inclusive manner to seek overseas talent with international vision, sound knowledge of international rules and rich experience in multinational management, while making extensive use of resources such as students studying abroad
- Intensify digital training to accelerate talent learning and digital skills and applications, continue to update and optimize the knowledge structure of incumbents to stay current, and improve work efficiency of existing talent

[6] Source: *New era of China's opening-up*, EY report

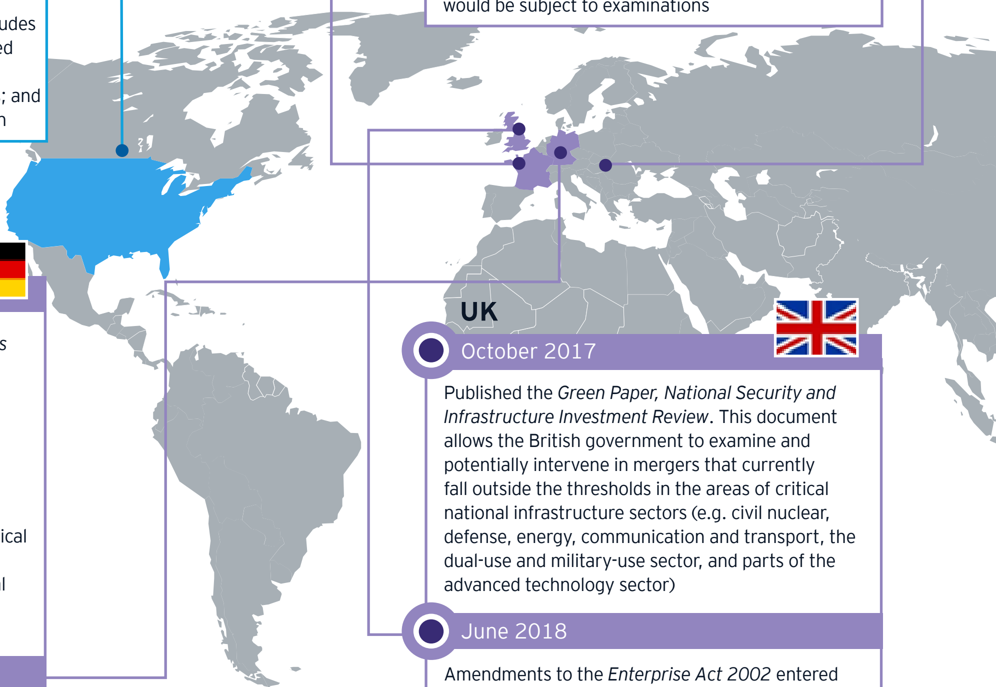
[7] Source: *Xinhua news agency*

2 The internationalization of Chinese enterprises under the new geopolitical landscape

2.1 Chinese enterprises face challenges in overseas investment as the international regulatory environment becomes increasingly stringent

Statistics show that 49 restrictions or regulations relevant to FDI were introduced in 28 overseas countries between 2017-2018 as global investment regulations became more stringent. Nearly 40% of new investment restrictions or regulations for foreign investors were based mainly on national security concerns about the foreign ownership of critical infrastructure, core technologies, elements of the defense sector, sensitive business assets or residential properties[1], indicating that the trends of global protectionism and deglobalization are becoming increasingly prevalent.

New regulatory measures in major developed countries



US

August and November 2018

US president Donald Trump signed FIRRMA, which expanded CFIUS's jurisdiction and amended the process for reviewing foreign investment by CFIUS. A pilot program pursuant to FIRRMA was also issued to request reviews on certain investments by foreign investors in a US business that relate to "critical technology". The "critical technology" mainly includes defense articles or defense services, items included on the Commerce Control List, nuclear facilities, equipment, and material; select agents and toxins; and emerging and foundational technologies and so on

Germany

July 2017

An amendment to the *Foreign Trade and Payments Ordinance ("FTPO")* entered into effect. Any acquisition involving at least 25% of voting rights of a company based in Germany by foreign/ non-EU investors in relation to the operation of critical infrastructure (e.g., energy, water, IT and telecommunication, finance and insurance and health, transport and food), the development of industry-specific software for the operation of critical infrastructure, and the supply of cloud computing services, must be subjected to the German Federal Ministry for Economic Affairs and Energy (BMWi) screening

December 2018

Amended the *FTPO* and lowered the threshold from 25% to 10% regarding security-related infrastructure and defense-related companies. The BMWi will decide whether to initiate a formal review process or not within a three-months' notice period of an FDI and up to five years after the deal has been signed

France

November 2018

Extended the scope of foreign investment screening. From 1 January 2019 onwards, foreign investment in French companies that conduct R&D activities in the areas of space operation or cybersecurity, AI, robotics, additive manufacturing and semiconductors would be subject to examinations

UK

October 2017

Published the *Green Paper, National Security and Infrastructure Investment Review*. This document allows the British government to examine and potentially intervene in mergers that currently fall outside the thresholds in the areas of critical national infrastructure sectors (e.g. civil nuclear, defense, energy, communication and transport, the dual-use and military-use sector, and parts of the advanced technology sector)

