Equity Investment in China: past experience and prospects.

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Introduction

In this paper the focus is on foreign direct investment ("FDI") where an investor has a degree of control over a business which is more significant than that of a portfolio investor. In other words the investor is able to impact upon the management and operations of the enterprise. Its quantum and function are important to gauge especially in developing countries because:

- it is generally longer term and less mercurial than portfolio investment, bank lending and traditional bond based lending;
- it adds to a country's source of capital and can facilitate skill transfers and technologies; and
- if laws allow it permits a more efficient international allocation of capital.

The Chinese Experience

FDI was invited into China, in a meaningful sense, only in 1979 and to-date China has received some US$300bn of foreign direct investments[1]. Only some US$30bn was invested from 1979-1992 – the balance since! So, whilst some might say inexperienced hands guided in FDI to China initially, FDI has continued through various crises - October 1987 – 1989 and more recently the East Asian crisis of 1997/1998.

Actual foreign direct investment in China from January 1999 to October 1999 fell 10.5% from a year earlier to US$32.1bn[2] (which most observers saw as worse than expected).

The Institute of International Finance in September 1999 foresaw the continuing decline in net inflow to US$22bn in 2000 from US$27bn in 1999 and US$40bn in 1998.

Whilst some explain the fall by referring to major investors from the region (including "round trippers" i.e. Chinese investors under the guise of being foreigners) retreating because of domestic problems the slowdown of the inflow has forced others to consider this an opportune time to review past experiences and future prospects of FDI into China.

Is FDI important to China? The Economist on 25th September 1999 says, "the decline in FDI is no disaster … its importance to the economy has been over-exaggerated".

But as Standard and Poor's remind us in their downgrading of China on 21st July 1999 "foreign funded ventures account for just under 20% of industrial output, contributed 13% of national tax revenues and employ 10% of the urban workforces".

Experience of FDI on any scale in China began only 20 years ago and people came because they felt they could not stay away. Asia was strengthening. The past experience resulted often in disappointment and what follows are some recent Asian press headlines:

> "Some Investors Quit China. Citing Poor Profits, Fraud": (Asian Wall Street Journal – 11th October 1999).
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> "Growing Number of Firms are Exiting China After Years of Red Ink & Red Tape " (Asian Wall Street Journal – 26th October 1999).
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> "Dark Clouds Over Foreign Investment in China" (South China Morning Post – 2nd October 1999).

A.T. Kearney and the Economist Intelligence Unit surveyed 70 Multinational Corporations operating in China in 1998 and whilst they found 52% failed to reach their profitability goals, 45% were profitable, 25% broke-even and 25% were unprofitable.

Factors cited by respondents for disappointing results included:

- overestimated market demand

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[1] State Statistical Bureau
[2] Ministry of Foreign Trade and Economic Co-operation

- intensive local competition
- poor productivity relationship
- inability to develop local management skills
- industry over-capacity

Others cited:

- a lack of focus on a certain product and geography
- establishment of too many joint ventures
- resulting inability to build critical mass
- involvement in sectors with too much government regulation especially the distribution system.

Furthermore the East Asian crisis forced FDI investors, if they had not already done so, to examine the macro social, economic and political environment in which they must operate. As Professor Lin concisely puts the backdrop:

> …in spite of the overall achievement that China has achieved in the past 20 years, the Chinese economy is encountering a series of problems. Each of them, if worsened, may lead to a sudden breakdown in the economic system and jeopardize China's possibility of realizing its growth potential. The major problems are as follows:
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> 1. The state-owned enterprises currently employ 100 million workers in urban areas, about two-thirds of the urban labor force, and possess two-thirds of total fixed assets in China. The economic performance of the state-owned sector is extremely poor. More than one third of the state-owned enterprises has continuously encountered explicit losses. Another one third of the enterprises has implicit losses. Only a small portion of the state-owned enterprises is profitable. Without the state's subsidies and protection, the majority of these enterprises would collapse immediately. Subsidies to the state-owned enterprises have

drained the government's fiscal resources and limited its ability to invest in education and other areas that are important to future growth and stability.

2. The banking sector is extremely weak. It is estimated that about 24 percent of the outstanding loans are non-performing, even higher than the figures in Thailand, Korea and other countries before the financial crises. As China has not liberalized its capital accounts, it has the ability to insulate itself from a possible speculative attack, thus preventing the country from the contagion of the recent crises. However, if the non-performing loans and other banking problems are not sorted out, depositors may eventually lose their confidence in the banking sector, resulting in a bank run and economic crises.

3. The growth in the past 20 years was not shared evenly across the regions. The economic development in the hinterland provinces has lagged far behind that in the coastal provinces. As a result, regional disparity is widening after the reforms. The disparity may develop into disrupting social and political issues.

