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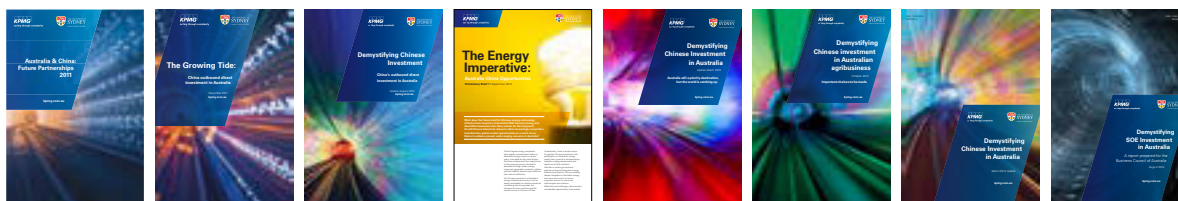
Demystifying SOE Investment in Australia

A report prepared for the
Business Council of Australia

August 2014

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About our reports



demystifyingchina.com.au

KPMG and The University of Sydney China Studies Centre have formed a strategic relationship to publish research and insights on doing business with Chinese investors. Our first report was published in September 2011, with *Demystifying SOE Investment in Australia* representing the eighth report in our series.

Despite strong public interest, little detailed factual information has been previously available about the actual nature and distribution of China's outbound direct investment (ODI) in Australia. This specialist report continues our comprehensive reporting of China's ODI into Australia.

The dataset is compiled by a joint University of Sydney and KPMG team and covers investments into Australia made by entities from the People's Republic of China through M&A, joint venture and greenfield projects. The dataset also tracks Chinese investment by subsidiaries or special purpose vehicles based in Hong Kong, Singapore and other locations. The data, however, does not include portfolio investments, such as the purchase of stocks and bonds, which does not result in foreign management, ownership, or legal control.

Our database includes completed direct investments recognised in the year in which parties enter into legally binding contracts and if necessary, receive mandatory FIRB and Chinese Government investment approvals. In certain circumstances, final completion and financial settlement may occur in a later year.

For consistency, the geographic distribution is based on the location of the Chinese invested company and not on the physical location of the actual investment project. Completed deals which are valued below USD 5 million are not included in our analysis, as such deals consistently lack detailed, reliable information. Unless otherwise indicated, the data referred to throughout this report is sourced from KPMG/University of Sydney database, and our previously published reports.¹

The University of Sydney and KPMG team obtains raw data on China's ODI from a wide variety of public information sources which are verified, analysed and presented in a consistent and summarised fashion. In line with international practice, we record deals using USD as the base currency.

We believe that the KPMG/University of Sydney dataset contains the most detailed and up-to-date information on Chinese ODI in Australia.



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¹ Includes: Australia & China Future Partnership, September 2011; The Growing Tide: China ODI in Australia, November 2011; Demystifying Chinese Investment, August 2012; The Energy Imperative: Australia-China Opportunities, 25 September 2012; Demystifying Chinese Investment in Australia, March 2013; Demystifying Chinese Investment in Australian Agribusiness, October 2013; Demystifying Chinese Investment in Australia (March 2014 update).

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Background: From regulation to integration

How large and active are State Owned Enterprises (SOEs) globally?

According to the United Nations Conference on Trade and Development (UNCTAD) estimates, there are at least 550 SOEs, from both developed and developing countries, with more than 15,000 foreign affiliates. Combined, they have estimated foreign assets of USD 2 trillion globally. Foreign direct investment (FDI) by these SOEs is estimated to have reached more than USD 160 billion in 2013, a slight increase after 4 years of consecutive decline. Although SOEs account for less than 1 percent of the universe of transnational companies (TNCs), they account for over 11 percent of global FDI flows.

In 2014, 14 of *Fortune* magazine's global 'top 50' companies were enterprises with state ownership. Combined total revenues and profits were USD 2.9 trillion and USD 198 billion respectively.

How do other countries regulate SOE investment?

The regulation of SOE FDI differs between major national jurisdictions. With the exception of the UK, most jurisdictions place heavy emphasis on pre-entry regulation (i.e. prior to investment) by controlling or restricting access to the local market according to various criteria. These range from national interest, to market behaviour and good character tests.

The UK stands out as having the only set of regulations that focuses on post-entry regulation and enforcement of market-conforming economic behaviour and policy compliance through integration in the domestic host economy.

What is Australia's history with investment from SOEs?

Foreign SOEs have been an important source of capital for Australia for many decades. SOEs from Japan, South Korea, Singapore, Malaysia and Qatar have invested in a variety of sectors across Australia. These SOE investors have not only provided capital, expertise and technologies, but also created job opportunities, increased tax revenue and generated trade benefits.

Over time the economic contribution, coupled with positive market behaviour and integration into local society have been important factors for foreign SOEs gaining public support and trust.

Investment from Chinese SOEs

Chinese SOEs have accounted for the vast majority of Chinese investment in Australia. Based on our records between 2007 and 2013, 58 Chinese SOEs have directly invested USD 52.26 billion across 122 deals into Australia's mining, gas and power sectors. Without the equity and debt these Chinese SOEs arranged and invested many of Australia's largest mining and gas projects may not have proceeded.

With 28 percent of investments completed at values higher than USD 200 million, Chinese investors have attracted significant attention focused on concerns about their state ownership structure. Chinese investment in politically sensitive areas such as agriculture and real estate is less dominated by SOEs.

Chinese SOEs are rapidly expanding their global investment in economies competing with Australia such as the US, Canada and the UK. In Australia, their level of experience is still quite low relative to American, British, Japanese and South Korean investors who have at least a 20-30 year head start. However, our report shows that Chinese SOEs are learning from past experiences and adapting their approach to suit Australian market conditions.

Report findings

At the World Economic Forum in 2013, Chinese Premier Li Keqiang announced a new Chinese global outbound direct investment (ODI) target of USD 500 billion over the next 5 years. This cumulative target appears conservative based on recent ODI outflows. Reaching this target figure would in fact require a slow down from current annual ODI growth rates. An extension of recent trends over the next 5 years would result in a total volume of approximately USD 750 billion.

If Australia maintained our average share of 12 percent of projected Chinese global ODI between 2013 and 2018, this would amount to between USD 60-90 billion of investment for our nation.

In order for Australia to attract Chinese SOE investment on a sustainable basis in an increasingly competitive global landscape, it is critical for us to better understand their operations, motivations and aspirations.

How Chinese SOEs conduct business in Australia

KPMG and the University of Sydney analysed 23 Chinese SOEs across a range of industry sectors to determine how they operate in Australia, and whether their modus operandi differs materially from other international investors.

Chinese SOEs have strong economic motivations

We found that in most cases, the investment motivations from Chinese SOEs are very similar to other foreign investors. These include seeking profitable growth, global reach beyond home markets, access to new customers, and acquisition of new technology, brands and knowledge.

A major strategic motivation for Chinese SOEs' investment in the mining and gas sectors is to evolve beyond a pure commodity trading relationship. Increasingly they are vertically integrating to secure reliable, high quality natural resource exports for their energy and economic development objectives, with a range of other strategic drivers in the power, financial services, transport and consumer products sectors.

Chinese SOEs access multiple funding sources – including Australian banks

Although most Chinese SOE investments obtain relatively low cost debt financing from Chinese state owned banks or policy banks (providing a major competitive advantage), there are increasing examples of Australian banks providing significant funding to Chinese investment projects at market rates.

Chinese SOEs are deploying local decision-making authority

Similar to observed trends from Japanese, South Korean and Singaporean companies, major corporate decisions are typically made back at headquarters in China. However, Chinese SOEs are increasingly authorising Australian based senior executives to make operational decisions, for which they are held accountable. Local executives are also increasingly influencing, if not leading, key strategic decision-making.

Chinese SOEs are westernising senior management

Of the 23 companies reviewed, only seven had non-Chinese CEOs. These were among the better performing Chinese investments. Most Chinese SOEs continue to have Chinese speaking CEOs who work to fixed appointment terms and network closely with each other. However, over the past two years we noted an increasing trend towards Chinese leaders with stronger English speaking and communication skills, who are based in Australia for a considerable period to build local knowledge, experience and business networks.



Chinese SOEs are increasingly diversifying their management teams

All Chinese SOE invested companies have a mix of Australian and Chinese management with a range of complementary skills. The number of Chinese expatriates relative to total full time employee (FTE) headcount is very low. The 23 Chinese SOEs analysed employ over 5,000 FTEs in Australia; and the three largest Chinese SOEs employ well over 500 Australian FTEs. No concerning trends in employment-related industrial disputes or workplace health and safety incidents from Chinese SOE invested companies and projects were identified. However anecdotally there are now ongoing and real cultural differences – which both sides must continue to work together to resolve.

Chinese SOEs comply with local laws and regulations

Based on a search of publicly available information, there were very few negative public media reports involving poor behaviour of Chinese SOEs (beyond normal commercial disputes); and none in relation to material non-compliance with Australian laws and regulations.

Chinese SOEs are increasingly utilising professional advisers

All but three Chinese SOEs analysed are audited by 'Big Four' accounting firms (the exceptions are audited by Tier 2 firms). We also noted an increasing trend by the more experienced and successful investors towards using professional advisors and consultants on major investment projects and regulatory matters.

Chinese SOEs are increasingly mindful of reputation

There are increasing examples of Chinese SOEs spending on advertising and brand promotion including sponsoring high profile sporting events, arenas and teams, and investing in community social and cultural assets to build goodwill and win local community support and trust.

Chinese SOEs have a preference for controlling equity stakes

Chinese SOEs maintain a strong preference for controlling equity stakes in investments. Of the 23 companies analysed, 19 held majority positions in Australian incorporated and licensed companies and ventures. This is different from other international investors, in particular Japan with its strong use of joint ventures, but is consistent with Chinese SOE investments in other developed countries.



How Chinese SOEs view Australia

We conducted a Chinese investor perceptions survey with 51 Chinese executives in Australia, of which 31 responses were from SOE representatives.

The results show:

- The majority of Chinese SOE executives feel welcome to invest in Australia. However, they believe that Australia is more welcoming to investors from other countries.
- Chinese SOE executives feel regulatory approval of foreign investment projects in Australia is becoming faster and easier.
- The majority of Chinese SOE executives believe that investment approvals should be decided on commercial merits, and not on ownership grounds.
- The majority of Chinese SOE executives responded that they need more information and education about investments and investing in Australia.
- Chinese SOE executives understand it is very important to protect the environment and work with local employees and trade unions. They are aware that to operate in the Australian market they need to be good corporate citizens.
- While Chinese SOE executives find governments at all levels, and the business sector in general, are supportive towards their investments, they generally disagreed with the statement that “*Australian media are supportive to Chinese investors*”.

How Chinese economic deregulation affects SOEs

SOE reform is a process that has been ongoing since the beginning of economic reforms in China in the late 1970s, and will continue to develop into the foreseeable future. The economic program of the new leadership team under President Xi Jinping and Premier Li Keqiang, announced during the Third Plenum, is pursuing a deregulation agenda with SOE reform at its core.

The largest centrally owned SOEs will enhance their strategic importance for integrating China into the global economy – in particular, through targeted investment. However, we can expect to witness a gradual market-based reform process resulting in less direct political interference, increased private capital investment (into SOEs), improved corporate governance systems and professionalisation of management. China is looking at applying Singapore’s Temasek model as the methodology to increase investment returns, while distancing the state from the management of the business without relinquishing ownership.

How Australian perspectives on Chinese SOE investment are changing

Australians are supportive of increased bilateral trade and certain investment links with China, including Chinese SOEs. At the same time, there is resistance and concern in particular in relation to controlling equity stakes and investment in Australia's real estate and agricultural land.

Interestingly, a 2014 Lowy Institute poll revealed a positive change in sentiment towards China with 31 percent of Australians saying China is "Australia's best friend in Asia", ahead of Japan at 28 percent the previous year. Australians' feelings towards China warmed to the highest levels in 10 years, at 60 degrees in the poll's 'thermometer' ratings. However, the Lowy poll also found that 56 percent of Australians consider the "Australian Government is allowing too much investment from China".

There is a time and trust equation at play: the longer Australians interact with foreign investors, the less concerned or resistant they appear to be. This is expected to be the case with Chinese investment as it becomes more integrated. However, there is a need to improve communication and information flows on both sides to increase mutual understanding and build stronger relationships.

"There is a time and trust equation at play: the longer Australians interact with foreign investors, the less concerned or resistant they appear to be."





International SOE investment in Australia

1

1. International SOE investment in Australia

What is an SOE?

There is no global consensus on the definition of a State Owned Enterprise (SOE). The commonly used definitions are based on a combination of ownership and control criteria. UNCTAD requires a minimum of 10 percent government ownership; while the Australian Foreign Investment Review Board (FIRB) requires 15 percent.

More specifically, FIRB categorises SOEs as:

- a body politic of a foreign country
- entities in which governments, their agencies or related entities from a single foreign country have an aggregate interest (direct or indirect) of 15 percent or more
- entities in which governments, their agencies or related entities from more than one foreign country have an aggregate interest (direct or indirect) of 40 percent or more or
- entities that are otherwise controlled by foreign governments, their agencies or related entities, and any associates, or could be controlled by them including as part of a controlling group.

Various terms are used interchangeably in relation to SOEs including State Owned Trans National Corporations (SO TNC), Foreign Government Investors, Government Invested Companies and Government Linked Companies. Throughout this report, we use SOE to generically describe all such companies.

SOEs and global foreign direct investment

Global foreign direct investment (FDI) recovered slightly in 2013 with an overall increase of 9 percent to USD 1.45 trillion, but remains at a level less than two thirds of pre-GFC volumes (USD 2.27 trillion in 2007).

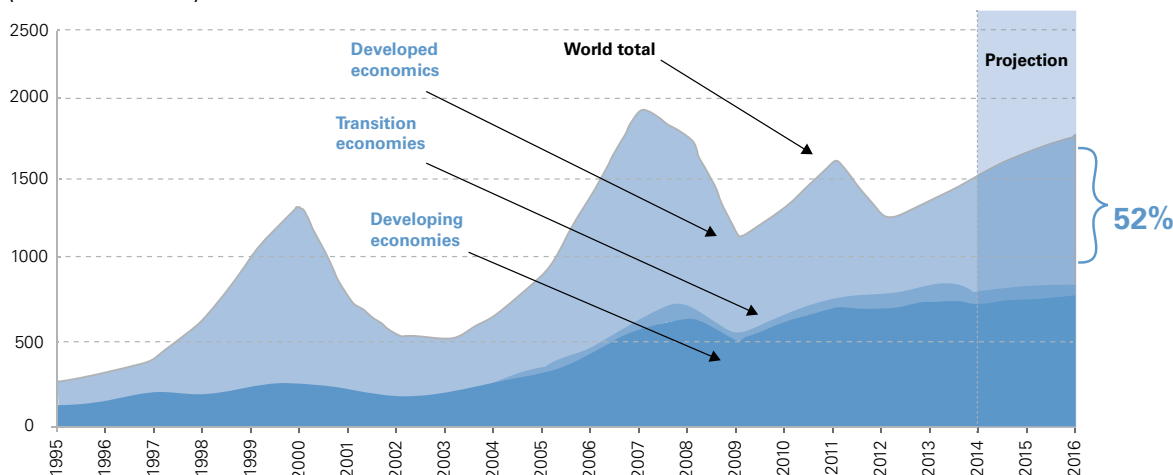
UNCTAD projects a gradual recovery with global FDI flows increasing to USD 1.6 trillion in 2014, USD 1.7 trillion in 2015 and USD 1.8 trillion in 2016.