June 2018

Amendments to the *Enterprise Act 2002* entered into force. The changes lowered the turnover test threshold for M&As from GBP70 million to GBP1 million in three sectors: the development or production of items for military or military and civilian use ('dual use'); the design and maintenance of the aspects of computing hardware; and the development and production of quantum technology

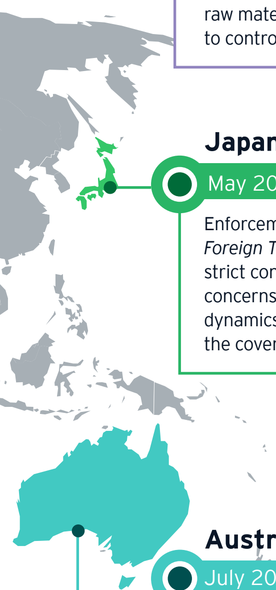
The impact of increasingly stringent regulatory environment on China overseas M&As

The increasingly stringent regulatory environment will increase the uncertainty and instability of China overseas M&As. In 2017-2018, multiple restrictions relevant to FDI were introduced in popular destinations for investment among Chinese enterprises, directly causing the lapse or withdrawal of many deals after announcement due to unsuccessful regulatory review. In 2018, the value of overseas M&As of Chinese enterprises that were lapsed or withdrawn after announcement reached US$37 billion with a total of 38 cases, reaching record highs in both categories[8].

EU

April 2019

EU Foreign Investment Screening Regulation came into effect and will be fully applied as of 11 October 2020. The regulation creates a cooperation mechanism where member states and the European Commission will be able to exchange information and raise concerns related to specific investmentscritical infrastructure, critical technologies, the supply of critical inputs such as energy or raw materials, access to sensitive information or the ability to control information, freedom and pluralism of the media.



Japan

May 2017

Enforcement of the *Revised Foreign Exchange and Foreign Trade Act* was established, aiming to exercise strict control on critical technologies and goods over the concerns of national security and changing commercial dynamics. The non-listed companies were included into the coverage of control targets

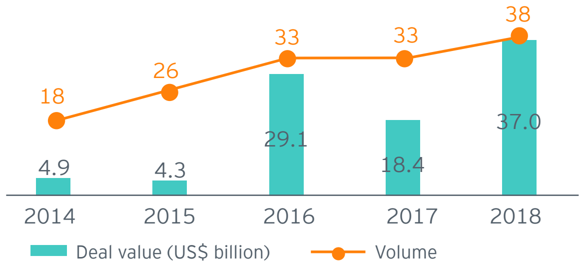
Australia

July 2018

The *Security of Critical Infrastructure Act 2018 (the Act)* came into effect. The Act seeks to manage the complex and evolving national security risks of sabotage, espionage and coercion posed by foreign involvement in Australia's critical infrastructure. The Act applies to approximately 165 assets in the electricity, gas, water and ports sectors

Source: UNCTAD; official website of the Australian government, Reuters, official website of the British Britain government, the European Council, official website of the German Federal Ministry for Economic Affairs and Energy, official website of the US Department of the Treasury, official website of the Ministry of Economy, Trade and Industry of the Government of Japan, and compiled by EY

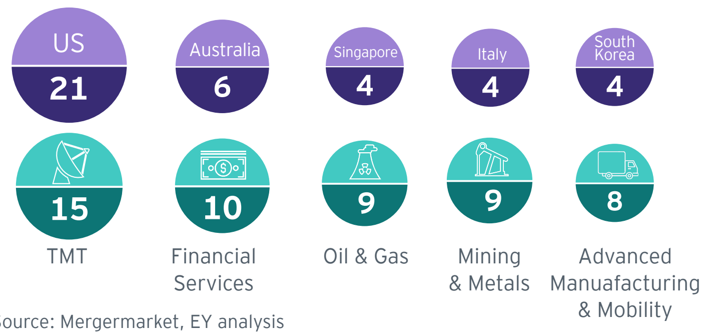
Figure 8: The deal value and volume of China overseas M&As that were lapsed or withdrawn after announcement



Source: Mergermarket, EY analysis

In 2017-2018, the US had the largest number of overseas lapsed or withdrawn M&As of Chinese companies. In terms of sector, nearly three-quarters of the lapsed or withdrawn transactions occurred in five major sectors, including TMT, financial services, oil and gas, mining and metals, and advanced manufacturing and mobility. Among the five mentioned sectors, TMT accounted for 21.1% of total M&As, in line with the "critical sectors" under increased scrutiny overseas. For example, Ant Financial Services Group was looking to acquire MoneyGram International, an US cross-border payment company, in January 2017, but gave up the deal in 2018 as it was not able to obtain CFIUS approval in time. For the same reason, in April 2017, Sino-IC Capital Co., Ltd. tried to acquire Xcerra, an US chip testing company, but announced its unsuccessful acquisition in 2018[8].

