# Whatever Became Of China, Inc.?

By Erica Downs

*Some used to worry that "China, Inc."—Chinese resource companies, state-owned banks and government agencies working in concert—would "lock up" energy and mineral resources around the world. Those fears proved misplaced, thanks to miscues by Chinese firms and changing market conditions.*

A decade ago, China's state-owned energy and mining companies seemed on the verge of becoming a global juggernaut. Driven by an unexpected surge in the country's commodity demand and fueled by cheap loans from state-owned policy banks, Chinese firms went on a resource buying binge from Afghanistan to Zambia. Many outside observers, especially in the United States, fretted that "China, Inc." would be able to acquire anything, anywhere, and that nobody could stop them.

Today, everyone has calmed down. True, Chinese resource companies are now big international players: their value share of global oil and natural gas mergers and acquisitions grew from less than 3% in 2005 to 15% percent in 2012, according to Bernstein Research. Yet they have learned some very hard lessons along the way, and anxiety in the rest of the world has notably lessened. Looking ahead, there are good reasons to believe that Chinese state firms will become more selective and commercially driven in their outward investments.

In fact, the "China, Inc." stereotype was never as accurate as some outside observers feared and some Chinese desired. China's companies,

**Erica Downs is a fellow at the John L. Thornton China Center at the Brookings Institution, focusing on the international expansion of China's companies and Chinese energy policy.**

government agencies and financial institutions rarely function as a coherent entity. Instead, the Chinese executives, bureaucrats and financiers involved in cross-border transactions often have competing and uncoordinated agendas. Chinese commentators have lamented a situation of "each soldier fighting his own war."

**Each soldier fighting his own war**

Chinese firms have competed against each other for overseas projects since they began venturing abroad in large numbers in the mid-2000s. Once one Chinese company identified an overseas target, other firms would join the pursuit in lemming-like fashion, prompting one Chinese manager to joke that the biggest fear of Chinese firms expanding abroad is not competition from foreign companies but rather poaching by domestic "brother" enterprises. Chinese officials decry such fraternal rivalry because it can lead to bidding wars, pushing up the price paid by the winning Chinese firm.

In two early iconic—and significantly, failed—"China, Inc." deals, the separate agendas of Chinese companies, government agencies and financiers were not well aligned. In the case of Minmetals' attempted acquisition of the Canadian miner Noranda in 2004, the Chinese government effectively scuttled the transaction by failing to approve it before the exclusive negotiating period expired. Minmetals, which sought to transform itself from a trading company to a diversified natural resources firm, had lined up debt financing from China Development Bank (CDB). The bank regarded the transaction as a way to promote the national interests in accessing raw materials and creating Chinese global champions, as well as bolstering its own expertise in financing cross-border M&A. Chinese officials, however, reportedly were worried about the cost of the acquisition and whether Minmetalswould be able to successfully manage an international mining company.

> In two early "China, Inc." deals, the separate agendas of Chinese companies, government agencies and financiers were not well aligned, leading to failure

In the case of China National Offshore Oil Corp.'s (CNOOC) attempt to acquire the US oil company Unocal in 2005, the Chinese oil major appeared to have had the acquiescence but not the support of the Chinese government. Soon after CNOOC withdrew its bid in the face of strong political opposition in the US, the company's CEO, Fu Chengyu (who now runs the country's biggest oil refiner, Sinopec), publicly lamented the lack of effective government backing for Chinese companies investing abroad. He noted that it would have been helpful if the Chinese government agencies involved in the negotiations over North Korea's nuclear program, the purchase of Boeing aircraft and adjusting the renminbi exchange rate had considered CNOOC's bid for Unocal in the context of these three issues in US-China relations. Putting aside the question of whether such linkages would have helped sway US policymakers and pundits in CNOOC's favor, the point is that Fu felt his government had let him down.

**Chinalco-Rio: the exception that proves the rule**

The deal that crystallized the China, Inc. image proved to be an exception, not the rule. This was Chinalco's stealth acquisition of a 9% stake in the Anglo-Australian mining giant Rio Tinto in 2008. Chinalco, CDB and the National Development and Reform Commission (NDRC) worked closely together to undertake the transaction and undermine the proposed takeover of Rio Tinto by BHP Billiton, the world's largest mining company.