4. Rapid economic growth has endangered China's environmental sustainability. The situation is quire alarming. Recent floods in the lower reach of the Yangtze River and in Northeast China are examples. If China does not pay enough attention to this issue, the revenges from nature may become more frequent and may render economic growth to a sudden halt.[3]

Professor Yasheng Huang of Harvard Business School in an interesting 1998 article called "Why is there so much demand for foreign equity capital in China"? "An institutional and policy perspective" described situations where local partners endeavoured to partner with foreigners to get certain fiscal advantages from a foreign

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3 "China in the New Millennium" by Justin Lin, Professor of Economics, Peking University and Hong Kong University of Science and Technology – Asia Conference 1999 of Deutsche Bank, Hong Kong, 6th October 1999.

joint venture but sometimes the marriage was strained as Chinese partners remained burdened by poor assets and huge debts!

Many examples of FDI challenges in China exist which may take on a more significance in the context of the reduction in FDI. Both Whirlpool Corporation and Caterpillar Inc. withdrew from unprofitable joint ventures in 1997 on the bases of extremely fierce local competition. Daimler Chrysler AG's, Freightliner subsidiary is withdrawing from its Shanghai truck joint venture where despite investments of capital over several years no trucks were produced.[4]

The most predictable behaviour is that of investment funds. Figures are hard to glean but the 1999 Guide to Venture Capital in Asia published in Hong Kong is likely accurate when it describes a 68% fall in China Funds aiming to invest in China in 1998. These investment funds proliferate and are opportunistic, most are pure financial investors, have a hard mentality and will likely return en masse when uncertainties resolve on China's future. Many have suffered large losses[5].

The experience of one fund manager is discussed in the article cited:

> "If it wasn't for the fear of being sued by their investors, many managers would just walk away and give their shares to their Chinese partner." says Roger Marshall, who was then in charge of the Crosby fund, which is listed in Hong Kong as China Investment Co. Crosby has already written down to zero two of the handful of investments in its portfolio, and is in the process of liquidating the rest. Mr Marshall, who now is in charge of private equity for ABN Amro Holding NV in the region, was still with Crosby at the time he commented."

> "World-wide, funds often have a finite life span, and five or six years isn't unusual. Typically, after liquidating a small, trial fund, managers go out and raise a large fund on the back of their track record. Mr Marshall says. But for China that isn't the case. Few managers have the sort of returns they anticipated, making it harder to go to investors and ask for more money".

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4 The Asian Wall Street Journal – 26th October 1999 "Growing Number of Firms Are Exiting China After Years of Red Ink, Red Tape" by Craig S. Smith.

5 Asian Wall Street Journal of 11th October 1999 "Some Investors Quit China, Citing Poor Profits, Fraud by Henny Sender.

China's ability to handle reform of obstacles faced by foreign investors and doubt over the immediate future of the economy therefore has likely exacerbated the slowdown of FDI. This no doubt has caused some foreign investors not to proceed with contracted investments and others to sit on the sidelines because their less than sanguine view of the economy including the current deflationary environment, the uncertainty on the likely benefits of the government's fiscal policy on taxes on interest and income support to civil servants. Superimposed on this are more uncertainties arising from the likelihood of true SOE reform proposed at the Fifteenth Party Plenum in September 1999, how the Asset Management Corporations will deal with Non Performing Loans and the very strength and integrity of the banking system (in which confidence is critical to investors), the likelihood of a devaluation, whether stock markets will truly become a major source of capital and the smooth implementation of W.T.O. membership[6]. The list is long but not surprising.

Going Forward

A.T. Kearney reported at the Global Economic Forum held in Shanghai, September 1999:

> "Many businesses acknowledge that their current strategies have not kept pace with the rapidly changing environment and are not responsive to the market. This calls for reevaluation and innovation: from downsizing the business to developing and executing niche strategies: from consolidation, cooperation and alliance formation to changing ownership structures; from rethinking investments to creating an aggressive growth strategy. All are fair game in China today.
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> Because China is a key country for any global strategic plan, companies must continue to place great importance on developing business there. And they are. A.T. Kearney's most recent semiannual FDI confidence survey of senior executives from the world's 1,000 largest companies (responsible for 70 percent of global FDI flows) shows that the mainland continues to be the

6 For a thorough discussion see " Return of the Reformists" by Erwin Sanft. Credit Lyonnais Securities Asia Report – October 1999.

second most popular FDI destination globally, and the top investment destination in Asia.

For all the challenges presented by China's complex – and sometimes confusing – operating environment, the majority of global companies have no intention of leaving. Over the next five years, the companies we talked with plan to invest one-and-a-half times again as much as the amount they have already invested or committed. Profits may be elusive in China, but the hunt for them will certainly not be under-funded.[7]

For all the challenges that China's changing landscape naturally provides, our research found the majority of these global companies not giving up. In our survey, for example, the respondents are not only increasing the utilized value of funds already committed, but also plan to invest over the next five years twice what they have already invested and committed.