As the graph below shows, in 2013 global FDI flows to developing countries reached a new high of USD 778 billion (54 percent of global total), while FDI flows to developed countries remained at an historic low (USD 566 billion or 39 percent of total inflows)² – the difference being made up by transition economies.

The FDI from SOEs globally is estimated to have surpassed USD 160 billion in 2013. This represents over 11 percent of total FDI flows, even though SOEs represent less than 1 percent of transnational corporations.

Despite the high public profile, Sovereign Wealth Funds (SWFs) – a category of state-owned enterprises – contributed only a small proportion of global FDI. In 2013, SWF FDI flows were USD 6.7 billion.³

FDI inflows, global and by group of economies, 1995-2013 and projections, 2014-2015
(Billions of USD)



Source: UNCTAD World Investment Report 2014, p14. xiii

2 UNCTAD, 2014, World Investment Report 2014, Investing in the SDGs: an Action Plan

3 UNCTAD, 2014, World Investment Report 2014, Investing in the SDGs: an Action Plan

China's FDI growth was essential in lifting the overall SOE share in global FDI, as SOEs account for approximately 60 percent of China's non-financial overseas investment stock by the end of 2012.

FDI outflows from China increased 15 percent to USD 101 billion in 2013, driven by a number of mega-sized deals in developed countries. As a global investor, China moved from sixth to third position, behind the United States and Japan.⁴ If FDI from China and Hong Kong was combined, China would rank second with USD 193 billion – still well behind the US (USD 338 billion).

Who are the world's major SOEs?

In 2014, 14 of *Fortune* magazine's global 'top 50' companies were enterprises with state ownership. Combined total revenues and profits were USD 2.9 trillion and USD 198 billion respectively.

Enterprises with state ownership within the top 50 of Fortune Global 500

Ranking in Fortune 2014 list	Company name	Country of origin	Revenue (USD billion)	Profits (USD billion)	Assets (USD billion)
3	Sinopec Group	China	457.2	8.9	353.0
4	China National Petroleum	China	432.0	18.5	620.7
7	State Grid	China	333.4	8.0	424.5
8	Volkswagen	Germany	261.5	12.1	446.9
13	Japan Post Holdings	Japan	152.1	4.8	2,838.2
17	Gazprom	Russia	165.0	35.8	409.2
22	ENI	Italy	154.1	6.9	190.6
25	ICBC	China	148.8	42.7	3,124.9
28	Petrobras	Brasil	141.5	11.1	321.4
36	Pemex	Mexico	125.9	-13.3	156.3
38	China Construction Bank	China	125.4	34.9	2,537.7
41	PDVSA	Venezuela	121.0	12.9	218.2
44	GDF Suez	France	118.6	-12.3	219.9
47	Agricultural Bank of China	China	115.4	27.1	2,405.4
Total			2,851.9	198.1	14266.9

Source: *Fortune* Global 500, 2014 <http://fortune.com/global500>

4 UNCTAD, 2014, World Investment Report 2014, Investing in the SDGs: an Action Plan

Major SOEs investing in Australia

Overall, Australia has enjoyed positive experiences with SOE investment from its major trading partners such as Japan, South Korea and Singapore. Many of these investors faced initial public resistance, as have private investments from the US in the immediate post-war period.

Over the last decade, SOE investment in Australia has come from a variety of countries and into a multiple industry sectors.

A selection of SOE investments in Australia in recent years

SOE investor	Year	Australian project	Investment value (AUD billion)	Sector
China			3.999	
China National Offshore Oil Corporation Ltd	2013	Queensland Curtis Island project	1.800	LNG
China Molybdenum Co Ltd	2013	Rio Tinto North parks project	0.745	Mining
Greenland Group	2013	Brookfield Asset Management residential and hotel project	0.100	Real estate
State Grid Corporation	2013	SP AusNet	0.824	Grid
Bright Food	2011	Manassen Foods	0.530	Agribusiness
Japan			34.350	
Nippon Telegraph and Telephone Corporation	2014	RagingWire Data Centres	0.350	Telecom
Inpex ⁱ	2012	Ichthys LNG Project	34.000	LNG
Singapore			20.173	
GIC Real Estate	2007	Westfield Parramatta	0.718	Property, shopping centre management
Olam International Limited	2007	Queensland Cotton Holdings Limited	0.303	Agribusiness
Everitt Investment Pte, Ltd., Temasek Holdings Pte, Ltd.	2007	Goodstart Early Learning Limited	0.402	Education
Singapore Power	2007	Alinta	4.500	Grid
Singapore Power	2004	TXU Australian Assets	5.000	Grid
SingTel	2001	Optus	9.250	Telecom
South Korea			5.201	
POSCO ⁱⁱ	2012	Roy Hill project	3.200	Mining
Korea Gas Corporation (KOGAS)	2011	Santos GLNG project	0.333	LNG
Korea National Pension Plan	2010	Aurora Place, Sydney	0.685	Real estate
Korea Electric Power Corp (KEPCO)	2010	Anglo Coal (Taroom) Pty Ltd (Bylong Coal Mine)	0.403	Mining
Korea Electric Power Corp (KEPCO), Korea Gas Corporation (KOGAS)	2010	Anglo American (5 Coal mine assets)	0.580	Mining
Others				
Hassad Food	2012	Farms in Western Australia at Bindi Bindi Jerramungup and Esperance	N/A	Agribusiness
Petrolam National Berhad	2008	Gladstone LNG project	2.330	LNG

i Total investment value of the project, which is jointly held by Inpex (76 percent) and Total S.A. (24 percent)

ii Total investment made by a Consortium comprising POSCO, Marubeni Corporation and STX Corporation

Japanese and South Korean SOE investment in Australia

Japanese and South Korean SOE investors have long been active in the Australian FDI market, investing in extractive industries, infrastructure and public utilities.

During the 1970s and 1980s, Japanese ODI to Australia was controversial for reasons including perceptions surrounding the central coordination of Japanese foreign trade and investment activities by the Japanese Ministry of International Trade and Industry (MITI).⁵

Among the South Korean investors in Australia, some originally state-owned corporations were later privatised. For example, POSCO was 75 percent owned by the South Korean Government when it was established in 1968. The Government sold its last shares in 2000.

Case study: Inpex/Ichthys LNG project

Inpex is a good example of a SOE investment in Australia. Inpex, the Japanese SOE which is building the Ichthys LNG project with Total Group, has been part of the Australian business community since 1986. The company, which is 18.9 percent owned by the Japanese Ministry of Economy, Trade and Industry formed a joint venture with the French Total Group of Companies to invest in the AUD 34 billion Ichthys LNG project. Gas from the Ichthys Field in the Browse Basin in offshore Western Australia will undergo preliminary processing offshore and then be exported to onshore processing facilities in Darwin via an 889km pipeline. The Ichthys project is expected to produce around 6 million tonnes of LNG annually, equal to 10 percent of Japan's yearly import requirements. According to Inpex⁶, an estimated 3,000 jobs will be created in Darwin during the peak of construction, with a further 1,000 jobs offshore.

Inpex's major shareholders (Common shares)

Name	Number of shares	Holding (%)
Ministry of Economy, Trade and Industry	692,307	18.9
Japan Petroleum Exploration Co., Ltd.	267,233	7.3
Mitsui Oil Exploration Co., Ltd	150,760	4.1
Japan Trustee Services Bank, Ltd (Trust Account)	119,797	3.3
The Master Trust Bank of Japan, Ltd. (Trust Account)	112,193	3.1
JX Holdings, Inc.	109,527	3.0
The Chase Manhattan Bank N.A. London Secs Lending Omnibus Account	86,538	2.4
CBNY – Orbis Funds	85,887	2.4
The Bank of New York, Treaty JASDEC Account	64,768	1.8
Mitsubishi Corporation	64,000	1.8

As of 30 September 2013

Source: <http://www.inpex.co.jp/english/ir/shareholder/stock.html>

Note: Total Group of Companies used to be controlled by the French Government. However, since the repeal on 3 October 2002 of a decree establishing a golden share of Elf Aquitaine held by the French Government, there are no longer any agreements or regulatory provisions governing shareholding relationships between Total (or its subsidiary Elf Aquitaine) and the French Government.

5 Chalmers Johnson, 1982, Japanese state influence. Miti and the Japanese Miracle: The Growth of Industrial Policy: 1925-1975

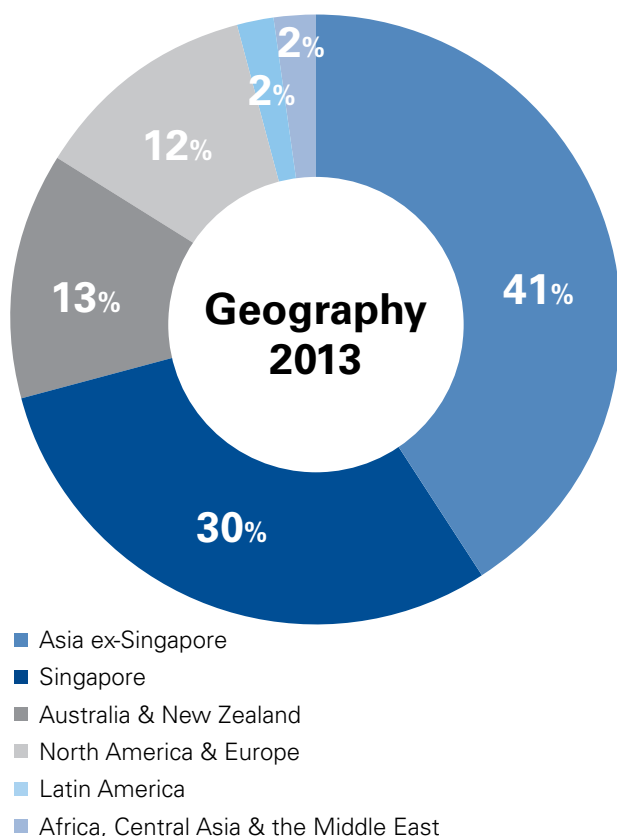
6 [http://www.inpex.com.au/media/32983/120113_media%20release%20-%20ichthysfid\(final\).pdf](http://www.inpex.com.au/media/32983/120113_media%20release%20-%20ichthysfid(final).pdf), accessed 31/05/2014

Singapore and Middle East SOE and Sovereign Wealth Fund (SWF) investment in Australia

Singapore is a well-respected SOE investor in Australia.

In 2013, 13 percent of Temasek's portfolio was invested in Australia and New Zealand. Temasek is an active investor in the Australian real estate market. Through its investment arm, Government Investment Corporation (GIC), the Singapore Government also has a stake in Australia's second largest mobile carrier, Optus. Temasek's 56 percent holding in Singapore Airlines has also made it a key investor in Virgin Australia.

Geographical distribution of Temasek's assets



Source: Temasek Review 2013: Beyond Investing, 2013

Other examples of successful Singaporean Government-linked investors include Singapore Power, which became a major player in the Australian utilities market and, until very recently, owned electricity and gas transmission networks across Australia's eastern states. Singapore Power bought the distressed assets of Alinta in 2007, estimated to be worth more than USD 10 billion.

Middle Eastern investment in Australia is mainly channelled through SWFs. To date, their investment value is relatively small and elicits little public interest, despite investment in agricultural land. Hassad Food, which has aggregated several farming properties in Australia, is owned by the sovereign wealth fund Qatar Investment Authority (QIA). The QIA is funded by the State of Qatar as part of Qatar's strategy to diversify its finances into new asset classes both inside and outside its territory, thereby reducing dependence on the country's oil and gas reserves.⁷

Hassad Australia currently has 13 agricultural aggregations under ownership comprising approximately 250,000 hectares of pastoral and cropping enterprises. Achieving food security for Qatar is one of Hassad's strategic focus areas.

Summary

Foreign SOEs have been an important source of capital for Australia for many decades. SOEs from Japan, South Korea, Singapore, Malaysia and Qatar have invested in a variety of sectors across Australia. These SOE investors have not only provided capital, expertise and technologies, but also created job opportunities, increased tax revenue and generated trade benefits.

Over time the economic contribution, coupled with positive market behaviour and integration into local society, have been important factors for foreign SOEs gaining public support and trust.

We expect the same trend to emerge for Chinese SOE investors.

“Foreign SOEs have been an important source of capital for Australia for many decades.

They have not only provided capital, expertise and technologies, but also created job opportunities, increased tax revenue and generated trade benefits.”



International regulation of SOE investment

2

2. International regulation of SOE investment

The regulation of SOE FDI differs between major national jurisdictions. There is a wide divergence in mechanisms and criteria used to review SOE FDI. With the exception of the UK, most jurisdictions place heavy emphasis on pre-entry regulation (prior to investment) by controlling or restricting access to the local market according to various criteria ranging from national interest, to market behaviour and good character tests.

Australia and Canada place heavy emphasis on pre-investment regulation. The US places more emphasis on national security considerations, while New Zealand's regulations increasingly protect special interests.

The UK regulations place emphasis on post-entry regulation as well as enforcement of market-conforming economic behaviour and compliance.

The effectiveness of these regulations has to be measured against the risks that are posed by foreign direct investment. These risks fall into two categories – national security risks and economic/commercial risks.

Managing the risks of SOE investment in Australia

National security risks are perceived to include the potential for the SOE's home government to direct the SOE to undertake non-commercial activities. The OECD supports the right of governments to protect their national security from threats by foreign investment in sensitive sectors, and it is widely accepted that regulation is appropriate in such cases where there are national security risks.

An analysis of specific risks relating to SOEs, in particular Chinese SOEs operating in Australia, was undertaken in 2009 by Peter Drysdale and Chris Findlay who identified three possible concerns.⁸

FDI investments involving state ownership and dominant shareholding and control *might* be used:

1. as a vehicle for shifting profits back to the home country through underpricing exports
2. as an instrument for subsidising the development of 'excess capacity' or 'extra-marginal' projects and to ratchet resource prices down
3. to pursue political or strategic goals inconsistent with the efficient development and marketing of national resources.

An analysis of economic risks related to foreign investment include: anti-competitive behaviour, subsidies of the factors of production (including access to lower priced credit), and commercial behaviour that runs counter to Australian legal and regulatory requirements, such as transfer pricing.

These risks apply equally to domestic enterprises and are currently managed by existing Commonwealth and state laws.

Issues relating to competition and fair trading are managed by the Australian Competition and Consumer Commission (ACCC), which is responsible for enforcing the *Competition and Consumer Act 2010*.

Australia has a robust anti-dumping regime, administered by the Anti-Dumping Commission, to prevent international companies undercutting domestic business through selling at lower-than-cost prices.

The Australian Taxation Office (ATO) manages issues relating to transfer pricing to ensure that goods are sold at market prices.

SOEs listed on the Australian Stock Exchange (ASX) have to abide by listing requirements, and SOEs in certain industries, (for example the financial services sector), are regulated by specific bodies such as the Australian Prudential Regulatory Authority (APRA).