Figure 9: Top five countries and sectors, by number of overseas lapsed or withdrawn post-announcement M&As of Chinese enterprises, 2017-2018



Source: Mergermarket, EY analysis

[8] Source: Mergermarket, EY analysis

2.2 The impacts and prospects of the new global trade landscape on China outbound investment

In 2018, global trade volume increased by 3%. Directly affected by China-US trade frictions, global trade growth slowed down, with the growth rate

Dropping by 1.6 percentage points from 2017

In 2018, the value of China's goods trade was

US$4.6 trillion

An increase of 12.6% YoY

Ranking no. 1 globally

the total service trade was

US$791.9 billion

An increase of 13.8% YoY

Ranking no. 2 globally

In 2018, China's top five trading countries were the US, Japan, Korea, Germany, Australia, whose trade with China accounted for

14%	7%	7%	4%	3%
US	Japan	South Korea	Germany	Australia

respectively

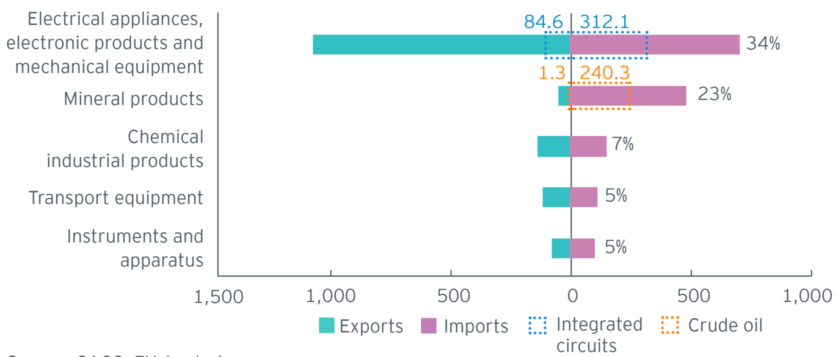
Source: Mergermarket, MOFCOM, WTO,GACC, EY analysis

With the development of globalization, the economic ties between countries have gradually deepened and global trade networks have become more interlinked. Since its inauguration, the Trump Administration of the US has emphasized "America First" and has continuously implemented various trade protection policies, creating challenges for the global trading system. Investment and trade, as two important engines that drive economic development, complement each other:

In terms of imports, when China has a large trade deficit or growth in annual imports in certain categories of commodities, it often indicates that domestic demand is strong but domestic production is insufficient. At this point, Chinese investors can take the opportunity to invest overseas or acquire similar assets or enterprises, through this "bringing in after going abroad" approach ,they can expand their international operations, improve supply chain safety and further develop the domestic markets.

China's imports are highly concentrated. The top five categories of imports in 2018 accounted for 75% of the total. After comparing the export data further, we found that among the five categories, only mineral products have a large trade deficit, indicating that the domestic minerals consumer market is more dependent on imports. Exports of electrical appliances, electronic products and mechanical equipment are greater than imports, indicating that China is only part of the value chain, and that most imports are for re-export. This suggests that China is highly dependent on upstream supply chains in such industries. Upstream disruptions in the supply chain will have a huge impact on Chinese manufacturers.

Figure 10: Top five categories and proportions of China's imports in 2018 (by value, US$ billion)



Source: GACC, EY Analysis

Analysis with regard to product categories:

Electrical appliances, electronic products and mechanical equipment are the largest categories of imports in China, although the aforementioned categories have a trade surplus when exports are also taken into account. However, looking at individual goods, integrated circuits are the second largest product in China's trade deficit. This indicates that China has advantages in the overall manufacturing supply chain of electrical and electronic products, but the Chinese market remains highly dependent on imports for key cutting-edge technology products such as integrated circuits.

Mineral products are the second largest category of imports in China and represent the largest goods category within China's trade deficit. Crude oil is the largest product of China's trade deficit. Crude oil imports accounting for 71% of apparent consumption in 2018[9]. This indicates that China is highly reliant on imported crude oil, and we should keep securing China's energy supply.

EY recommends that Chinese enterprises should ,on one hand, actively seek overseas investment in high-quality mineral products, crude oil and integrated circuits, thereby securing the supply of strategic resources and key technology products from a supply chain perspective. On the other hand, Chinese enterprises should also increase their R&D investment in fields such as integrated circuits, instruments and apparatus gradually improving self-sufficiency and production capacity, while actively developing renewable energy and new energy-related industries, thereby reducing dependence on imports of crude oil.

[9] Source: *Blue Book of China's Oil and Gas Industry Development Analysis and Outlook Report (2018-2019)*, EY analysis

The fragmentation of production processes and the international dispersion of sub-processes have led to the emergence of borderless production systems. These can be sequential chains or complex networks, their scope can be global or regional, and they are commonly referred to as Global Value Chains (GVCs). GVCs are typically coordinated by transnational corporations (TNCs), with patterns of value-added trade in GVCs being shaped to a significant extent by the investment decisions of TNCs[10].