Increasing foreign investment

Foreign direct-investment projects and total contracted foreign direct-investment values decreased significantly over the past four years. However, our survey confirms that global companies are increasingly utilizing money they have already committed, drawing it down for investments at the opportune time. In fact, on a compound-annual-growth-rate basis, respondents report that the total number of projects has decreased 34 percent annually over the past four years, and the total contracted value decreased 13 percent, while the total utilized value – or value of capital committed to projects – has increased 15 percent in the same time period. The average amount per project is also increasing. For example, Fortune 500 companies responding to our survey typically invest an average of US$10 million per project in China; whereas Fortune 500 companies with a presence in the government-subsidized Pudong Development Zone (centered around Shanghai) invest an average of over US$30 million per project.

[7] A.T. Kearney – "Global Investment in China – A White Paper on the Quest for Profitability", September 1999

> For respondents, current China operations represent, on average, only 1 percent of their global revenue and employee base. However, they plan to expand their China operations in the next five years, investing twice as much as the total amount already invested and committed.
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> This suggests continuing optimism and high expectations. Headquarters of several global companies are becoming more patient about the timing of expected returns from their China investments. They have more down-to-earth expectations compared to the first investment wave, when many overoptimistic projections failed to materialize. Global companies, cautious at first, now appear willing to invest for the longer term[8]."

Realistic is the view of Fred Hu, Goldman Sachs economist, in a paper to the September Global Forum in Shanghai in September 1999. He felt it was premature to conclude the golden era for FDI in China is over because of the decline in FDI inflows in 1999 for 3 reasons:

(a) First, the modest fall in FDI is a lagged response to the Asian crises. Since leading investors from Hong Kong, Japan, Korea, and Southeast Asia have all been hit by domestic economic problems, they have reduced their overseas investments. As these economies recover, their outward investments will resume, including those into mainland China.

(b) Second, an increasing proportion of FDI is targeting domestic markets in China, rather than only taking advantage of low-cost production for exports. In the past, foreign investors have been frustrated by protectionist barriers, policy restrictions, and an unpredictable regulatory regime. However, with expected entry to the WTO, China is obligated to play by international rules, and its policy and regulatory systems will become more stable and transparent. The playing field will be more level for both domestic and foreign firms. Therefore, we believe the overall investment climate should significantly improve in the coming years.

(c) Third, in conjunction with deepening trade integration, China will renew the process of capital account liberalization interrupted by the Asian crises. The speed at which China will achieve full capital account convertibility depends on progress in domestic financial sector restructuring, and improved financial supervision. Taking to heart the lessons from the Asian crises, China is focusing on creating a sound banking system to prepare itself to a fully open capital account. Once remaining exchange and capital restrictions are removed, foreign portfolio investment will start to surge. This will provide significant opportunities for international banks and institutional investors to participate in China's rapidly expanding domestic financial markets.[9]

Conclusion

In the light of current uncertainties mentioned earlier and China's handling the many challenges touched upon before one is likely, for the present, to see the level of FDI be more subdued than before. However, when coupled with China's professed commitments to market reform and its responsible reaction, in consultation with the United States and the IMF, to the East Asian financial crises the October 1999 W.T.O. agreement between China and the United States takes on huge import with respect to prospective FDI flows.

Not only does it auger a modest devaluation, should one occur at all, but it shows a further tangible commitment to unlocking regulatory barriers of entry to China and its hitherto much restricted sectors such as telecommunications, banking, insurance, information technology, importation and distribution, automobiles and agriculture. With a likely increase in transparency and confluence with international standards of legal and regulatory behaviour it removes one of the prime sources of uncertainty held by many foreign investors and a common cause of complaint by foreign investors.

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8 A.T. Kearney – "Global Companies in China – A White Paper on the Changing Landscape", September 1999

9 Goldman Sachs – "Global Economics Paper No. 32" presented by Fred Hu at the Fortune Global Forum held in Shanghai on 27th – 29th September 1999.

There are obstacles remaining to full Chinese accession, not least of which is United States Congressional approval, but the effect thereafter should be major on FDI flows into China. Whilst the impact of W.T.O. membership on FDI is hard to quantify some observers can imagine a doubling of FDI over the next five years[10] or “This could set the stage for a dramatic expansion in foreign direct investments in China, 12 to 18 months from now”.[11]

This anticipated increased flow of FDI into China can be expected to assist in ameliorating some of the expected negative impacts of W.T.O. membership such as increased unemployment, increased imports and likely SOE closures.

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[10] Economist – “China and the W.T.O.”, 20th November 1999.
[11] David Hale reported by Bloomberg on 16th November 1999.