Similarly, SOEs must comply with Australia's domestic requirements on environmental approvals and industrial relations.

⁸ Peter Drysdale and Christopher Findlay, 2009, 'Chinese foreign direct investment in the Australian resource sector', *China's New Place in a World in Crisis: Economic, Geopolitical and Environmental Dimensions*, Edited by Ross Garnaut, Ligang Song and Wing Thye Woo, pp. 349-388, pp. 372ff

Australia

The OECD FDI Regulatory Restrictiveness Index shows Australia's FDI regime ranks sixteenth of 58 countries in terms of regulatory restrictiveness, ahead of all other developed member countries except South Korea, New Zealand and Canada.

Inbound foreign investment in Australia is regulated by the *Foreign Acquisitions and Takeovers Act 1975*, Australia's Foreign Investment Policy, and specific legislation in certain 'sensitive' sectors or companies. The Foreign Investment Review Board (FIRB), a division of the Treasury, screens potential foreign investments above a threshold value of AUD 248 million; and AUD 1,078 million for US, New Zealand, South Korean and Japanese investors.

FIRB reviews each notifiable foreign investment application against a national interest test. The test considers national security, competition, other government policies (including taxation and environment), impacts on the economy and community, and the character of the investor.⁹ Based on advice from FIRB, the Treasurer may deny or place conditions on the grounds of national interest on the approval of particular investments above those thresholds.

Australia's foreign investment policy requires all SOE investors to notify the Government and obtain prior approval before making a direct investment in Australia, regardless of the value of the investment. The Government then considers if the investment is commercial in nature or if the investor may be pursuing broader political or strategic objectives.

Mitigating factors that assist in determining such proposals are not contrary to the national interest may include: the existence of external partners or shareholders in the investment, the level of non-associated ownership interests, the governance arrangements for the investment, ongoing arrangements to protect Australian interests from non-commercial dealings, and whether the target will be, or remain, listed on the ASX or another recognised exchange. The Government will also consider the size, importance and potential impact of such investments in deciding whether or not the proposal is contrary to the national interest.¹⁰

In 2012-13, the total value of foreign investment proposals for Australia approved by FIRB was AUD 135.7 billion. And according to FIRB during this time no proposals were rejected (compared with 13 real estate related proposals rejected in 2011-12¹¹). Historically, rejections by FIRB are very limited but include the 2001 rejection of Shell's bid for Woodside; the 2009 refusal to allow China Minmetals' bid for Oz Minerals; the 2011 rejection of the ASX and Singapore Exchange merger; and the 2103-14 rejection of the Archer Daniels Midland bid for GrainCorp.

United States

The OECD FDI Regulatory Restrictiveness Index ranks the US twenty-third of 58 countries in terms of regulatory restrictiveness in 2013.¹² The US framework consists of two pillars: The Committee on Foreign Investment in the United States (CFIUS), which investigates national security risks; and the Department of Justice (DOJ) and the Federal Trade Commission (FTC), which consider potentially anti-competitive impacts. Various other issues are delegated to domestic regulators, including labour rights, environmental protection and industry-specific rules.

This approach has served US interests well in the past, but the 2013 USD 4.7 billion acquisition by China's Shuanghui International, the country's largest meat processor, of Smithfield Foods rekindled debate about expanding the scope of reviews to include the 'net benefit' test.¹³

The US framework distinguishes between state-controlled entities and other companies for the purpose of screening incoming M&A transactions on national security grounds. An investigation needs to be undertaken by CFIUS if a merger or acquisition in the US is undertaken by a SOE.

Foreign government ownership or control of the acquiring entity gives rise to a mandatory investigation by CFIUS unless "the transaction will not impair the national security of the United States", according to the Treasury Department and any lead agency.¹⁴ This national security review mechanism does not apply to greenfield investment.

9 Australian Treasurer, 2013, Australia's foreign investment policy

10 Australian Treasurer, 2013, Australia's foreign investment policy

11 Foreign Investment Review Board, 2014, Foreign Investment Review Board Annual Report 2012-13

12 OECD's FDI restrictiveness index, <http://www.oecd.org/investment/fdiindex.htm>

13 Daniel H. Rosen and Thilo Hanemann, June 8, 2013, The Danger of Politicized Foreign Investment Reviews, <http://rhg.com/articles/the-danger-of-politicized-foreign-investment-reviews>, accessed 29/05/2014

14 Sauvant, K.P., Sachs, L.E., and Schmit Jongbloed, V.P.F., 2012, Sovereign Investment: Concerns and Policy Reactions

Canada

Canada reviews investments under the Investment Canada Act (ICA) and fewer than 10 percent of foreign acquisitions are subject to ICA review. In December 2012, Canada announced significant changes to the ICA in response to an increase in SOE investment from 2008 to 2011 and an increasing trend for these investors to seek to acquire controlling stakes in Canadian companies.

The changes were designed to limit SOE investment in Canada's oil and gas sector. Foreign investment is prohibited or restricted in several key sectors of the economy. The ICA provides for review of large acquisitions by non-Canadian investors and imposes a requirement that these investments be of 'net benefit' to Canada.¹⁵

The new rules stipulate that future SOE bids to acquire control of a Canadian oil sands business will be approved on an "exceptional basis only". Canada also altered its definition of an SOE to include entities that are "influenced directly or indirectly" by a foreign government.¹⁶

New Zealand

New Zealand screens foreign investment relating to certain criteria. Under the auspices of the *Overseas Investment Act 2005*, New Zealand's Overseas Investment Office (OIO) screens foreign investments that would result in the acquisition of 25 percent more ownership of, or a controlling interest in 'significant business assets' (significant business assets are defined as assets valued at more than NZD 100 million).

Government approval is required for purchases of land area larger than 5 hectares and land in certain sensitive or protected areas, or in relation to fishing quotas.

Since 2011, newly implemented rules provide government ministers with increased power to consider a wider range of issues when assessing foreign investment in sensitive assets – primarily large-scale overseas ownership of farmland and vertically integrated primary production companies. Besides applying to land adjoining the foreshore or under conservation, the rules now include 'sensitive land', defined as large areas of farmland ten times the average size of any given type of farm.

The OIO publicly releases a brief summary of every application decision that is granted or declined. Decision summaries are normally released at the end of the month following the decision.¹⁷

United Kingdom

With a few exceptions, the UK imposes few impediments to foreign investment and ownership, although at least one director of any company registered in the UK must be an ordinarily resident in the UK. Once established in the UK, foreign-owned companies are treated no differently from UK firms.

Summary

There are national security and economic risks associated with foreign investment from SOEs which governments are expected to understand and manage.

Our analysis of foreign investment policies from countries that Australia competes with for SOE investment shows a weighting towards pre-investment policy controls.

These controls present extra regulatory risks for SOEs when they are competing against other companies to secure investments with vendors (and advisors) who will normally seek higher bid prices and non refundable deposits to compensate for completion risk.

If conditions to SOE investment are imposed by FIRB, there are normally additional costs or ongoing commercial implications for SOE investors which further act as a financial and operational disincentive to invest.

When investment regulations are inconsistent and discriminate against SOEs or investors from other countries, it creates a deeper sense of inequity in the mind of the investor.

15 <http://laws-lois.justice.gc.ca/eng/acts/I-21.8/index.html>, accessed 31/05/2014

16 <https://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk00064.html>; accessed 31/05/2014

17 <http://www.lin.govt.nz/overseas-investment/decisions>, accessed 31/05/2014

“Our analysis of foreign investment policies from countries that Australia competes with for SOE investment shows a weighting towards pre-investment policy controls... which present extra regulatory risks for SOEs.”





An introduction to Chinese SOEs

3

3. An introduction to Chinese SOEs

Driven by an increasing level of trade and outbound ODI, China's economic importance outside its borders has increased rapidly in recent years. China's SOEs, many of which are among the world's largest companies, lead this surge in ODI as they seek the resources, technology, and know-how necessary for China to continue on its characteristically gradualist path to economic development.

China's state-owned companies dominate key utility and infrastructure sectors such as electricity, aviation, banking, railway and shipping, natural resources, food commodity supply, defence, energy and power, and telecommunications services.¹⁸

Chinese SOEs are owned and supervised by different levels of government agencies

China's Central SOEs, of which there are 113¹⁹, have made a significant contribution to China's economic development and continue to be a key component of the national economy. In 2013, 69.2 percent of all SOE profits (equivalent to approximately 12.9 percent of total government revenues), originated from central SOEs. In 2012, China's top three oil giants alone contributed more than 10 percent of total profits of China's top 500 largest companies.²⁰

Most Central SOEs operate within what are deemed China's 'strategic' markets, namely: natural resources, food commodity supply, defence, energy and power, and telecommunications services. Domestically, these industries are generally closed to foreign investment.

Aside from China's 113 centrally-controlled strategic companies and their many subsidiaries, China also has other categories of SOEs including financial SOEs, China Investment Corporation, Social Security Fund, SOEs owned by Ministries of the State Council or organisations of public ownership, and a large number of non-financial provincial or local SOEs that report to

different levels of the government. Due to reforms and restructuring, the number of provincial or local SOEs is constantly changing. Figures for 2012 range between 144,700²¹ and 160,00.²²

While China's Central Enterprises report to the central State-owned Asset Supervision and Administration Commission (SASAC), directly under the State Council, the provincial or local SOEs report to regional levels of divisions of SASAC.

China's SOEs have gradually reformed from their original role as policy extensions of the central government to market-oriented firms that are slowly adopting modern corporate governance practices.

Ongoing reforms in ownership, governance, and access to factors of production are being undertaken so that Chinese SOEs can fulfil their role in a 'unified and open, orderly and competitive' market where the market plays a 'decisive' role in resource allocation. This journey of reform is expected to hasten significantly following recent announcements in China's Third Plenary Session of the 18th Central Committee of the Communist Party of China (CCCCP). This reform journey is further explored in section 8.

Chinese SOEs go global: implications and opportunities for Australia

Global investment is a relatively new phenomenon for Chinese companies. In recent years, China's ODI has increased rapidly as China's largest firms venture beyond China's borders for the first time.

SOEs were the first Chinese companies that traded with international suppliers, but over time have evolved in financial strength and confidence to seek other investments overseas. Their initial investment focus was in developing countries on the African, Middle Eastern and Latin American continents and then to developed countries, initially including Australia, which became a test case for Chinese SOEs.

18 <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Economic-Roundup-Issue-2/Economic-Roundup/Chinas-unfinished-SOE-reforms>, accessed 1/06/2014

19 The 113 central SOEs in China are listed in SASAC website: <http://www.sasac.gov.cn/n2963340/n2971121/n4956567/4956583.html>

20 Sources:
2013年国企利润2.4万亿元, 经济日报, 2014年1月22日, http://paper.ce.cn/jjrb/html/2014-01/22/content_185947.htm;
2013年全国财政收入12.9万亿完成全年预算目标, 人民网, 2014年1月23日, <http://finance.people.com.cn/n/2014/0123/c1004-24208617.html>;
2013年中国企业500强排行榜(完全名单), 中国经济网, 2013年7月16日, http://www.ce.cn/xwxz/gnsz/gdxw/201307/16/t20130716_24577361.shtml

21 <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Economic-Roundup-Issue-2/Economic-Roundup/Chinas-unfinished-SOE-reforms>, accessed 1/06/2014

22 According to the National Bureau of Statistics, in 2012, there were almost 160,000 SOE legal entities, <http://data.stats.gov.cn/workspace/index?m=hgnd>; accessed 1/06/2014

As China's companies mature in their abilities and confidence to conduct business internationally, we will witness the next major chapter in China's growth story. This will be driven by China's emerging multinationals – well-funded and looking to acquire the resources they need to become globally competitive and better able to serve the evolving needs of the Chinese economy and rising middle class consumers.

A selection of Chinese SOE global investments 2012-2014

Year	Activities	Country	Sector
2014	A consortium of industrial partners including EDF, AREVA, China General Nuclear Corporation (CGN) and China National Nuclear Corporation (CNNC) to invest in GBP 16 billion Hinkley Point C nuclear power station	UK	Nuclear power station
2014	COFCO bought 51 percent of Nidera BV for a possible sum of USD 1.2 billion	Netherlands	Food
2014	China's Dongfeng Motors and the French government will each invest about EURO 800 million in PSA Peugeot Citroen in return for 14 percent stakes	France	Car manufacturing
2013	CNOOC bought Nexen Inc for USD 15.1 billion	Canada	Oil and gas
2013	Sinopec formed joint venture with Chesapeake, acquiring 50 percent of Chesapeake's share gas property in northern Oklahoma for USD 1.02 billion	US	Oil and gas
2013	Sinochem bought 40 percent stake in Texas oil-shale acreage from Pioneer Natural Resources Co (PXD) for USD 500 million	US	Oil and gas
2012	Bright Food acquired 60 percent of Weetabix for GBP 1.2 billion	UK	Food
2012	State Grid acquired 25 percent stake in REN for EURO 592 million	Portugal	Power grid





Overview of Chinese investment in Australia

4

4. Overview of Chinese investment in Australia

For the past 8 years, Australia has punched far above its economic weight to successfully attract the largest share of Chinese investment. In 2012, Australia and the US were on par, each with a 12 percent share of Chinese accumulated global ODI.²³ However in 2013, Australia narrowly lost its mantle as the world's top destination for Chinese ODI²⁴ to the US.

In 2013, the US attracted 17 percent of Chinese investment while Australia attracted 8 percent. Australia now ranks behind the US but ahead of Canada, Brazil and Britain.²⁵

Top five destinations for accumulated Chinese investment 2005-2013 (USD million)

Country	Total value 2005-2013	Global share (%)
US	59,900	13
Australia	57,250	12
Canada	37,650	8
Brazil	29,180	6
Britain	18,530	4

Source: The Heritage Foundation China Global Investment Tracker Dataset 1

Top five destinations for Chinese investment in 2013 (USD million)

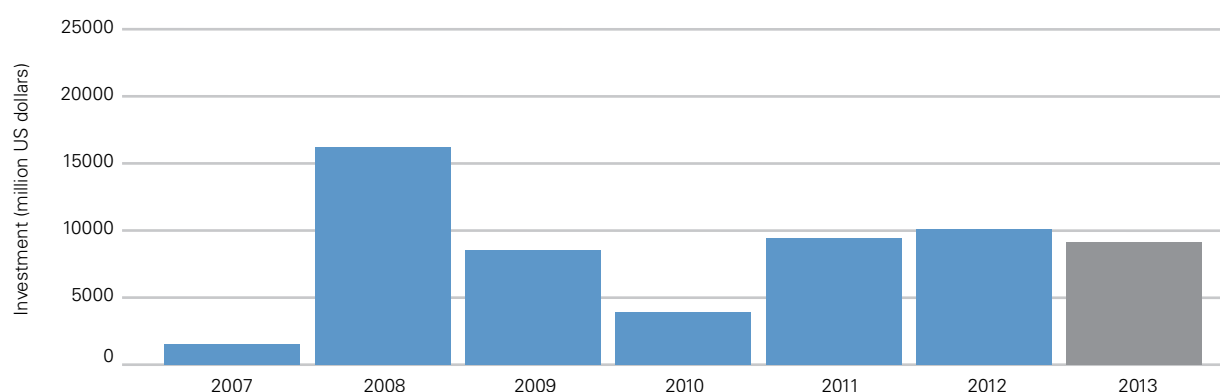
Country	Value	Global share (%)
US	14,550	17
Australia	7,130	8
Guinea	5,950	7
Kazakhstan	5,300	6
Russia	5,170	6
Global total	84,450	-

Source: The Heritage Foundation China Global Investment Tracker Dataset 1

Based on our database, from 2007, an accumulated USD 58.8 billion was invested by Chinese enterprises in Australia, with a total of 182 deals recorded.²⁶ By the end of 2013, China has become Australia's sixth largest foreign investor.²⁷

However, this ranking has to be seen in context. China's accumulated investment stock in Australia only accounts for 3 percent of the total FDI.²⁸ Nevertheless, Chinese investment has shown a long-term growth trend and has the potential to becoming one of the key sources of new investment capital for Australia.