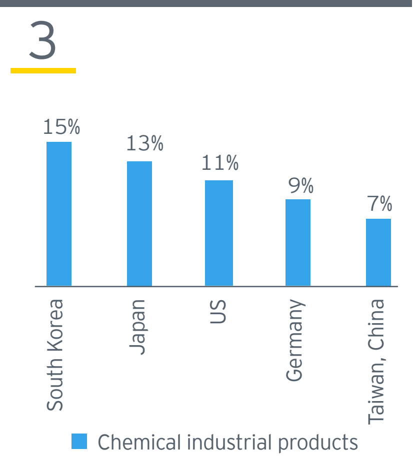
Global value chains

Regarding the geographic concentration of import origins: within China's top five import categories, the origins of transport equipment-related imports are the most concentrated, with the top five origins accounting for 80% of imports. The least geographically concentrated import category is the mineral products, with the top five origins accounting for 42% of imports.

EY recommends that Chinese enterprises focus on:

- Relevant investment and industry cooperation opportunities in markets such as Taiwan (China), South Korea and Japan pertaining to electrical appliances, electronic products and machinery equipment, chemical industrial products, instruments and apparatus
- Investment opportunities in Australia, Russia and Brazil pertaining to high-quality mineral resources, thereby reducing enterprise reliance on imported non-renewable resources
- Investment opportunities in the US, Germany and Japan in the advanced automotive and transportation industries, aiming for a deeper and wider presence in the industry supply chain

Figure 11: Main origins & proportions of China's top five import categories in 2018



Source: GACC, EY analysis

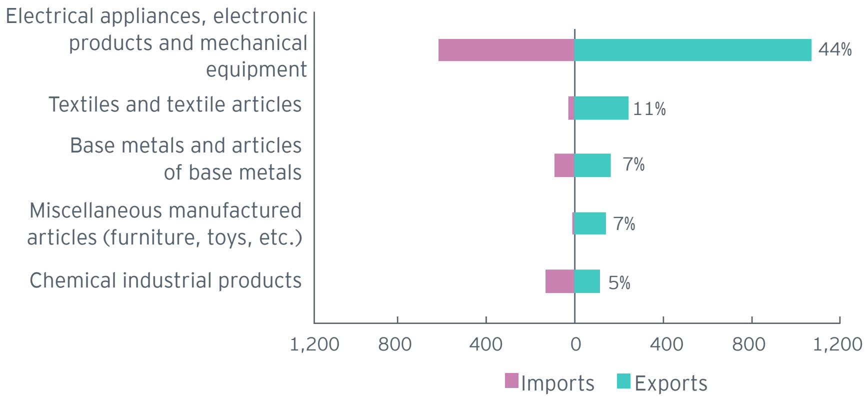
[10] Source: UNCTAD

In terms of exports, when China has a large trade surplus in certain categories of commodities, or an increase in annual exports, it implies that China has an international competitive advantage in terms of price, quality or production of such commodities, showing potential in future international expansion. And export destinations pointing to the demand of certain categories of commodities. Based on export data, enterprises can optimize their supply chain arrangement downstream, balance between the cost and distance from the target market. It can also effectively avoid tariff barriers and geopolitical risks by adjusting the supply chain when the geopolitical situation becomes more complex.

An analysis of goods flow in the trade of the manufacturing industry reveals the development trends of industries in the global value chain. For example, both of China's imports and exports of electrical appliances, electronic products and machinery equipment are very large. This indicates that on one hand, China as a manufacturer has strong dependence on upstream products, such as integrated circuits. On the other hand, China has certain industrial advantages in electronics manufacturing, and has comprehensive advantages in production cost and specialized talents.

Similar to imports, China's exports are also highly concentrated, with the top five categories accounting for 74.4% of all exports in 2018. Moreover, 44% of the aforementioned figure consisted of electrical appliances, electronic products and mechanical equipment exports (in 2014, the aforementioned goods accounted for only 41.5%). This indicates that China's industrial structure is continuously optimized, and that China's international competitiveness in high-tech and high value-added sectors continue to increase. If taking import data into account, it can be seen that China's textiles and textile articles, as well as miscellaneous manufactured articles such as furniture and toys can basically meet the domestic demand, representing a high trade surplus. In the backdrop of today's deepening deglobalization and the emergence of trade frictions, China's strong industrial capabilities allow enterprises to actively carry out their operations globally to satisfy international demand, further explore overseas markets, optimize the geographical distribution of supply chains, and effectively prevent and mitigate geopolitical risks.

