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Tackling “fake” FDI: why China is clamping down on foreign acquisitions

Blog post by Asia Director Ying Staton, 09 December 2016

At the end of November, the Chinese government indicated that it intended to exert greater scrutiny over Chinese outbound investment. Draft policy papers released online outlined a new policy whereby government approval would be required for foreign acquisitions valued over US$10 billion, or US$1 billion if the target was considered to be outside of the acquirer’s core business. In addition, a moratorium would be imposed on state-owned companies acquiring real estate overseas beyond a value of US$1 billion. In addition, it was mooted that the State Administration of Foreign Exchange (SAFE) would lower the upper threshold for money transfers requiring approval from the current level of US$50 million to US$5 million.

The new policies have yet to be officially inked, but send a strong signal of intent. A startling trend reversal over the last few years has seen Chinese outbound investment soar as inbound investment has begun to tail off. The fall in inbound FDI reflects the slowdown in the global economy coupled with growing doubts about prospects for the Chinese economy. At the same time, Chinese outbound investment has soared: China surpassed the US as the largest acquirer of foreign assets this year, with the total of value of M&A activity growing by 68% in the first 9 months of the year to US$174 billion, according to Dealogic.

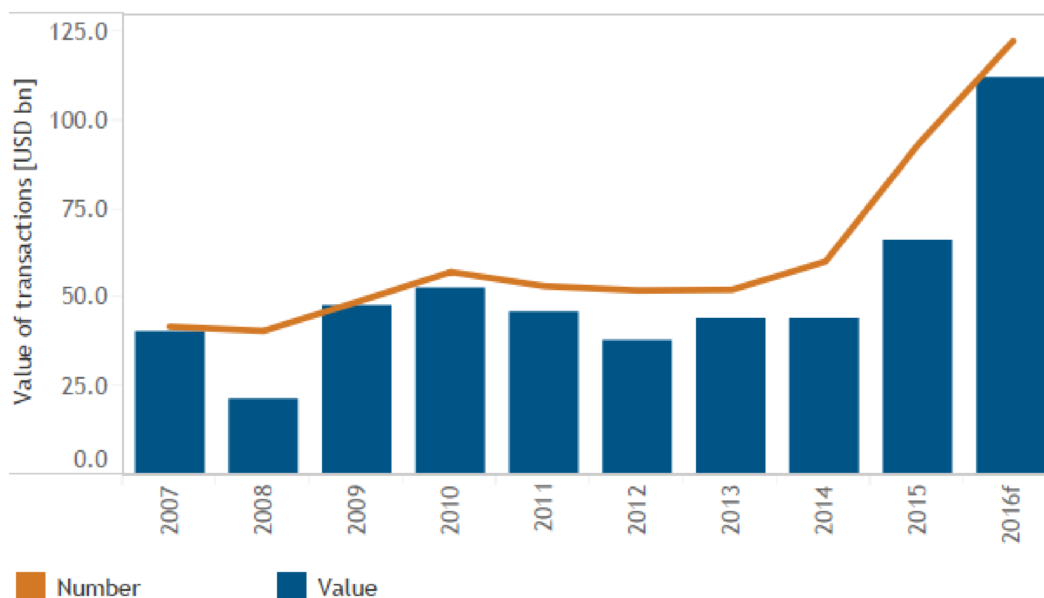
A turning point came in 2015 when, for the first time since 1998, Chinese outbound capital flows have surpassed those flowing into the country. The trend has continued, and China is due to record its first net FDI deficit this year. This deficit has exacerbated downward pressure on the RMB, which has fallen 6% this year against the USD, and forced the People’s Bank of China (PBoC) to deploy unprecedented amounts of its forex reserves to prop up the currency. Foreign exchange reserves fell from nearly US$4 trillion in July 2014 to just over US$3 trillion in November.

The challenge, as Beijing sees it, is controlling capital flight – not in the conventional sense of flighty foreigners, but Chinese money seeking to make its way offshore. The Chinese system has increasingly tried to clamp down on this type of activity. Earlier this year, Anbang Insurance’s high profile US$14 billion bid for Starwood hotels group was withdrawn largely as a result of opposition by the China Insurance Regulatory Commission (CIRC), which has made comments about the dangers of insurers behaving like “ATMs”, taking premiums from household savers to invest outside the country.

An appetite of this size is difficult to control. Controls on capital movement over the last decade, as well as an extended anti-corruption campaign, has created a great wall of capital that is frantically trying to make its way out of China. Some of it is strategic – acquisitions of technology and premium brands in the US and Europe, or natural resources and infrastructure in Southeast Asia and Africa – but much of it is not.

At the most basic level, there are extensive ranks of would-be outbound investors ranging from household savers to state-owned banks who will happily accept near-zero levels of interest on investments in Europe over returns of 6% or over in China. They are united in the belief that their assets will be safer in Europe, and depreciation of a couple of percentage points is negligible compared to the risk of a market crash in China or having all of one's assets seized as part of an anti-corruption investigation (Xinhua announced last week that the ongoing anti-corruption campaign is now set to focus on the family networks of Party officials).

Chinese outbound M&A transactions



Source: IMAA

It is not just non-strategic acquisitions, such as the purchase for US$300 million of a UK videogame developer by a Chinese provincial iron ore miner, that Chinese regulators are worried about. "Fake" transactions have been a perennial feature of Chinese outbound investment. Every year SAFE uncovers billions of dollars' worth of fake trades – fraudulent transactions with no purpose except to move money overseas. On top of this, Chinese buyers often seem to be willing to pay inflated prices for assets, and to pay entirely with cash.

Part of the reason is the patronage system. Middlemen brokers are a common feature in Chinese overseas M&A. In return for identifying the acquisition target and facilitating the

transaction, these brokers often levy fees of up to 5% on the value of the transaction; subsequently, half is passed back to the Chinese buyer, with funds often landing offshore in a personal rather than a corporate bank account. The same principle can also apply to loans - and indeed many of these transactions involve a high level of leverage. A broker finds an acquisition target and arranges for a loan to finance the Chinese acquisition; he levies a 5% fee on the value of the transaction and on the value of the loan, half or more of which is redistributed to the buyer, and potentially to the loan provider and even the seller. On a US$500 million transaction (the average deal size for Chinese outbound acquisitions in 2016, according to Thomson Reuters), that fee is US$25 million, quite a significant incentive.

This system of personal kickbacks massively skews incentives for investment and presents a huge challenge to financial stability not just in China but in the markets where these assets are based. When transactions are being undertaken with the principal motive of moving money overseas or securing personal kickbacks, it is difficult to assess what proportion of these acquisitions – or the loans arranged to finance them – are based on sound investment theses.

The ballooning of “fake” FDI comprising inflated asset values and unsound loans should worry regulators not just in China. Even markets such as the UK, Germany and Australia, who have traditionally been more open to Chinese investment than for example the US, have in recent months begun to grow more wary of the Chinese “ATM”. Potential Chinese buyers and foreign sellers are set to face more scrutiny over future deals, both in Beijing and in their target markets. This may be no bad thing.

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