Chinese investment in Australia by year, 2007-2013



Source: KPMG/University of Sydney database

²³ KPMG/University of Sydney, 2014, Demystifying Chinese Investment in Australia, March 2014 Update.

²⁴ Based on Heritage Foundation figures for accumulated Chinese investment, 2005-2013; and also year-on-year figures for Chinese investment in Australia 2012 versus 2013 from KPMG/University of Sydney database analysis.

²⁵ <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map> Chinese Investment Tracker 2014, Dataset 1, accessed 26 Feb 2014, 6.40pm

²⁶ KPMG/University of Sydney, 2014, Demystifying Chinese Investment in Australia, March 2014 Update.

²⁷ Australian Bureau of Statistics, 2014, 53520 – International Investment Position, Australia: Supplementary Statistics, 2013.

²⁸ Australian Bureau of Statistics Cat. No. 53520 – International Investment Position, Australia: Supplementary Statistics, 2012 (Released 2 May 2013); Table 2. Foreign Investment in Australia: Level of Investment by Country and Country Groups by type of investment and year; Austrade

Chinese SOE investment in Australia

Between 2007 and 2013, SOE investors contributed approximately 90 percent of the total value of Chinese ODI.²⁹ Although there is an increasing trend of investments by private Chinese enterprises in recent years, SOEs still accounted for 89 percent of total ODI value between 2007 and 2013. By number of deals, they have accounted for 67 percent of the Chinese investment deals in Australia over the last 8 years.³⁰

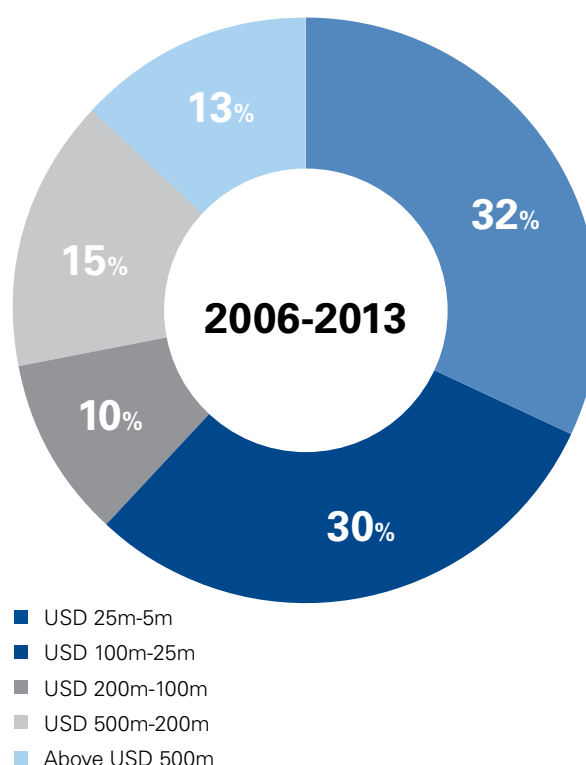
Deals by ownership from 2007 to 2013 in Australia

Ownership	Investment value (US million)	%	no. of deals	%
SOE	52,254.87	89	122	67
Private	6,570.91	11	60	33
Total	58,825.78	100	182	100

Source: KPMG/University of Sydney database

Chinese investment in Australia is characterised by a small number of very large deals

Deal size analysis 2006-2013 by number of deals



Source: KPMG/University of Sydney database

One feature of the fast growing Chinese direct investment is the size of SOE investment in capital intensive sectors such as resources, energy and utilities. These sectors require high levels of initial capital outlay and the projects often involve longer investment cycles and higher investment risk.

Given 13 percent of these deals have an investment value higher than USD 500 million, Chinese SOEs have attracted a lot of public attention, particularly because of their state ownership structure.

29 KPMG/University of Sydney, 2014, Demystifying Chinese Investment in Australia, March 2014 Update

30 KPMG/University of Sydney, 2014, Demystifying Chinese Investment in Australia, March 2014 Update

A selection of major Chinese SOEs in Australia

Company name	Ownership state owners	Other owners	Australian projects				
			Managing owner	Listed	Name	Date	Accumulated equity
Sinopec Corp.	75.84%	19.35% +4.81%	Sinopec Group (SASAC 100%)	HK, NY, London, Shanghai	Australia Pacific LNG	2011	15%
						2012	25%
					AED Oil	2008	60%
Minmetals Resource Ltd	71.56%	28.44%	China Mimetals Corp. (SASAC 100%)	HK	Havilah Resource	2011	< 5%
					Anvil Mining Ltd	2012	100%
					OZ minerals Ltd	2009/10	
Yanzhou Coal Mining Company (Yancoal Australia)	52.86%	47.14%	Yankuang Croup (Shandong SASAC 100%)	HK, NY, Shanghai	Felix Resources	2009	100%
					Syntech Resources	2011	100%
					Gloucester	2012	78%
China Merchants Group	100%	0.00%	China Merchants Group (SASAC 100%)	N/A	Loscam Ltd	2010	< 100%
PetroChina Company Ltd	86.5%	13.50%	China National Petroleum Corp. (SASAC 100%)	HK, NY, Shanghai	Arrow Energy	2010	100%
Shanghai Tangjiu Group	100%	0.00%	Bright Food Group (Shanghai SASAC 100%)	N/A	Manassen Foods Group	2011	75%
Taurus	100%	0.00%	Guangdong Nuclear Power Group (SASAC 100%)	N/A	Extract Resources	2012	100%
Sinosteel Corp.	100%	0.00%	Sinosteel Corp (SASAC 100%)	N/A	Midwest Corp.	2008	100%
China Metallurgical Corporation Mining Pty /Holding Pty Ltd	64.2%	35.82%	Metallurgical Group Corp. (SASAC 100%)	HK, Shanghai	Western Australia SINO Iron Ore Project		
Chinalco (Shinning Prospect Pte.Ltd)	100%	0.00%	Chinalco (SASAC 100%)	N/A	Rio Tinto	2008	9.3%
						2009	9.8%
China Datang Corp Renewable Power Co	88.4%	11.60%	China Datang Corp. (SASAC 100%)	HK	CBD Energy Ltd	2011	63.75%

Source: KPMG/University of Sydney, 2012, Demystifying Chinese Investment in Australia: Update August 2012

Chinese SOEs have participated in some of the largest investments into Australia's mining, gas and power sectors, playing an important role in the mining boom that underwrote Australia's prosperity during the post GFC era.

The five largest investments include:

1. **CITIC Pacific's Sino iron ore project in WA** (since 2006): Approximately USD 9.9 billion. CITIC Pacific is a Hong Kong listed company with controlling SOE investment from CITIC Group. Sino Iron is the largest Chinese iron ore mining project globally.
2. **Minmetals/MMG non-ferrous** (since 2009): USD 2.8 billion. MMG has since listed in Hong Kong.
3. **Yanzhou Coal** (since 2004): USD 6 billion. The largest independent coal mining company in Australia, listed on the ASX (but currently in the process of delisting and privatising). Yancoal introduced Chinese deep wall underground mining technology to Australia.
4. **State Grid electricity transmission** (since 2011). The largest power utility in the world and now the largest foreign investor in South Australia and Victorian electricity transmission sectors.³¹
5. **CNOOC LNG** (2003). This was the first joint Australia/China LNG contract signed, secured by a AUD 25 billion, 25 year gas trade supply contract to China.³²

The early pioneers of Chinese SOE in Australia were Sinosteel, Chinatex and Bank of China.

- Sinosteel's investment with Rio Tinto in the Channar Iron Ore project was the first major Chinese SOE investment in Australia and the first overseas Chinese mining project. It was signed in 1987 after being negotiated by the then Prime Minister Bob Hawke and Chinese Premier Zhao Ziyang.³³
- Chinatex made its first cotton sector investment in NSW in 1987 in Moree.³⁴
- Bank of China (BOC) was the first Chinese SOE Bank to operate in Australia. BOC had previously been in Australia before the Communist Government came to power in 1949³⁵ but re-activated its APRA banking license in 1992.³⁶

The respective roles and advantages of China's SOE and private investors are likely to change over coming years as new sectors such as infrastructure, real estate, agribusiness and services further open up for foreign investment.

An examination of two of the recently active sectors for Chinese investment into Australia provides a helpful insight into the underlying drivers and changing focus of Chinese ODI activity.

Mining and Gas

Since 2007, investments in Australia's mining and gas natural resources have dominated the country's inbound investment from China, accounting for 81 percent of total Chinese investment.³⁷ This investment has been driven by China's need for large-scale natural resources to fuel its domestic economic growth.

In 2013 for the first time, Chinese investment in Australia was not concentrated in the mining sector. The recent 2013 downturn is a reflection of China's moderating growth trajectory and focus on quality and sustainable development, along with decreased reliance on fixed asset investment to drive growth and meet GDP targets.

Agriculture

Agriculture modernisation and food security are top priorities in China's 12th Five-Year Plan. Urbanisation trends, environmental degradation, changes in dietary preferences to include higher levels of protein, and a growing and more discerning middle class collectively mean that China needs to produce more and higher-quality foods using less land, and with fewer farmers.

Viewed against this background, ODI and international cooperation are certainly part of the solution to modernise China's agriculture industry and gain access to safe and reliable food sources.

31 Maiden, M 2013, 'China's State Grid powers up in Australia', *Sydney Morning Herald*, 18th May 2013

32 Priestley, M 2010, 'China's reliance on Australian LNG exports', *Parliament of Australia*, 6th January 2010

33 Sinosteel Australia 2013, 'Corporate Overview', *Sinosteel Australia Pty Ltd*

34 KPMG Analysis

35 Packer, J 2013, 'Address To Asia Society', Speech presented at The Asia Society, 14th March 2013

36 KPMG Analysis

37 KPMG/University of Sydney, 2012, database

Australia is uniquely positioned to help China address its food security goals. We can provide both a supply of high quality, premium, and safe foods for exports; and be a source of technology acquisition targets or China market entry opportunities for Australian agricultural technology companies that have products that can enhance domestic production. An example of Australian agricultural technology, of direct relevance to China, is drought-tolerant crops.

Examination of China's recent investments in Australian agriculture shows that between 2007-2012 there have been only 10 completed transactions with a total value of just over AUD 1 billion, and Chinese investors may own less than 1 percent of Australian productive farmland. Chinese investors are primarily interested in food processing and securing high quality, semi-processed foods for export, rather than owning large tracts of farmland. This is consistent with our view that China's FDI into Australia is motivated by commercial goals, rather than potential geopolitical interests.³⁸

In 2014, major investment continues

The first half of 2014 has seen continued Australian investment by Chinese SOEs, including:

- China Merchants Group 50/50 joint venture with Hastings Funds Management to secure a 98 year lease over the Newcastle Port facilities for USD 1.6 billion.
- Guangdong Rising Asset Management's (GRAM) USD 1.4 billion bid for PanAust Mining.
- Baosteel and Aurizon's joint USD 1.3 billion bid for Aquila Resources.

Summary

Chinese SOE investment in Australia has been a driving force in the mining boom. Diversification of investment into new sectors should see the Chinese private sector become far more active, however Chinese SOEs will remain the key investors for large scale mining, gas, power and infrastructure projects.

³⁸ For a detailed discussion on China's ODI into the Australian market, please see: 'Turning point for Chinese investment into Australia' <http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/china-insights/Pages/demystifying-chinese-investment-in-australia-march-2014.aspx>





A close-up, slightly angled view of the Australian flag, showing the Union Jack in the upper left and the seven-pointed star in the lower right. The flag's colors are red, white, and blue.

Chinese SOE integration in Australia

5

5. Chinese SOE integration in Australia

Having assessed the scope of Chinese SOE direct investment in Australia, we now analyse the investment motivations, strategies, governance and operational behavioural characteristics of Chinese SOEs that have invested in Australia.

Our objective is to specifically consider how these Chinese SOEs are conducting themselves in Australia and to compare and contrast these observable trends to the experiences of other multi-national companies investing and operating in Australia. We cite examples and case studies of the rapidly evolving localisation strategies being pursued by these SOEs. These companies are gradually learning about local market conditions, from past experiences of other pioneering Chinese investors and the strategies of other MNCs. Meanwhile most are still maintaining characteristics that are common for Chinese SOEs.

Our sample is drawn from a total of 58 Chinese SOEs which have invested USD 52.26 billion across 122 deals directly into Australia's mining, gas and power sectors since 2007.³⁹

These 23 (listed opposite) are among the largest and most established global SOEs in Australia and therefore an appropriate base for analysis. Of the Chinese SOEs analysed in our sample, 16 completed investments from 2007 to 2013.

We specifically profiled each SOE company across multiple criteria including:

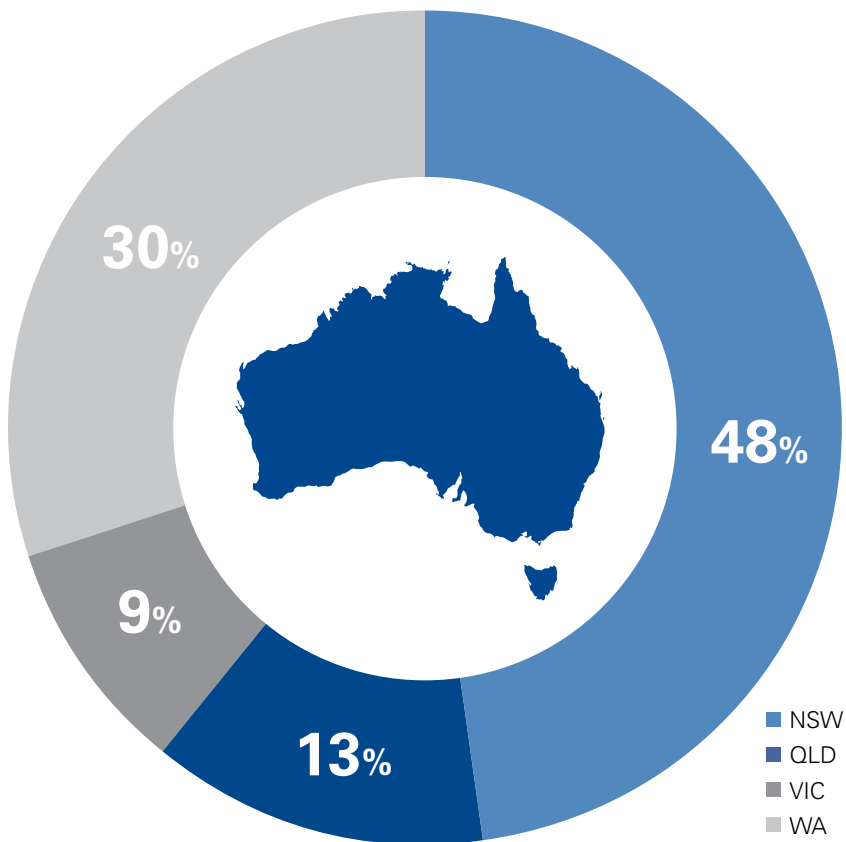
1. size of investment and level of experience operating in Australia
2. investment strategies, motivations and structures
3. decision making and approach to governance
4. management and employment profiles
5. compliance with Australian laws and regulations.