Figure 12: Top five categories and proportions of China's exports in 2018 (by value, US$ billion)



Note: base metals include steel, aluminum, copper, nickel, lead, zinc, tin, etc
Source: GACC, EY analysis

In 2018, China-US goods trade totaled

US$633.5 billion

Up 8.5% YoY

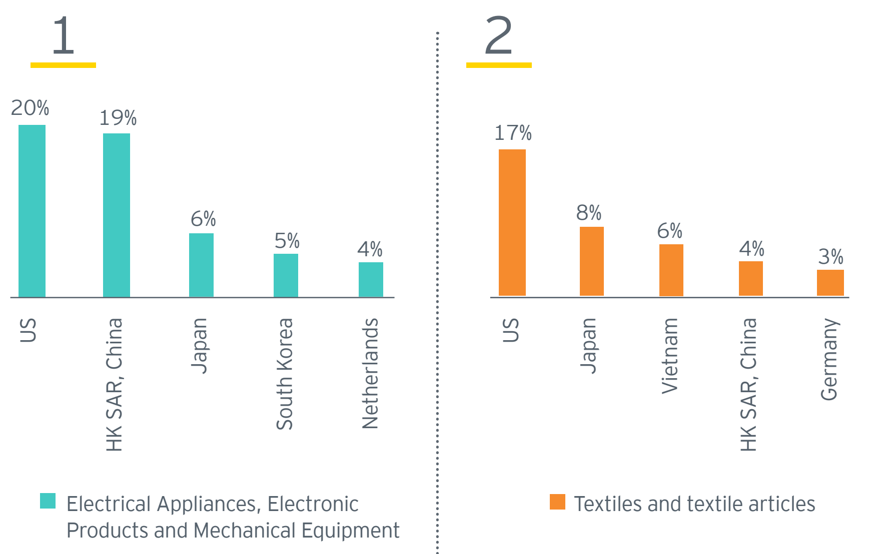
Source: GACC, MOFCOM,World Bank

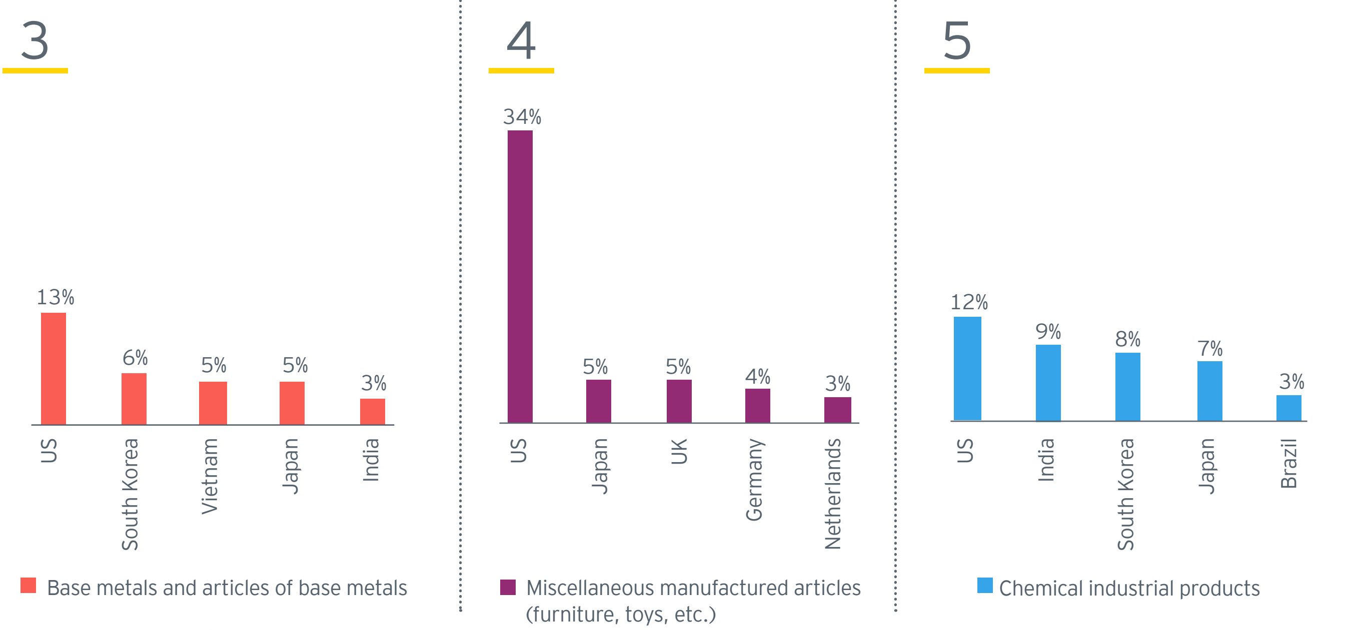
In 2018, China was the US largest goods trade partner, the third largest export market and the largest source of imports

In 2018, the US was also China's largest goods trade partner, largest export market and the third largest source of imports

Based on analysis of the export destinations of China's top five export categories, US ranked first among all five categories, especially miscellaneous manufactured articles such as furniture and toys which accounted for 34%. This indicates the US market is unarguable significant to China's exports. China-US trade frictions have great impact on the top five categories of Chinese manufacturing exports, especially on smaller enterprises that have limited bargaining power whose competitiveness may be compromised. EY predicts that trade frictions will accelerate the integration of related industries and push companies to transform and upgrade. Apart from the top five export categories, we have also analyzed other categories that exports to the US account for more than 20% of the total. These categories include: plastics and rubber products, leather goods, wood products, paper products, footwear and headgear.