Chinalco's raid on Rio Tinto seemed proof positive of the existence of China, Inc. The government feared that the merger of BHP Billiton and Rio Tinto—two of the three companies that dominated the global iron ore trade, and suppliers of 40% of China's ore needs—would drive up prices. So it put out a call to stop the marriage. Chinalco and CDB responded to this call for national service and worked hand in glove with China's leaders to flawlessly execute the largest share raid in history.

Chinalco's 2008 raid on Rio Tinto showed a level of concerted action that China has subsequently never been able to match

In fact the coordination in this case was entirely exceptional. First, the circumstances were unusual. The contract iron ore price increased fourfold between 2004 and 2008, including a 66% increase in 2008 alone, to US$61 a ton. Chinese officials, who did not understand global commodities markets as well as they do today, assumed that a tighter oligopoly would lead automatically to an even greater rise in prices. (Ironically, the iron ore price climbed even more dramatically after Chinalco's investment in Rio, thanks to the abandonment of the contract-price system. The spot price peaked at over US$180 a ton in early 2011).

Second, Chinalco's talented CEO, Xiao Yaqing, saw the share raid as a way of transforming Chinalco into a global multi-metal company and serving his personal ambition to climb higher in the Party-state bureaucracy (after the Rio deal, he was rewarded with a promotion to deputy secretary-general of the State Council) At any rate, no large Chinese resource deal before or since has exhibited anywhere near the level of concerted action shown in this instance.

A second reason people have stopped worrying about China's energy and mining companies taking over the world is the fact that, as latecomers to the global commodity markets, Chinese firms have mainly been stuck bidding for relatively low-quality, high-risk projects. As Fu Chengyu observed in late 2004, "It's actually not easy for us to find good projects. The world oil industry has a one hundred year history. The good projects are already taken."

That said, the shale gas and tight oil boom in the US has created some good opportunities for China's oil companies. Not only have they invested in unconventional oil and natural gas projects in the US, but they have also purchased assets in third countries sold by US oil companies that want to focus their investments at home. Moreover, China's oil companies probably face less competition for assets in Canada's oil sands and Brazil's offshore fields than they would have had the American unconventional energy revolution not occurred.

> The main reason for reduced anxiety abroad is that many of China's overseas energy and mining projects have fared poorly

Perhaps the most important reason for reduced anxiety abroad is simply that many of China's overseas mining projects have not fared very well. Chinese companies have struggled to deliver natural resource development projects on time and on budget and to be good corporate citizens, damaging their reputations in the process. Many of the problems Chinese firms have encountered overseas stem from their failure to do adequate due diligence.

The poster child for overseas investments gone awry is the Sino Iron project being developed by Citic Pacific and Metallurgical Corporation of China (MCC) in Western Australia. The project is US$6 bn over budget and four years behind schedule. Some industry experts think it may never be economically viable. The basic problem was that the Chinese developers, who had never before mined iron ore, failed to do their homework. Citici Pacific and MCC were unaware of the specific environmental challenges at the project site, which are vastly different from those in China. They were also in the dark about Australia's immigration and labor laws, which thwarted MCC's plan to use low-cost Chinese workers to develop the project.

Other mining mishaps span the globe. In Ghana, illegal Chinese gold miners have been a diplomatic headache for Beijing. Accused of looting resources, taking jobs from Ghanaians, flouting local laws and damaging the environment, hundreds of Chinese gold diggers have been deported while others have been attacked by angry Ghanaians. In Zambia, protests by workers over low wages and poor working conditions have turned violent, with Chinese managers shooting the protestors and tarring the reputation of Chinese companies as foreign investors.

**New commandments for going out**

China's companies and government have learned from these setbacks abroad. CEOs and officials are now focused on ensuring that overseas investments do not lose money or damage the China brand. The new thinking about China's "going out" strategy can be summed up in four commandments:

*Thou shalt not overpay.* Chinese energy and mining companies, which had developed a reputationfor paying top dollar, are getting more cautious about the premiums they offer. In 2011, for example, Minmetals subsidiary MMG walked away from a bidding war with Barrick Gold for Equinox Minerals on the grounds that topping Barrick's offer would be value destructive. Similarly, NDRC, tired of watching China's companies throw good money after bad, has made its approval of proposed overseas acquisitions conditional upon the Chinese buyer obtaining a "reasonable" acquisition price. This requirement prompted Hanlong Mining to revise its offer for a stake in Australia's Sundance Resources from A$0.57 to A$0.42 a share before the deal collapsed with the arrest of Hanlong's CEO Liu Han in 2013.