Chinese SOEs analysed in this report

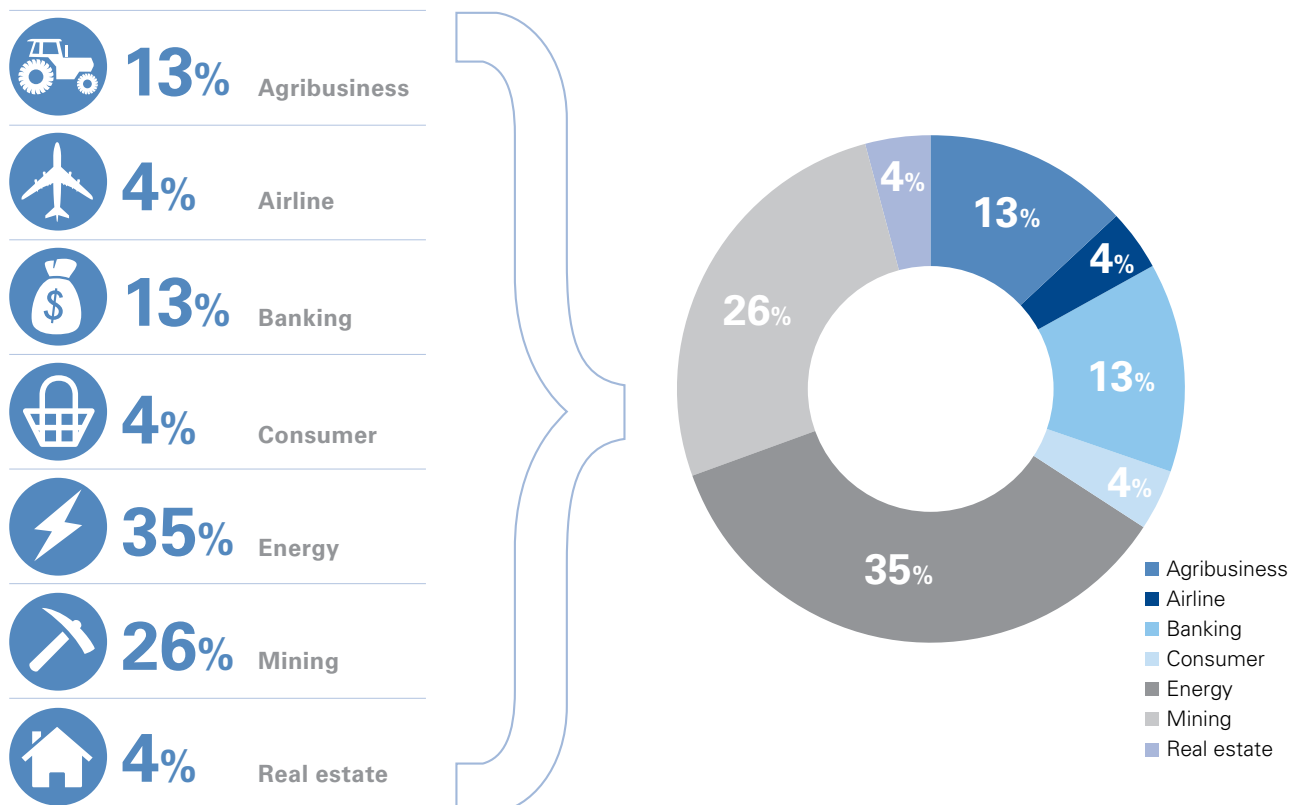
SOE company name	Prime industry sector	State
Yancoal	Mining	NSW
Shenhua	Energy	NSW
CITIC Pacific	Mining	WA
Sinosteel	Mining	WA
Ansteel	Mining	WA
Minmetals	Mining	VIC
Zijin	Mining	WA
CNOOC	Energy	WA
Petrochina	Energy	QLD
Sinopec	Energy	QLD
State Grid	Energy	NSW
Huaneng	Energy	QLD
Shenhua Energy	Energy	NSW
Datang	Energy	NSW
COFCO	Agribusiness	WA
Chinatex	Agribusiness	NSW
Bright Foods	Agribusiness	WA
Greenland	Real estate	NSW
Hisense	Consumer	VIC
Bank of China	Banking	NSW
ICBC	Banking	NSW
CCB	Banking	NSW
China Southern	Airline	NSW

39 KPMG/University of Sydney, 2012, database

Geographic distribution of the sample 23 SOE investments



Industry sector distribution of the sample 23 SOE investors



Investment strategies, motivations and structures

Investment motivations vary according to industry and company.

From the first Chinese mining investment in 1986 (Sinosteel Channar) and gas sector investment in 2003 (CNOOC LNG), there has been a range of investment project outcomes and some painfully expensive lessons have been learned by Chinese SOEs on Australia projects.

Beyond securing resource supply through integrated investment, Chinese SOEs are motivated by a range of strategies including:

- *Global profit seeking*
State Grid transmits and distributes electricity to domestic South Australian and Victorian markets seeking higher returns in overseas markets than currently made in China. Following its investment in Electranet in 2011, State Grid received FIRB approval in December 2013 to invest in SP Ausnet and Jemena, effectively replacing Singapore Power's interest.⁴⁰
- *Consumer market reach*
Hisense import finished electronic appliance products and sell into the Australian market through JB Hi-Fi, Harvey Norman, The Good Guys, Myer, Radio Rentals and others.⁴¹
- *Following Chinese migrants*
Greenland aims to diversify growth beyond China and develop properties which are attractive to Australian investors and migrant Chinese investors, including Chinese foreign students. In March 2013, Greenland acquired a central Sydney property from Canada's Brookfield Asset Management for AUD 100 million and plans to develop it into the Greenland Centre, a AUD 600 million high end boutique hotel and residential tower.
- *Local integration*
Industrial and Commercial Bank of China (ICBC) has offices in Sydney, Perth and Melbourne and successfully obtained a subsidiary retail banking license in 2008 from APRA to offer both corporate and retail lending and private wealth services to offshore Chinese and Australian customers. ICBC is looking to partner with local wealth management firms and become a major player in the sector.

- *Strategic expansion*

BOC has been present in Australia's corporate lending market since 1992 and now has nine local branches. BOC recently created and launched a joint venture with the ASX Group to offer offshore RMB settlement services. This will further help Australia become a RMB trading hub.

- *Enabling tourism growth*

China Southern Airlines has been established in Australia since 1997⁴² and now operates nearly 50 return flights per week between Australia and Guangzhou.⁴³ China Southern established its pilot flying college in Perth in 1993 and invested over AUD 50 million in flight simulators, plant and equipment to train all pilots and crew.

- *Brand acquisition*

Bright Food made its platform acquisition of Manassen Foods, an Australian food producer with a portfolio of 70 famous consumer brands⁴⁴ including Ryvita, Bovril, McVities, Sharwoods, Trident and Sunbeam, which are now distributed through the parent group's 60,000 retail outlets throughout China.⁴⁵ Manassen also provides the platform for future inorganic growth in Australia and further distribution of Bright Food's portfolio of products.

These examples show Chinese SOE investors think strategically with diversified agendas when investing offshore.

Andrew Michelmore, CEO of MMG Limited, speaking at a Lowy Institute event in September 2013 said,

"Success in acquisitions is being redefined to mean much more than simple ownership control. Generating value is now firmly at the heart of the 'going out' approach. The tenets of strong due diligence, good corporate governance, appropriate risk weighting and return on invested capital are now firmly part of the China lexicon."

Preference for control

One characteristic often cited in relation to Chinese SOEs is a strong preference for controlling stakes in their target companies or greenfield projects. Based on the 23 companies analysed, 19 held majority stakes in one of more Australian companies. Chinese companies prefer to control their offshore investments where possible to control key decision making. It also enables the investment to be consolidated on their

40 Maiden, M 2013, 'China's State Grid powers up in Australia', *Sydney Morning Herald*, 18th May 2013

41 Hisense 2013, 'Hisense Expands Retail Distribution in Australia', *Hisense Press Releases*

42 SAI Global 2014, 'ASIC Report – Current Extract – China Southern Airlines Company Limited', *SAI Global Property Search Manager*

43 China Southern Airline 2013, 'China Southern's A380 Arrives Down Under', *Media Release – Australia/New Zealand Region*, China Southern Airlines

44 OOI, T 2011, 'China's Bright Food hungry for more Australian mergers', *The Australian*, 30th August 2011

45 ibid

balance sheet suiting Chinese companies' preference to measure themselves on asset size, total revenues and market share.

This approach is quite different to the approach taken by Japanese, South Korean and Singaporean investors who have shown a preference or willingness to take minority positions and either learn and increase their shareholding over time hold the minority position.

In more recent transactions, this trend may be changing as Chinese SOEs either have difficulty in negotiating controlling positions or seek to take a minority position in mature, well managed Australian companies. This allows them to gradually learn about the company and the local market conditions before seeking to increase their shareholding. In 2013, State Grid acquired Singapore Power's minority position in SP Ausnet but at the same time, acquired their majority stake in the unlisted Jemena. Meanwhile passive investments are held by Huaneng Power (OzGen BV)⁴⁶ and Shenhua Clean Energy (Hydro Tasmania).⁴⁷

Financing structure

Chinese SOEs have demonstrated a willingness to invest 100 percent equity in smaller to mid-sized Australian targets. However for the major mining, gas and power (and future infrastructure) sector projects, Chinese SOEs require significant debt funding, similar to all players in those situations. Without access to very large and affordable debt facilities, these mega sized mining and gas projects, which require significant up-front capital expenditure before the economic benefits flow, would not be able to go ahead.

Chinese SOEs borrow from both banks under State Council leadership, such as the China Development Bank and Export-Import Bank based in China, and/or the offshore subsidiaries of the Big Four Chinese SOE Banks: Bank of China (BoC), Industrial and Commercial Bank Of China (ICBC), China Construction Bank (CCB) and Agricultural Bank Of China (ABC).

These banks are APRA regulated and competing in the Australian market not only to serve their very important mainland Chinese client relationships on major investments but also to lend to Australian borrowing clients.⁴⁸

Australian banks are lending to major Chinese SOEs for project finance and corporate facilities. Based on public records, ANZ is a syndicate lender in MMG's capital structure.⁴⁹ They are also involved in the capital structure of Yancoal.

Decision making and approach to governance

Given the obvious language and cultural differences, Chinese SOEs prefer senior Chinese speaking executives, who understand the company's cultural and decision making process, to fill the most senior executive positions in the investments they control in Australia. This is very similar to other Asian investors, including the Japanese, South Koreans and Singaporeans.

Chief Executive Officers/ Managing Directors

The Chinese SOEs are similar to Japanese and South Korean investors in requiring senior board and management positions to be held by country nationals. This is globally consistent.

Despite this, we noted that of the 23 companies analysed, the following had Australian CEOs: Minmetals (MMG), COFCO (Tully Sugar), Yancoal, Bright Foods (Manassen Foods), State Grid (Electranet, SP Ausnet and Jemena), Huaneng and Shenhua Clean Energy.

Andrew Micheltmore, CEO of MMG Limited, speaking at a Lowy Institute event in September 2013 said:

"I stand here before you today as the CEO of a vibrant international mining company with significant Australian and international asset, majority owned by one of China's largest state owned enterprises. We represent a new and unique model of Chinese investment with the management of cultural diversity and local participation at its core. As a chief executive who has worked with many boards and shareholder structures across cultures, I can say at MMG we are blessed. We share a robust debate on strategy, an international vision for growth and the support of an investor with a long term horizon".

46 ChinaHuaneng 2003, 'Huaneng OzGen B.V.', *Overseas Projects, International Cooperation, China Huaneng*

47 Hydro Tasmania 2012, 'Woolnorth wind farm partnership finalised', *Current News, About Us, Hydro Tasmania*
Hydro Tasmania 2012, 'Musselroe wind farm agreement signed', *Current News, About Us, Hydro Tasmania*

48 Henshaw, C and Holye, R 2012, 'China's Banks Target Australia', *The Wall Street Journal*, 26th January 2012

49 Capital IQ Company Snapshot: MMG Capital Structure FQ2 2013, FY 2012

The remainder of the companies analysed are led by Chinese CEOs who increasingly have English speaking skills and an understanding of our local culture.

However, there is still a perception that Chinese SOEs don't network enough with business communities or communicate as frequently or openly with media as western executives. This remains a key area of further improvement. However, it should be understood that in Chinese culture there is a reluctance to talk publicly about sensitive and confidential matters. Most recently, the Chinese Chamber of Commerce (CCCA) in Australia has appointed as Chairman a very senior Chinese banking Managing Director with strong English skills. To encourage better integration he is arranging more joint Australian-Chinese industry networking events.

Several Chinese SOEs have hired Chinese-Australians into senior management roles, such as the MD of CITIC Securities, who has deep local experience and industry relationships. Others, such as Shenhua Australia have successfully retained former senior Chinese diplomats into the executive rank of chairman.

Chinese companies in the past regularly rotated their senior executives on formal postings and there was a strong sense by many mid-level Chinese executives working for SOEs that brighter career paths and better family life ultimately lay back in China. This is changing as the opportunity to work, live and raise families in Australia becomes increasingly attractive. However, performance is very formally assessed and these CEOs are held accountable for the success or failures of their investments, project delivery and long-term profitable growth. In the past 3 years, we have seen several very senior Chinese executives replaced.

Professor Zha Daojong,⁵⁰ the inaugural Lowy Institute Rio Tinto Fellow, stated in his February 2013 report:

"An SOE executive has certain performance indicators such as earning a profit, improving the technical and managerial skills of his team and establishing a positive reputation for his/her company... The movement of SOE executives between SOE and government roles leads some foreign observers to suspect executives of being party agents. There is indeed a revolving door in place."

But for an SOE executive to be successful on the job abroad, he/she must play by the rules". He went on to say, *"Chinese government regulators conduct reviews of profit generation of investments according to a fixed timeline. This is a source of pressure on those executives who initiated and/or are managing investment projects abroad".*

The senior management rotation trend will continue just as it has always done for foreign expatriate executives, however the newly appointed senior executives appear to be better trained and prepared for local Australian conditions. Many have been educated at prestigious tertiary institutions in the US, UK or Australia.

Other than the replacements referred to above, the majority of Chinese SOEs analysed had stable CEOs in place over the past 3 to 5 years, consistent within most large corporations.