Figure 13: Main destinations & proportions of China's top five export categories in 2018





Source: GACC, EY analysis

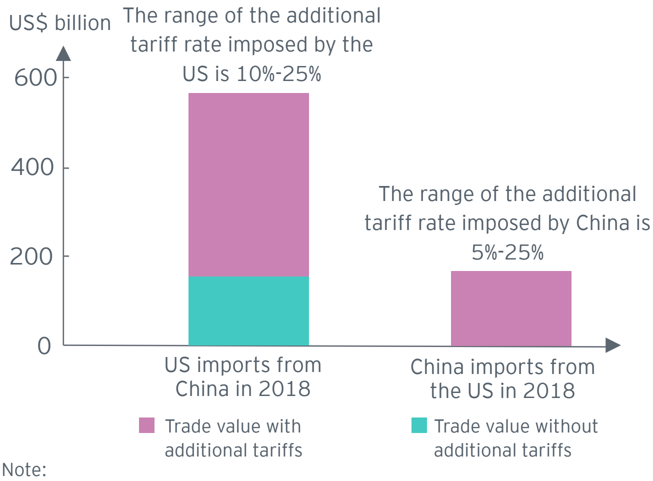
Enterprises need to pay closer attention to geopolitical risks. Chinese companies that are more dependent on US market should adjust their supply chain timely to enjoy the preferential tax rates of trade agreements to safeguard the international competitiveness of their products. It is also necessary that enterprises actively explore the markets of other countries and regions to reduce export reliance on a single market.

2.3 Framework for managing trade frictions

There are significant uncertainties in global trade such as punitive and retaliatory duties, sanctions, and trade agreement renegotiations. At the same time, recent US foreign policy towards China also exhibits signs that the current political and economic relations will continue. The aforementioned measures and national responses triggered global companies to take action and develop plans in response.

The Trump Administration has taken a number of trade actions such as additional tariffs, a speech delivered by US Vice President Pence in October 2018, the interagency task force report – *Assessing and Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency of the United States*, and the Agreement between the United States of America, the United Mexican States, and Canada (USMCA). In addition, the upcoming US-Japan bilateral trade negotiations and the post-Brexit global trade arrangements will complicate the global trading environment and bring more uncertainties.

Figure14: Additional tariffs from China-US trade frictions (as of September 2019)



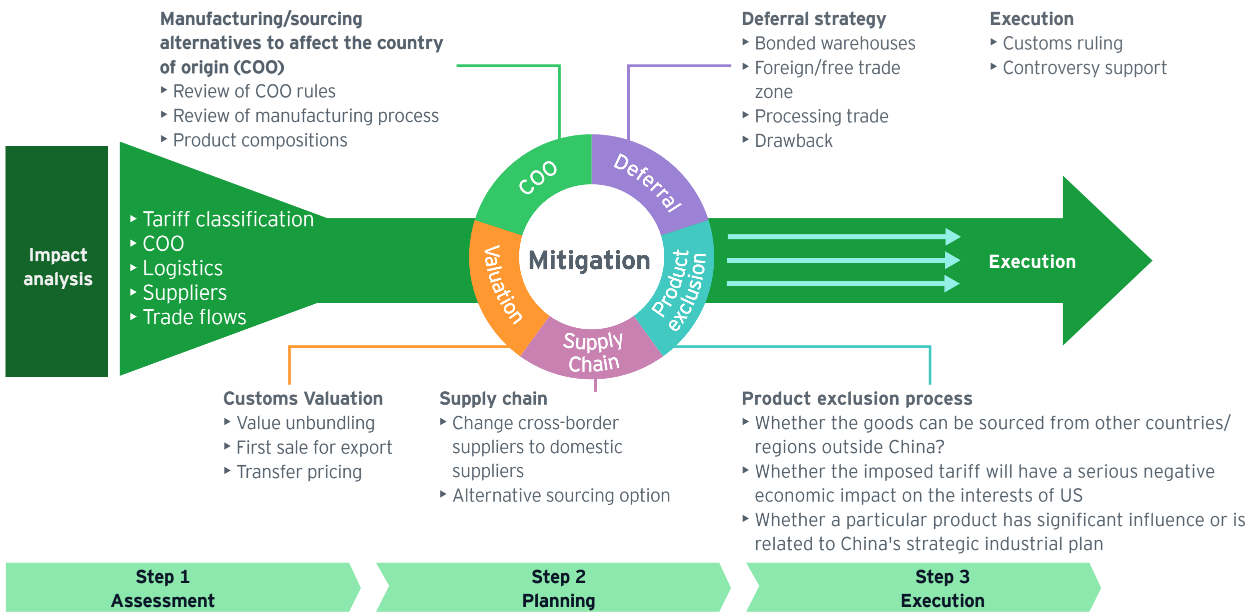
Note:
China and US import data are both on CIF (Cost, Insurance and Freight) basis
Source:
GACC, The Customs Tariff Commission of the State Council of PRC, United States Department of Commerce, Office of the United States Trade Representative, EY analysis

What are the impacts of China-US trade frictions?