*Thou shalt thoroughly vet potential acquisitions*. The endorsement of the chief engineer of the Chinese acquirer is no longer enough to get the green light from NDRC and debt financing from CDB. Chinese executives, officials and financiers want independent, professional assessments of potential targets to help separate the good projects from the bad ones. Indeed, the State-owned Assets Supervision and Administration Commission (Sasac) now requires state-owned companies seeking to invest abroad to procure feasibility studies and due diligence reports, including a third-party appraisal of the value of the target.

*Thou shalt be held responsible for deals gone south.* Unlike their counterparts at companies like Rio Tinto and Exxon Mobil, the CEOs of China's state-owned mining companies appear to have suffered few consequences for spectacular losses that have occurred during their tenures. Former Rio

Tinto CEO Tom Albanese lost his job in connection with a US$3 bn write-down on coal assets acquired in Mozambique. But no heads have rolled at Citic Pacific, where Chairman Chang Zhenming has seen the costs of the Sino-Iron project balloon on his watch. Similarly, Shen Heting remains the boss of MCC despite a series of overseas investments that have lost money or harmed MCC's reputation (or both). However, the times may be a-changing. In 2011, Sasac unveiled new rules stipulating that state-owned enterprises (SOEs) and related persons will be held responsible for major losses on overseas investments if the company did not provide Sasac with an investment plan and information on financial sources before undertaking the transaction.

*Thou shalt be good corporate citizens.* Numerous Chinese companies have learned the hard way that good corporate citizenship is good for business. Indeed, CEOs increasingly recognize that winning the hearts and minds of their hosts is critical to successfully running multi-billion dollar, multi-decade operations. Consequently, China's energy and mining firms are building schools and health clinics, creating jobs for locals, protecting rare species of flora and fauna, and supporting sports teams around the globe as part of their efforts to reduce above-ground risks and burnish their reputations.

**A fading phantom**

Looking down the road, other factors are conspiring to constrain the might of the mythical China Inc. These include a diminishing capital-cost advantage, increased environmental consciousness, and a state-enterprise reform agenda that will increasingly force big firms to justify acquisitions on purely commercial terms.

China's SOEs have traditionally enjoyed a low cost of capital, in part because of access to three cheap funding sources: low-interest bank loans, low-interest bonds, and (especially for overseas deals) attractively-priced loans from the CDB. All three sources are at risk. As financial liberalization progresses, bond rates could rise—threatening SOEs' own direct funding costs and also putting pressure on CDB, which funds itself on the bond market. Bank loan rates have not yet moved up but could well do so within a couple of years, if Beijing makes good on its pledge to liberalize deposit interest rates. Moreover, very low inflation (and outright deflation in many materials prices) means that the real cost of capital for SOEs is rising faster than nominal rates imply.

Second, China's companies may become more environmentally conscious thanks to Premier Li Keqiang's "declaration of war on pollution" at the last meeting of the National People's Congress. Sinopec, for example, has committed to spending billions of dollars to upgrade its refineries to produce cleaner fuels after years of foot-dragging in response to dangerous levels of air pollution. Greener behavior at home could translate into greener, and more cautious, behavior abroad.

Third, as China shifts from a growth model that relied heavily on investment and exports to one that is more dependent on productivity growth and consumption, the energy and metals intensity of China's economy will diminish, tamping down the demand for commodities. More modest import growth, combined with greater understanding in China about how commodity markets operate, are likely to result in more deliberate overseas natural-resource acquisitions by Chinese companies—a shift from the panic buying of the mid-2000s.

Finally, Chinese companies can no longer count on getting permission to "go out" and generous debt financing simply because they are investing in natural resources in short supply in China. The call in last November's Third Plenum decision for SOEs to maintain and increase the value of state assets, raise production efficiency, and compete on an equal footing means that government and policy bank support for resource investments abroad will be more likely to be conditional than it was in the past. Companies are more likely to receive approval and financing for their acquisitions if they have proven overseas track records and experience producing the commodities they seek to acquire, and if the proposed investment is unlikely to create diplomatic challenges for China or damage its reputation. In other words, individual Chinese resource companies should mature into more savvy competitors. Nevertheless, the threat of unfair competition from a vague and monstrous "China, Inc." with unlimited access to cheap capital and unconditional government backing appears to be fading fast.