Board composition and decision making

These CEOs normally report to the local boards of the Australian companies and also to headquarters in China. Local operating decisions are increasingly made in Australia while major investment, financing and contract decisions are made in China, but with significant input and involvement from local CEOs. This justifies the ongoing importance of Chinese language skills and explains the regular travel for these executives between Australia and China.

Some examples of Chinese invested company boards which feature diversified director composition include:

Yancoal (Gloucester)

Of the 11 directors, seven are Chinese and four are Australian. The chairman is also the chairman of the SOE parent, Yukuang. He is supported by three vice Chairman, two of which are Chinese and one is Australian. The remaining Directors are a mix of executive and independent non-executives with very deep industry backgrounds and a former Australian Ambassador to China.⁵¹ The Audit Committee is chaired by an Australian who is an ex Big Four accounting partner.⁵²

Yancoal's CEO, Regional General Managers for NSW, Queensland, WA and Chief Development Officer are all Australian. All seven of the mining subsidiary general managers are Australian. The CEO is Australian.

Bright (Manassen Foods)

Bright Foods acquired 75 percent of Food Holdings Pty Limited (Manassen Foods) for AUD 516 million in August 2011⁵³. Of the 10 directors, four are Chinese and six are Australian.⁵⁴

COFCO (Tully Sugar)

Of the six directors, only two are Chinese. The CEO and executive team are all Australian.⁵⁵

50 Zha, D 2013, 'Chinese FDI in Australia: drivers and perceptions', Lowy Institute, 27th February 2013, pp.7

51 Yancoal Australia Limited – Company website

52 ibid

53 Burkitt, L and Koons, C 2011, 'Chinese Food Company is Poised for major Acquisition', *The Wall Street Journal*, 16th August 2011

54 SAI Global 2014, 'ASIC Report – Current Extract – Food Holdings Pty Ltd', *SAI Global Property Search Manager*

55 Tully Sugar Limited – Company website

Management and employment profiles

On initial investments, Chinese SOEs prefer to bring out larger teams of Chinese management. The mix between Chinese and Australian management is rapidly changing as Chinese learn the importance of retaining and empowering local Australian management, coupled with the cost and complexity of bringing Chinese expatriates into Australia. Management teams for COFCO (Tully Sugar) and Bright Food (Manassen Food) are mostly Australian. The Chinese banks are also increasingly hiring Australian banking professionals into very key risk, regulatory compliance and operational roles.

The Chinese SOE invested companies and projects employ very large numbers of Australian FTEs and contractors, making a very personal and meaningful contribution to Australia's economy and social well-being. In total, those 23 Chinese SOEs employ more than 5,000 Australian FTEs plus contractors.

In terms of FTEs, CITIC Pacific Mining employed over 1,000 people at its peak, plus contractors. Bright Food (Manassen) employs 900 FTEs, Yancoal and MMG both employ over 500 FTEs plus contractors, Zijin (Norton Goldfields) over 300 FTEs plus contractors, COFCO (Tully Sugar) 200-300 people depending on the season and the three established Chinese banks together employ approximately 500 FTEs.

Compliance with Australian laws and regulations

Once the investment has been formally approved and completed, Chinese SOEs are subject to the same legal and regulatory landscape as all companies, executives and directors that operate in Australia. The investors accept this and are expected to be fully compliant.

Chinese SOEs are expected by their parent shareholders to be compliant and 'good ambassadors'. In his Lowy Institute report, Professor Zha Daojiong⁵⁶ cited one unnamed Australian mining executive as saying, *"a Chinese SOE executive is fully aware that his company's performance will be reviewed as reflective of his country and even government"*.

Based on observations of the 23 Chinese SOEs analysed, all hire reputable accounting and legal firms in Australia to help understand and comply with local laws and regulations and most appear to be building in house risk and compliance capabilities.⁵⁷

While there is some public record of a small number of high profile legal disputes between shareholders and there may be isolated examples of orderly negotiations with Treasury/FIRB (potential

Yancoal delisting⁵⁸), ASIC, ASX, APRA, ATO, EPA, industrial relations and various authorities, to the best of our knowledge based on public research, to date there is no record of major public scandals involving illegal activities involving Chinese SOEs in Australia. This includes fraud, tax evasion, environmental pollution or work safety breaches.

Social integration

There are some great examples emerging of Chinese SOEs engaging in corporate citizenship projects, such as Shenhua Watermark's AUD 5 million commitment⁵⁹ (AUD 4 million invested⁶⁰) into a range of community activities and assets in Gunnedah.

At the initial stages of the mining project, there were public concerns from the local community about the environmental impacts of the proposed project. In response, Shenhua established three Community Reference Groups (CRGs) to work directly with the project teams to ensure all community and environmental issues and concerns were identified and assessed in the Environmental Impact Study (EIS).

Shenhua also commenced the Shenhua Watermark Community Fund, investing AUD 4 million in the Gunnedah and Liverpool plains community across arts, sport, health, tourism and recreation. Shenhua has recently published a very comprehensive community stakeholder relations report which explains their approach in detail.

Some Chinese companies have adopted a similar approach to other international investors by sponsoring sporting arenas (Hisense Arena in Melbourne) and sporting teams (Liugong: Balmain Tigers – now ceased).

Summary

Chinese SOEs are still very new investors in Australia which is a mature and highly regulated developed economy and fundamentally different to their home market. As such, their level of experience is still quite low relative to American, British, Japanese and South Korean investors who have at least a 20 to 30 year head start.

Chinese SOEs are learning from past experiences and gradually adapting their approach to suit local market conditions.

⁵⁶ Zha, D 2013, 'Chinese FDI in Australia: drivers and perceptions', Lowy Institute, 27th February 2013, pp.6

⁵⁷ KPMG database

⁵⁸ Hoyle, R 2013, 'Yanzhou Coal Plans Yancoal Australia Buyout Offer', *The Wall Street Journal*, 9th July 2013

⁵⁹ Shenhua Australia 2011, 'Shenhua Finalist for Industry's top Honour', *News, Shenhua Australian Holdings Pty Limited*, 28th October 2011

⁶⁰ Shenhua Australia 2011, '\$4 million Invested in Local Community Thanks to the Watermark Community Fund', *News, Shenhua Australian Holdings Pty Limited*, 3rd October 2011

WELCOME
TO
COCKLES
POPULATION

8 PEOPLE

3 Dogs

30 BUDGIES

3 QUAILS - 9 EGGS last count

1 COCKATIEL - THAT WOLF
WHISTLES

1000,000,000 KANGAROOS



Chinese SOE perceptions of investing in Australia

6

6. Chinese SOE perceptions of investing in Australia

The following summary of key perceptions by Chinese investors in Australia is derived from a sample survey conducted by KPMG and the University of Sydney with Chinese senior managers in charge of investment projects in Australia during the period from March to May 2014. We received a total of 51 completed responses, of which 31 responses were from Chinese SOE managers.

Of the 31 Chinese SOEs to complete surveys, 21 represented central SOEs and 10 were from local SOEs. These companies have invested in a variety of areas, ranging from agribusiness and construction to resources, energy and renewable energy.

Based on their responses, we have a number of key observations:

Commercial motivations

Rather than being politically driven, respondents indicated they are driven by commercial factors to invest in Australia just as other MNCs. The top three motivations for Chinese SOE managers in investing in Australia are making profits, securing resources, and access to global markets.

Post investment integration

Chinese SOE executives understand it is very important to protect the environment and work with local employees and trade unions. They are also aware they need to be good corporate citizens to operate in the Australian market.

Integration remains a challenge for Chinese SOE executives with problems cited in corporate governance, industrial relations and working effectively with Australian employees. Faced with unfamiliar issues, Chinese SOE executives aspire to majority control, giving them greater control over operations, and prefer takeovers as opposed to joint ventures as an entry strategy.

The cost of doing business in Australia is seen as higher compared to Canada and the US. Chinese SOEs estimate that in Australia overall business costs are 30 percent higher than in the US and current infrastructure constraints are limiting Chinese investment.

Institutional support

The majority of Chinese SOE executives state that they need more information from government and the private sector about investment opportunities in Australia.

While Chinese SOE executives find that governments at all levels and the business sectors in general are supportive towards their investment, they disagree with the statement that 'Australian media are supportive to Chinese investors'.

The majority of Chinese SOE executives feel welcome to invest in Australia, however, they feel Australia is more welcoming to investors from other countries than to Chinese investors.

FIRB approval issues

Chinese SOE executives feel that approval of foreign investment projects is becoming faster and easier.

The majority of Chinese SOE executives state that investment approvals should be decided on commercial merits not on ownership.

Summary

The survey respondents see integration in the Australian economy as a continuing challenge. The survey indicates a need for greater pre-investment preparation and post-investment support for integration in Australia.



Chinese company, Goldwind International Holdings (HK) Ltd, is the world's second largest manufacturer of wind turbines. Picture shows the first wind farm of its Australian subsidiary, Goldwind Australia Pty Ltd, at Morton Lane in Victoria.





Australian perspectives on Chinese investment

7

7. Australian perspectives on Chinese investment

Based on accumulated FDI records from the Australian Bureau of Statistics (ABS), China with a 3 percent share ranks well behind the US (24 percent), UK (14 percent), Japan (10 percent) and Singapore (4 percent). This fact is not well known by Australians based on the annual Lowy Institute and the Kreab Gavin Anderson's (KGA) poll and survey findings.⁶¹

Australians have benefited enormously from trade and investment from Chinese SOEs. In the 2012 Lowy Institute poll of approximately 1,000 Australian adults, 70 percent of respondents credited the "demand for Australian resources from countries like China... as a major reason why Australia managed to avoid a recession".⁶²

This was similarly noted in the KGA survey which found that 64 percent of respondents ranked China as Australia's most important economic partner, ahead of Japan (9 percent), US, India, UK and Indonesia (all 3 percent).⁶³

Australians are clearly supportive of increased bilateral trade, yet there remains genuine resistance and concern about Chinese SOEs motives for investment, particularly in relation to controlling stakes and investment in Australia's agricultural land.

The 2014 Lowy poll found that 56 percent of Australians still consider that the "Australian Government is allowing too much investment from China", slightly better than 57 percent in 2013. Meanwhile 34 percent felt the Australian Government was allowing about the right amount of investment from China (down from 42 percent in 2009), so negative perceptions still persist.⁶⁴

KGA's survey found that "nearly 70 percent supported the acquisition of profitable, but not controlling, interests in Australian companies by Chinese investors".⁶⁵ Further, while half of the respondents thought that Chinese companies (i.e. SOEs) should be treated no differently from other foreign investors in terms of FIRB review standards, "nearly 80 percent thought Australia was well within its rights to place limits on Chinese investment that were deemed contrary to national interests".⁶⁶

China/Japan/South Korea

The 2014 Lowy poll revealed a positive change in sentiment towards China with 31 percent of Australians saying China is "Australia's best friend in Asia" ahead of Japan at 28 percent. In the same survey, Australian's feelings towards China warmed to the highest levels in 10 years at 60 degrees in the 'thermometer ratings' but behind Japan at 67 degrees which appears inconsistent to the 'best friend' ranking result.

The well recognised deficiency in Australia's infrastructure funding has been estimated to be as high as AUD 760 billion⁶⁷ and there is a clear recognition that foreign investment from Japan, South Korea and China will be necessary to enable Australia to deliver these infrastructure projects. Sixty five percent of Lowy respondents in 2013 felt that it was either very important (22 percent) or somewhat important (43 percent) that the Australian Government should do more to attract Asian investment into Australia.⁶⁸ This finding reveals that Australians are generally welcoming of foreign investment from Asian companies.

Australia is ranked as the tenth largest foreign investment country destination for Japanese ODI and fourteenth for Korean ODI, ranked below Thailand and the Philippines.⁶⁹

61 Australian Bureau of Statistics Cat. No. 53520 – International Investment Position, Australia: Supplementary Statistics, 2012 (Released 2 May 2013), Table 2. Foreign Investment in Australia: Level of Investment by Country and Country Groups by type of investment and year; Austrade

62 Oliver A 2013, 'Australia and the World – Public Opinion and Foreign Policy', *The Lowy Institute Poll 2013*, Lowy Institute, pp.6

63 Kreab Gavin Anderson 2013, 'Room to Grow – How Chinese investors can make the most of the changing Australian Investment relationship', *Kreab Gavin Anderson Hong Kong*, pp.3

64 Oliver A 2013, 'Australia and the World – Public Opinion and Foreign Policy', *The Lowy Institute Poll 2013*, Lowy Institute, pp.6

65 Kreab Gavin Anderson 2013, 'Room to Grow – How Chinese investors can make the most of the changing Australian Investment relationship', *Kreab Gavin Anderson Hong Kong*, pp.4

66 Ibid, pp.3

67 BCA 2013, 'Decision Time on Infrastructure Funding and Financing', *News Release, Business Council of Australia*, 28th November 2013

68 Oliver A 2013, 'Australia and the World – Public Opinion and Foreign Policy', *The Lowy Institute Poll 2013*, Lowy Institute, pp.26, Table 22

69 Trade Sub-Committee 2013, 'Australia's trade and investment relationship with Japan and the Republic of Korea', *The Parliament of the Commonwealth of Australia*, pp.52, 118

US/China/Australia

Australians perceive the US to be our most important international relationship, with the KGA survey showing 42 percent support for the US versus 19 percent for China.⁷⁰ There is little doubt this reflects very close historical and cultural bonds but it also ties into national security concerns, despite China and Australia never being involved in direct national military conflict. The 2014 Lowy Institute poll found that a significant minority of Australians (48 percent) consider it likely that China will become a military threat to Australia in the next 20 years,⁷¹ up 7 percent from the previous year, perhaps as a result of China's increased regional military activity. The 2013 poll established that 87 percent of Australians believe that Australia's security and defence alliance with the US is 'very' or 'fairly important' for Australia's security. There was a concern that "China might use its ownership of Australian companies as leverage if there is ever a conflict".⁷²

Mr Peter Varghese AO, Secretary of the Department of Foreign Affairs and Trade, made the point in his speech *Mapping the Future* in Feb 2014.

*"There will inevitably be an element of strategic competition between the US and China. But they are also economic partners with an undeniable interest in making sure competition does not slide into confrontation. Each country understands the importance of each other."*⁷³

The US appears to be getting on with its business with China, replacing Australia as the number one country for receiving Chinese direct investment in 2013. The investment by Chinese company Shuanghui into US's Smithfield Foods business was a major indication that the US is also 'open for business'.⁷⁴ In 2011, Vice President Joe Biden said,

"President Obama and I welcome, encourage and see nothing but positive benefit from direct investment in the United States by Chinese businesses and Chinese entities. It means jobs".⁷⁵

Since becoming Prime Minister, Tony Abbott's MP public statements towards Chinese investment have become far more welcoming; reminding all foreign investors that Australia is "open for business".⁷⁶

The commitment and progress made during the inaugural *Australia Week in China* in April 2014 was generally seen by both Australian and Chinese business and political leaders as positive. The comments made at the official gala lunch regarding the Government's views on Chinese and specifically Chinese state owned investment was significant in improving government relationships and helping with negotiations to secure a Free Trade Agreement.