Many enterprises face the challenge of adapting to volatile and rapidly-changing external factors. Thus, in order to stay competitive, it is vital that enterprises have efficient management strategies in their global trade operations as well as effective control over trade-related costs.

The EY global network is committed to providing quality services that help companies gain a competitive edge in the transformative age and develop suitable development plans. Our professional team can help you formulate effective strategies and solutions with services as illustrated below:

Figure 15: EY trade conflicts service



EY Indirect Tax:

Kenneth Leung
Greater China Indirect Tax Leader
kenneth.leung@cn.ey.com
+86 10 5815 3808
Beijing

Bryan Tang
Indirect Tax Partner
Ernst&Young (China) Advisory Limited
bryan.tang@cn.ey.com
+86 21 2228 2294
Shanghai

Summary and outlook

The world economy is facing new challenges as unilateralism and protectionism are on the rise, affecting economic globalization and free trade. Digital transformation could also increase uncertainties. However, the economic systems between countries are increasingly interconnected, and only win-win cooperation can advance development. We need to have a global perspective in uncertainty and instability to manage risks and challenges of the world economy.

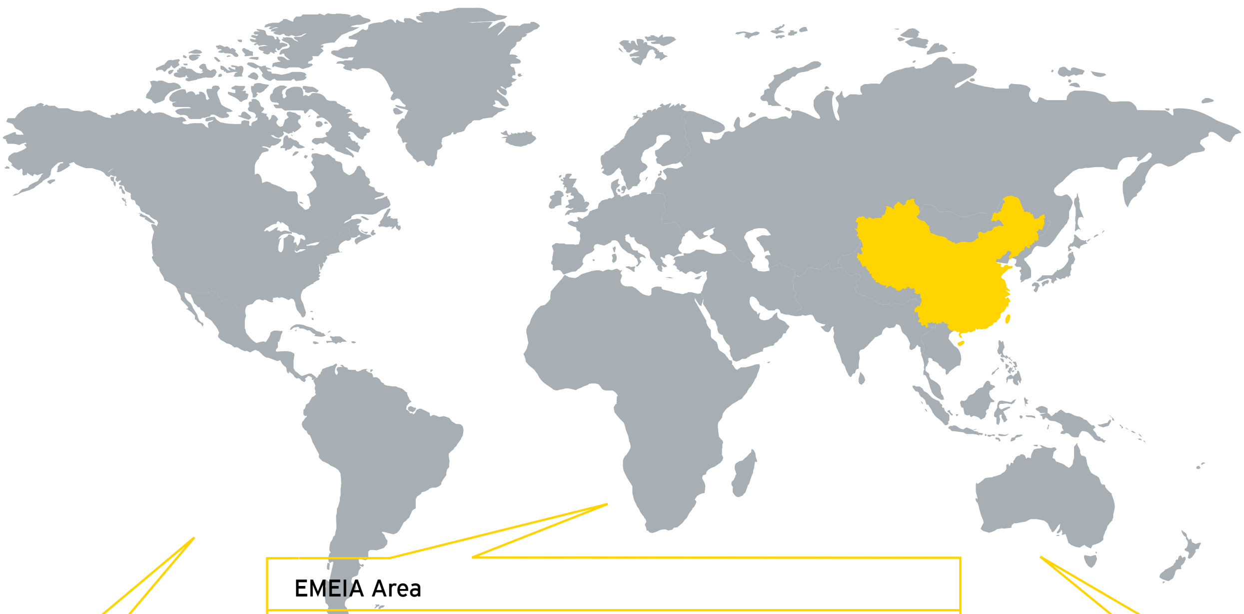
EY recommends that Chinese companies should be aware of both internal and external changes and be resilient. Internally, Chinese enterprises should continuously improve their innovation capabilities and tap new growth drivers, build an industrial structure that meets development trends and manage the global trading system more efficiently in order to enhance their core competitive advantages. Externally, they should recognize that there are still distance between the enterprises of developed in technology and management. Chinese enterprises should also seize internationalization opportunities, continue to progress in the global and industrial value chain, enhance their presence, and deal with geopolitical risks effectively.

Globalization is unavoidable, "going abroad" is necessary for Chinese enterprises to achieve development. We believe with China's all-round opening policy and further promotion of the BRI, China outbound investment will still realize great development against the uncertainties.

China Overseas Investment Network helps Chinese businesss navigate through global markets

The current wave of globalization continues to transform the business landscape and impact companies around the world. With the BRI, China will undoubtedly play an increasingly mature and globalized role in the global economy. The global economic situation is still uncertain and challenges may arise due to cultural differences, language barriers, financing difficulties and regulatory issues. Chinese companies need to respond in a timely manner to these challenges while navigating a complex and dynamic outbound transaction environment.