Negative Australian sentiment poll results and political mixed messages are a source of frustration, even disappointment for Chinese officials. One Australian based Chinese diplomat admitted being 'sad' to hear the 2013 Lowy poll suggesting 57 percent of Australian feel there is already too much Chinese investment.⁷⁷ He went on to say such perceptions *"could be harmful to future development if not handled properly"*.⁷⁸

In his departing speech as Chinese Ambassador to Australia at an Asia Society and Australia China Business Council (ACBC) event in 2013, Ambassador Chen Yuming made a subtle reference,

"As a Chinese old saying goes 'sincerity is vital to a lasting friendship'. We need to regard each other as a partner instead of a rival from a strategic perspective".⁷⁹

In an address to The Asia Society in March 2013, Mr James Packer, Executive Chairman of Crown Ltd also addressed the importance of taking greater care in politically driven public statements by our leaders.

*"If I can urge our political leaders across all parties to keep in mind when it comes to the issue of foreign and domestic affairs, the rhetoric we casually throw around is keenly followed throughout the region... some of the recent debate does not reflect well on any of us...even worse it plays on fears and prejudices which is completely unnecessary. We are all better than that. To succeed in China and Asia, we must be better than that."*⁸⁰

70 Kreab Gavin Anderson 2013, 'Room to Grow – How Chinese investors can make the most of the changing Australian Investment relationship', *Kreab Gavin Anderson Hong Kong*, pp.3

71 Oliver A 2013, 'Australia and the World – Public Opinion and Foreign Policy', *The Lowy Institute Poll 2013*, Lowy Institute, pp.6

72 Ibid. pp.7

73 Varghese, P, 'Mapping the Future', Speech presented at Lowy Institute, NSW, 24th February 2014

74 Thomas, D and Oran, O 2013, 'China's appetite for pork spurs \$4.7 billion Smithfield deal', Reuters, 29th May 2013

75 Marchick, D 2012, 'Forecasting Greater Chinese Investment in the United States', *Policy Innovation Memorandum*, No. 13, Council of Foreign Relations

76 Packham, B and Maher, S 2013, 'Tony Abbott claims victory and says Australia is 'open for business'', *The Australian*, 8th Sep 2013

77 Kwek, G 2013, 'China envoy warns of trade perceptions', *Sydney Morning Herald*, 4th July 2013

78 Ibid

79 Yuming, C 2013, 'China-Australia Cooperation – A Blessing to Both Peoples', Speech presented at the Joint Reception by Asia Society, Australia China Business Council, Australia and New Zealand Banking

80 Packer, J 2013, 'Address To Asia Society', Speech presented at The Asia Society, 14th March 2013

Time and trust

There is a time and trust equation in play whereby the longer Australians experience interaction with certain foreign investors, the less concerned or resistant they appear to be and this is hopefully the case with the Chinese.

Andrew Michelmore, CEO of MMG said in his Lowy Institute speech in September 2013,

*"There is no difference to the early phases of US and Japanese investment in Australia, where community caution transformed to general acceptance over time. I firmly believe Australian attitudes to Chinese investment will travel a similar path".*⁸¹

He went on to say, *"It is time to stop judging and start understanding the challenges and opportunities presented by SOEs and Sovereign Wealth Funds participation in investment, trade and commerce."*⁸²

Professor Zha Daojiong said that during his over 40 interviews with Australian and Chinese executives in 2012/13, *"it was generally acknowledged that once (the investment) was approved, the ownership structure of a Chinese investment is seldom an issue of concern."*⁸³

In the Australian Parliamentary Trade Committee 2013 report, *Australia's trade and investment relationship with Japan and the Republic of Korea*, several participants noted that the attention given to Japanese investment is generally much less than investment from China and India. The Australia Japan Business Co-operation Committee (AJBCC) commented,

*"Much of the new and substantial investment in resources has gone almost unnoticed". Meanwhile the Australia Korea Business Council (AKBC) referred to the Australian "north east Asian gaze, which moves from Japan to China and back again, but overlooks Korea."*⁸⁴

Agribusiness

The 2014 Lowy poll revealed that 60 percent of Australians remain opposed to foreign investment in Australian agriculture, with 38 percent in support.

Foreign investment in Australia's agribusiness sector presents a good example of the level of public misunderstanding of the facts. Despite the constant media controversy, Chinese companies have only

invested approximately USD 1.1 billion across 12 agribusiness sector deals since 2006 and own less than 1 percent of Australian land.⁸⁵

Chinatex, COFCO and Bright Foods have been investing in and managing Australian agribusiness companies for many years. Chinese companies, who are still very interested to invest, have found the largest and most attractive Australian based companies are already foreign invested or controlled.

For example:

- meat processing: JBS (Brazil), Cargill (US), Nippon Meats (Japan)
- sugar processing: Sucrogen/Wilmar (Singapore), Finasucro (Belgium), MSF Sugar (Thailand)
- milk and powder processing: Fonterra (NZ), Kirin (Japan).

Under newly announced FIRB regulations the thresholds for foreign investment will be reduced from AUD 248 million to AUD 15 million (agricultural land) and AUD 53 million (agribusiness) cap.⁸⁶ All SOE/SWF investments must be individually approved.

Mr Zong Qing Hou, Chairman of Hangzhou Wahaha Group visited Australia in 2012 and famously said he found Australia's foreign investment laws difficult to navigate and was worried about the negative perception of Chinese companies.

"The treatment is not equal with American and Japanese firms. The Australian media always reacts to Chinese investment but there is no reaction to American investment".⁸⁷

Clearly, these negative comments, from the Chairman of China's largest milk, infant formula and soft drink (sugar) group, with annual sales of USD 11 billion annual sales⁸⁸, do nothing to improve the perceptions of Chinese investors about investing in Australia.

81 Michelmore, A 2013, 'What drives Chinese investment in Australia', Speech presented at Lowy Institute 10th Anniversary 'China Changing' lecture, 18th Sep 2013

82 Ibid

83 Zha, D 2013, 'Chinese FDI in Australia: drivers and perceptions', Lowy Institute, 27th February 2013, pp.19

84 Trade Sub-Committee 2013, 'Australia's trade and investment relationship with Japan and the Republic of Korea, *The Parliament of the Commonwealth of Australia*, pp.36

85 KPMG and University of Sydney 2013, 'Demystifying Chinese Investment in Australia', *KPMG and University of Sydney*, October 2013, pp.6, 13

86 KPMG and University of Sydney 2013, 'Demystifying Chinese Investment in Australia', *KPMG and University of Sydney*, October 2013, pp.27

87 Grigg, A 2013, 'Chinese tycoon feels unwelcome in Australia', *Australian Financial Review*, 8th March 2013

88 Ibid

The need for better mutual understanding

The speech by the Hon Warwick Smith AM at the 2014 Australia in China's Century conference recalled a famous letter from Stephen Fitzgerald, Australia's first Ambassador to China to Australia's Foreign Affairs Minister, Andrew Peacock.

He said, 38 years ago,

"China is not a habit of mind for Australians. The spread of Chinese influence is a process we don't understand."

In calling for more focus on cultural exchange between both countries, he went on to say,

"without this, our relations with China will never be more than superficial, and we will be damagingly ill equipped to adjust to a China dominant in our region."

The significance of this message in 2014 was not lost on the audience.

In an address to The Asia Society in March 2013, Mr James Packer, Executive Chairman of Crown Ltd provided a very large and mainly Australian corporate audience with some sound advice in approaching the challenges of improving relationship and understanding of Chinese investors. He said,

"For Australia to take advantage of this once in a lifetime opportunity, we must embrace China and deepen our ties at every level. This is not an easy task and will require a complete change in the way we think about our place in the world and for that matter, China's place in the world. Most importantly, as a country, we need to stop viewing China as a strange foreign land which has little in common with Australia. The truth is the complete opposite."

Warwick Smith concluded his 2014 key note speech with a recommendation for "three Ps" to grow our relationship with China on a whole of Australia scale:

- **passion** – learning and understanding of new ideas, perspectives and practices that China brings to the world
- **persistence** – thinking long term, building partnerships and overcoming barriers,
- **proactivity** – making the first steps and driving the activity.

Summary

There remains concern within mainstream Australian society regarding Chinese SOE investment. Business perspectives, government perspectives and general public perspectives are not always congruent. The way we feel about Chinese investment in Australia is slowly improving but we must continue to change our mindset to be more pragmatic and objective. This requires much education, understanding, communication and working experience from both sides over the next decade.







China's SOE reform pathway

8

8. China's SOE reform pathway

The economy of China has fundamentally changed since the founding of the People's Republic of China (PRC) 6 decades ago, especially after the reform and opening up started in 1978. China's SOEs have dramatically reformed from their original role as policy extensions of the central government to market-oriented firms that are slowly adopting modern corporate governance practices. Ongoing reforms in ownership, governance and access to factors of production are being undertaken so that Chinese SOEs can fulfil their role in a 'unified and open, orderly and competitive' market where the market plays a 'decisive' role in resource allocation.

Institutional reforms in SOEs and the broader economy

The theme of the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CCCCP) last year was 'comprehensive and profound reform'. The following excerpt from its Communiqué is central to understanding the principle which is driving and will continue to drive institutional reforms affecting SOEs:

"The key to comprehensive and profound reform is in economic reform, and the core question is to manage relations between the government and market, so that the market can play a decisive role in resource allocation and the government can play its role better".

The key reforms affecting SOEs are summarised below.

Diversified ownership

The decisions by the CCCCPC on *Some Major Issues Concerning Comprehensively Deepening Reform (The Decision)* which was released in November 2013, called on SOEs to develop diversified ownership. Private capital will be encouraged to invest in SOEs.

SASAC has since taken actions to encourage private investors and investment funds to participate in the restructuring, capital raising and international M&A by SOEs with the ultimate objective of transitioning most SOEs (except for those in special sectors which may pose national security threats such as national defence and military industries) to diversified ownership by 2020.

It is expected that the degree of regulatory supervision and the amount of private capital and foreign capital which is ultimately allowed to invest in SOEs in each sector will depend on considerations such as: national security (where SOEs may be more likely to retain their wholly state owned structure) and importance to the national economy and people's livelihood (which covers industries such as upstream resource assets, power, telecom, transportation and ports, where state capital may be more likely to retain a majority stake of at least 51 percent).

In February 2014, China Petrochemical Corporation (Sinopec) announced that it plans to carry out a restructuring of its fuel sales business and sell up to 30 percent of the business to private investors, to achieve a diversified ownership business structure.

It is widely believed in the market that this is a substantial step for the central government to break the monopoly of SOEs in the oil and gas fields. After the reform, the monopoly of the state-owned oil giants, such as Sinopec and China National Petroleum Corporation (CNPC), will be weakened, benefiting small and medium sized enterprises in the energy industry. Sinopec made the first move in this new round of SOE reforms, with the other Central Enterprises expected to follow.

Some examples of SOEs' diversified ownership reform in the second quarter in 2014 include:

- State Grid Corp announced that it plans to introduce private capital in four business fields, namely grid interconnection of electricity, electric car charger facilities, pumped-storage hydroelectric power stations and energy storage power stations, and plans for certain affiliated companies to go public.
- COFCO and a consortium of international investors led by a Chinese private equity investment firm Hopu Investments reached an agreement with Noble Group to establish an agribusiness joint venture with Noble. COFCO will own two-thirds of the 51 percent joint venture interest, with the balance being held by the consortium.
- Shanghai Bright Food Group's draft reform plan will focus on asset securitisation and the group aims to increase the percentage of its assets which are listed to 50 percent of its total assets from its current level of 20 percent.
- China Aerospace Science and Technology Corporation introduced equity investment from Tencent in its subsidiary NavInfo.

- China Telecom announced its plans to introduce diversified ownership into certain areas of its business, including internet related applications, information communication technology applications, and innovative product development.

Local SOEs are also starting to follow suit as a number of local governments including Shanghai, Guangdong and Jiangxi have expressed their intention to allow private capital to invest in local SOEs to facilitate transition to diversified ownership. The Shanghai government will also encourage the establishment of equity investment funds composed of state and private capital to be involved in SOEs' strategic investment and overseas M&A.

To deepen SOE reform, Jiangxi province launched 49 state-owned projects with total investments of RMB 109.6 billion in May, inviting Global 500 enterprises, China Top 500 enterprises, Central SOEs, POEs and other foreign companies to participate. Thirty seven out of 49 projects are earmarked as key projects covering natural resources, construction and installation, financial services and investment sectors.

Proper delineation of the functions and roles of government and enterprises

The second key theme to come out of *The Decision* is the need to achieve clearer separation of government from enterprises. This can be seen in the following developments.

The Decision says that China will set up state-owned capital operating and investment companies. While the details are yet to be worked out, the intention is for China to shift its approach from a state-owned asset management system to a Temasek model management system. The important characteristic of the latter is that although wholly-owned by the government, the government does not exercise heavy handed intervention in the operational and business decisions of Temasek, or Temasek-linked companies. A state-owned capital operating and investment company is only responsible for the management and reallocation of SOE's state capital. It will not be engaged in SOE's daily operations, focusing mainly on enhancing SOE governance and building sound boards of directors in SOEs to play its role more effectively.

In May 2014, SASAC announced that three SOEs, including the State Development and Investment Corporation, China Chengtong Holdings Group Limited and China Merchants Group, will be converted to state capital investment corporations. These three SOEs will perform more of a shareholder oversight role for their subordinate entities, while SASAC will exercise the regulatory function.

The Decision also requires the functions and roles of SOEs in different industries to be defined, which will be the basis for determining the type of regulatory oversight and supervision. SASAC is working on the classification criteria. Most SOEs are concentrated in industries that are vital to the national security, economic development and people's livelihood; and these are the industries where more stringent supervision by SASAC and other authorities is expected.

The Decision paved the way for more changes to implement a 'modern corporate governance system' in SOEs which will be explored further in the next section.

The Decision sets a target of increasing the SOE profit payout ratio to 30 percent by 2020 (from just 4.6 percent in 2012). In addition to providing needed financial resources for the government to meet its obligations towards society, other positive outcomes are help to reduce the low-cost capital available to the SOEs that encourages inefficient investment and over expansion, and assistance towards lowering the barriers for private competitors.⁸⁹

On 6 May, 2014, the Ministry of Finance (MOF) announced an increase to the percentage of profits to be collected from central state-owned enterprises. Beginning in 2014, the percentage of profits generated by wholly owned SOEs which must be delivered to the government will increase by 5 percentage points from the current level. The MOF predicts the after-tax profits of central SOEs turned over to the government will reach RMB 141.49 billion in 2014, up RMB 37.54 billion (36.1 percent) from the previous year.

The Decision emphasises that enterprises and private individual investors will be allowed to play a principal role in ODI activities. This means the government will give more authority to companies to make decisions about their overseas investments by simplifying the approval process. To this end, in April 2014, The National Development and Reform Commission (NDRC) released the "*Administrative Measures on the Approval and Registration of Outbound Investment Projects (the Administrative Measures)*". According to the *Administrative Measures*, overseas projects below USD 1 billion will only be required to register with the NDRC or local government agencies in charge of overseas investment, while overseas investments greater than USD 1 billion will still need approval from the NDRC. Previously, any Chinese company wishing to invest greater than USD 300 million in overseas natural resources sector, or greater than USD 100 million in other overseas sectors were required to obtain approval from the NDRC.