The China Overseas Investment Network (COIN) links EY professionals around the globe, facilitates collaboration, and provides consistent and coordinated services to our Chinese clients making outbound investments. Building on the existing China Business Group in the Americas, EMEIA and Asia-Pacific, COIN has expanded our network into over 70 countries and territories around the world.



Americas Area

- The United States
- Canada
- Caribbean Region
- Israel
- Mexico
- Argentina
- Bolivia
- Brazil
- Chile
- Ecuador
- Peru
- Venezuela
- Jamaica

EMEIA Area

- Austria
- Belgium
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Greece
- Hungary
- Italy
- Luxembourg
- Netherlands
- Norway
- Poland
- Portugal
- Romania
- Spain
- Sweden
- Switzerland
- United Kingdom
- Kazakhstan
- Pakistan
- Kyrgyzstan
- Uzbekistan
- Russia
- Algeria
- Angola
- Cameroon
- Democratic Republic of Congo
- Ethiopia
- Libya
- Mozambique
- Nigeria
- South Africa
- South Sudan
- Uganda
- Zambia
- Zimbabwe
- India
- Bahrain
- Egypt
- Kuwait
- Saudi Arabia
- Turkey
- United Arab Emirates

Asia-Pacific Area

- Australia
- New Zealand
- Japan
- Korea
- Singapore
- Indonesia
- Malaysia
- Philippines
- Thailand
- Vietnam
- Laos
- Myanmar
- Cambodia

Our global COIN network

Our global COIN network

For more information on our China Overseas Investment Network, please visit our website at www.ey.com/cn/coin or contact:

China

Albert Ng
Chairman, China | Managing Partner, Greater China
+86 21 2228 3288
albert.ng@cn.ey.com
Shanghai

Loletta Chow
Global Leader, China Overseas Investment Network
+852 2629 3133
loletta.chow@hk.ey.com
Hong Kong

Jesse Lv
Global Tax Leader, China Overseas Investment Network
+86 21 2228 2798
jesse.lv@cn.ey.com
Shanghai

Erica Su
Transaction Advisory Services Leader, Greater China
+86 21 2228 2205
erica.su@cn.ey.com
Shanghai

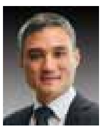
Alex Zhu
Transaction Advisory Services Leader, China North
+86 10 5815 3891
alex.zhu@cn.ey.com
Beijing

Julie Hao
Co-Leader of China Tax Outbound Center
+86 10 5815 2805
julie.hao@cn.ey.com
Beijing

Soon Yen Chong
International Tax and Transaction Services Partner
Ernst&Young (China) Advisory Limited
+86 21 22288789
Soonyen.Chong@cn.ey.com
Shanghai

Dr. Zhong Lin
Managing Partner, Chen & Co. Law Firm*
+86 21 2228 8358
zlin@chenandco.com
Shanghai

Gui Chen
Partner, Chen & Co. Law Firm*
+86 21 2228 8418
gui.chen@chenandco.com
Shanghai



Edward Chang
Advisory PI Finance Leader, Asia Pacific
Advisory Chief Operating Officer, Greater China
+86 21 2228 5975
edward.chang@cn.ey.com
Shanghaii

Lawrence Lau
Financial Accounting Advisory Services Leader
+86 21 2228 2816
lawrence.lau@cn.ey.com
Shanghai

Wood Zhang
Audit Partner, Ernst & Young Hua Ming LLP
+86 10 5815 2086
wood.zhang@cn.ey.com
Beijing

Michelle Ho
China Overseas Investment Network
+852 2846 9660
michelle.ho@hk.ey.com
Hong Kong

Area leaders

Americas

Shau Zhang
Americas Area COIN Market Leader
+1 617 375 3792
xiaoqing.zhang@ey.com
Boston, USA

Eric Xiao
Canada COIN Leader
+1 416 943 2943
eric.c.xiao@ca.ey.com
Toronto, Canada

Fernanda Chang
South America COIN Leader
+55 11 9625 2084
fernanda.chang@br.ey.com
Sao Paulo, Brazil

EMEIA

Qinghua Xu-pionchon
EMEIA Area COIN Leader
+33 1 4693 4363
qinghua.xu-pionchon@fr.ey.com
Paris, France

Yi Sun
Germany, Switzerland and Austria COIN Leader
+49 211 9352 20153
yi.sun@de.ey.com
Dusseldorf, Germany

Suwin Lee
The United Kingdom and Ireland COIN Leader
+44 20 7951 7952
slee1@uk.ey.com
London, UK

Asia-Pacific

Swee Cher Choo
ASEAN COIN Leader
+65 6309 8679
swee-cher.choo@sg.ey.com
Singapore

John Li
Oceania Area COIN Leader
+61 2 9248 5008
john.li@au.ey.com
Sydney, Australia

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