89 Fan and Hope, 'The Role of State-Owned Enterprises in the Chinese Economy', US-China Economic Exchange Foundation, 2013

The Modified Catalogue of Investments Verified by the Government (2013) (the 2013 Catalogue)⁹⁰ which raised its investment size and simplified the most important review step by the National Development and Reform Commission (NDRC) for non-resource projects from USD 100 million to USD 300 million, and for resource projects from USD 300 million to USD 1 billion. Additionally, many projects that required prior verification of the NDRC or Ministry of Commerce now only require notification and registration. China's approval process is primarily concerned with three considerations, namely, that outbound investments should not: impact China's national sovereignty, security or public interests; be in violation of Chinese law, or be banned by international treaties; or directly impact China's balance of payments or ability to regulate the RMB.⁹¹

Improved corporate governance

Corporatisation

After the Company Law was enacted in 1994, the prevailing trend of China's SOEs has been corporatisation with significant improvement in governance standards. By 2012, more than 80 percent of central SOEs, including their numerous subsidiaries, had enacted some form of shareholder reform and separation of ownership from management.⁹² The remaining 20 percent of firms are largely in areas of direct national security, such as defence.

SOE management, though still influenced by the party, increasingly incorporates international best practices for day-to-day corporate oversight and for setting executive expectations. The 1993-97 reforms introduced modern management and financial structures to SOEs.⁹³ Recently, larger SOEs have successfully increased efficiency and profitability by adopting modern management practices.⁹⁴

In May 2014, SASAC announced that three SOEs, including the State Development and Investment Corporation, China Chengtong Holdings Group Limited and China Merchants Group, would be converted to state capital investment corporations. These three SOEs will perform more of a shareholder oversight role for their subordinate entities, while SASAC will exercise the regulatory function.

The Decision outlines the importance of establishing modern corporate governance systems that include effective coordination, efficient governance structures, and a professional management team including more executives hired from the open market and remunerated in accordance with market-based principles.⁹⁵ In 2008, 19 Central Enterprises began appointing senior executives themselves, subject to evaluation by the party and SASAC.⁹⁶

The Third Plenum has already furthered this process with SASAC indicating recently that directors will be able to appoint general managers in some Central Enterprises in 2014.⁹⁷ Management compensation is increasingly dependent on market-oriented key performance indicators (KPIs) such as profit maximisation.⁹⁸ Official Chinese media has recently reported that executives appointed by the government will have their remuneration decided by the government whereas those hired from the market will have their remuneration set in accordance with market levels. Further, during the Third Plenum, the new government has proposed a plan to strengthen the accountability of management of SOEs which implies that the Chinese government will enforce punitive measures on executives responsible for significant operating losses or major investment failures.

The prevalence of independent directors within China's Central SOEs continues to increase. The China Securities Regulatory Commission defined their concept of independent directorship in 1997, and issued an opinion in 2001 that required listed companies to have at least two independent directors by 30 June 2002, and that independent members must make up one third of the entire board by 30 June 2003, of which one must be an accounting professional.⁹⁹ These independent members have veto authority over related-party transactions and must fulfil requirements such as: not being among the top 10 shareholders, not a family member of a controlling shareholder or insider, and not holding an executive position in the company.¹⁰⁰ By August of 2013, 57 of the Central Enterprises had established 'normative boards' with external directors.¹⁰¹

90 NDRC website

91 余劲松 陈正健, 中国境外投资核准制度改革刍议, 《法学家》2013年第2期, <http://www.financialservicelaw.com.cn/article/default.asp?id=1800>

92 Fan and Hope, 'The Role of State-Owned Enterprises in the Chinese Economy', US-China Economic Exchange Foundation, 2013

93 Ho and Young, 'China's Experience in Reforming Its State-Owned Enterprises: Something New, Something Old and Something Chinese?', International Journal of Economy, Management, and Social Sciences, April 2013

94 Ibid

95 《中共中央关于全面深化改革若干重大问题的决定》, 新华网, 2013年11月15日, http://finance.ifeng.com/a/20131115/11093995_0.shtml

96 国务院国资委下放部分央企高管任免权, 《财经》, 2008年12月, <http://www.caijing.com.cn/2008-12-25/110042545.html>

97 央企高管市场化选聘要“蹄疾步稳”, 人民日报, 2014年2月, <http://finance.people.com.cn/n/2014/0218/c1004-24386215.html>

98 《中央企业负责人经营业绩考核暂行办法》(2012), 国资委, 2012年12月, <http://www.sasac.gov.cn/n1180/n1566/n257060/n257203/15124088.html>

99 'Notice on Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies', Zhengjianfa [2001] No. 102, 16 August 2001. http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.htm

100 Ibid

101 企业选聘退休高官任独董: 三高症待除旋转门待破, 企业观察网, 2013年8月, <http://finance.sina.com.cn/china/20130826/144816564395.shtml>

Initial Public Offerings (IPOs)

By 2013, more than 1,000 Chinese SOEs had listed on the Shanghai and Shenzhen stock exchanges alone, accounting for more than 40 percent of the total domestic listings.¹⁰² China's larger SOEs have also ventured overseas to capital markets in Hong Kong, New York, London, and Singapore.

Generally, SOEs attempting to list on capital markets, whether domestic or international, will separate the firm's most valuable assets and profitable businesses to form a listed company, which is able to meet listing requirements. At the point of IPO, a certain percentage of shares are sold to the public, but the holding company maintains a controlling stake. By the end of 2012, 378 subsidiaries of SOEs owned by the central government, and another 681 provincial and local SOEs, traded on global stock exchanges.¹⁰³ SOEs that list overseas are required to comply with the stringent transparency and corporate governance requirements of the target international markets. Commentators generally agree that corporate governance standards have been improved through compliance with overseas listing requirements and the incorporation of diversified stakeholders, such as HSBC's 20 percent stake in Bank of Communications.^{104 105}

The recent announcement that China's first state-owned capitalist company, CITIC Group, will list all of its main assets in Hong Kong through a multi-billion dollar asset injection into its listed Hong Kong unit, CITIC Pacific Limited, is another step forward in reforming China's SOEs. The move would bring CITIC Group into the more robust regulatory environment in Hong Kong, and put it under scrutiny of international investors. As part of its plans, it has been reported that CITIC Group will also move its headquarters from Beijing to Hong Kong.¹⁰⁶

102 Long, 'Overseas Listing and State-Owned-Enterprise, Governance in China: the Role of the State' http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2012_Miao.pdf

103 Reuters, 'China's Sinopec sale points to next round of state privatization', 3 March 2014, <http://www.reuters.com/article/2014/03/03/us-china-parliament-SOE-idUSBREA223820140303>

104 The World Bank and Development Research Center of the State Council, 'China 2030', 2012 at p. 53: 'In line with these developments, the new policy direction has been to diversify the ownership of state enterprises. Indeed, many large state enterprises have been 'corporatized' and some of the biggest (including those directly monitored by the central government) are now not only listed on stock exchanges but have also improved their governance structure, managerial professionalism, and profitability.'

105 Fan and Hope, 'The Role of State-Owned Enterprises in the Chinese Economy', US-China Economic Exchange Foundation, 2013. Footnote 8 refers to a survey on the corporate governance standards of copies listed in Hong Kong – conducted by the Hong Kong Institute of Directors and Hong Kong Baptist University in 2012 – more than half of the top-10 firms with the best corporate governance practices are state-owned or backed with funding from China (see www.hkid.com/scorecard.html)

106 Levin, N. and Lee, Y., 'Citic Group's Hong Kong Listing Viewed as a Reform Move', Wall Street Journal, 27 March 2014

Reduced access to non-market factors of production

Much has been made of the subsidies that SOEs receive, which some believe puts them at an unfair advantage in acquiring overseas assets. In particular, SOEs still tend to benefit from lower cost of and better access to capital in China than non-public-sector enterprises such as POEs and foreign competitors. This is because under the current system where the People's Bank of China maintains a deposit rate ceiling, 'big banks have profited for years by paying very low rates for deposits and lending to large, state-owned firms that are seen as riskless borrowers.'¹⁰⁷

But this asymmetry in the access to domestic funding is set to change. Following on a commitment in *the Decision* "to accelerate the process of interest rate liberalisation", Zhou Xiaochuan, Governor of the People's Bank of China, recently estimated that this objective would be achieved within 1 to 2 years.

It is expected that this reform will require lenders to better analyse risks and allocate more funds to higher productivity activities of private firms (e.g., in the service and high technology fields) that would therefore be willing to pay higher rates. Similarly, allowing qualified private investors to establish small and medium-sized banks and other financial institutions – as called for in *the Decision* – should also ease the financing difficulties that small and medium-sized enterprises are facing.¹⁰⁸

On 11 March 2014, Shang Fulin, Chairman of the China Banking Regulatory Commission, announced at a press conference for the second session of China's 12th National People's Congress that China will set up five private banks on a trial basis in Tianjin, Shanghai, Zhejiang Province and Guangdong Province.¹⁰⁹

Commentators argue the reason SOEs are able to borrow more money at lower interest rates than private enterprises is because SOEs are assessed as less risky and more creditworthy. Fan and Hope argue that such lending considerations and decisions are common, not only among state-owned banks in China, but also among the foreign banks that operate in China, and in the credit pricing of syndicated loans made to Chinese enterprises in overseas markets with participation by foreign banks. To remedy this, they argue that the government should remove the disincentives to lend to non-SOEs by improving the business, legal and financial infrastructure that

107 Wei, L. and Davis, B., 'China Will Free Interest Rates, as it Loosens State's Reins', Wall Street Journal, 12 March 2014 <http://online.wsj.com/news/articles/SB10001424052702304020104579432011372086646?mg=reno64-wsj>

108 Fung and Peng, 'China's new golden decade ahead: The decisions from the Third Plenum and their implication for the economy', KPMG's Global China Practice, 2013

109 'China to pilot five private banks', [wn.com](http://article.wn.com/view/2014/03/11/China_to_pilot_five_private_banks), 11 March 2014, http://article.wn.com/view/2014/03/11/China_to_pilot_five_private_banks

supports the financial system in China. This is consistent with broader calls to help POEs overcome the challenges they face investing overseas, so the non-SOE share of Chinese ODI activity can increase to be more consistent with their contribution to GDP. The recent changes to the ODI approval regime can also be seen as an initial step towards furthering this objective.

Although exact figures are not available, it is reasonable to conclude that Chinese SOEs have historically relied heavily on financing from Chinese banks, particularly the two policy banks China Development Bank and Export-Import Bank of China, to fund their ODI activities.

However, as SOEs have become more sophisticated at managing their capital and more experienced in making overseas investments, comparatively high costs of domestic loans have also prompted SOEs to begin to seek overseas financing for their ODI activities. For example, out of the total USD 15.1 billion that CNOOC paid to acquire Nexen in February 2013, USD 6 billion was financed from a consortium of foreign and Chinese banks on commercial terms. CNOOC later refinanced part of this short-term credit facility with the proceeds of an issue of USD 3.9 billion Guaranteed Notes that were listed on the Hong Kong Stock Exchange.¹¹⁰ Bright Food Group, a flagship SOE in Shanghai, is another example.¹¹¹ During an interview in 2013, its Vice President Ge Junjie said that the company has not borrowed any low-interest funds from the government. Instead it has been using financing techniques such as overseas borrowing with domestic guarantee, raising overseas syndicated loans and bonds, taking advantage of cheaper funding available in international capital markets to support its overseas expansion through M&A.¹¹²

¹¹⁰ Company announcement by CNOOC Limited on 3 May 2013

¹¹¹ Bright Food has become a leading ODI investor among Chinese SOEs from Shanghai after acquiring high-quality assets in Australia, New Zealand, France and the UK

¹¹² 国企海外投资如何炼就“市场化基因”？21世纪经济报道，2013年11月，<http://finance.21cbh.com/2013/11-16/yMMzcxXzkzNTUyMA.html>



Concerns about the level of foreign investment in Australia, and how the government should regulate foreign investment, are not new.

Commentary at the time by Douglas Copland, founder of the Committee of Economic Development of Australia (CEDA) made in 1965, could equally be made today:

"There is little doubt that Australia gains a great deal by foreign investment, as do also those making the investment. The problem, however, is one of considering the conditions under which a good and constructive working partnership can be established between the overseas investor and the local government and economic authorities in their joint efforts to promote a higher rate of growth in the Australian economy".¹¹⁴

Widespread community concern about foreign investment by foreign governments, including SOEs, must be properly considered and addressed. The economic risks of allowing SOE capital to invest must be weighed up against the risks of missing out on this segment of foreign capital.

As witnessed in 2013, global competition for Chinese investment from other nations is intensifying and Australia must continue to maintain and improve competitive strategies to attract Chinese investment and maintain and grow our share of total ODI.

Chinese SOE investment in our country is a relatively new experience, both for Australian society and for the companies investing. We need to develop a better understanding of SOEs, both in China and when they are operating in Australia.

114 Douglas Copeland, p4, 'Growth', No 6 Review of Australian Economic Development, CEDA, Nov 1965

Chinese SOEs, through trade and investment, have made a significant contribution to the growth of the Australian economy in the past decade. They are gradually learning from past experiences and, similar to other MNCs, adapting to Australian market conditions and regulations.

Chinese SOEs are, and will, remain the dominant players in the sectors that count for Australia – mining, infrastructure and gas. However Chinese investment interests in Australia are diversifying beyond these sectors. This reflects both a slowing domestic economy (pushing Chinese infrastructure and real estate companies offshore for growth) and an increasing level of Chinese consumer demand for lifestyle-related goods and services – higher quality food and beverage, education, tourism, real estate and services generally.

The diversification of Chinese investment in Australia will require new and more flexible approaches to regulating the entry of Chinese investors and creating incentives for their integration in the local economy. Australia can draw on the successful experience of other countries such as the UK in creating a market based regulatory environment.

Australian governments, companies and communities must continue to work together to ensure that our policies and regulations are welcoming, globally competitive and consistently applied for all foreign investors while addressing the associated risks.

As former Treasury Secretary Ted Evans said in 1999:

"It is impossible to quantify the restrictiveness of foreign investment policy... the key, unmeasurable, dimension is the value of investments that might have been received, but instead went to other countries or 'stayed at home' without ever formally registering an interest in Australia as a destination."¹¹⁵

¹¹⁵ Evans, Ted, (1999), Ninth Annual Colin Clark Memorial Lecture – Economic Nationalism and Performance: Australia from the 1960s to the 1990s, *Economic Analysis and Policy (EAP)*, 29, issue 2, p. 103-107.

Glossary

Abbreviation	Full name
ABC	Agricultural Bank Of China
ABS	Australian Bureau of Statistics
ACBC	Australia China Business Council
AJBCC	Australia Japan Business Co-operation Committee
AKBC	Australia Korea Business Council
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
AUD	Australian Dollar
BCA	Business Council of Australia
BOC	Bank of China
BRICS	A group of five major emerging national economies: Brazil, Russia, India, China, and South Africa
CCB	China Construction Bank
CCCA	Chinese Chamber of Commerce Association
CCCPC	Central Committee of the Communist Party of China
CFIUS	Committee on Foreign Investment in the United States
CNPC	China National Petroleum Corporation
CNOOC	China National Offshore Oil Corporation
COFCO	China National Cereals, Oils and Foodstuffs Corporation
CPC	The Communist Party of China
CRGs	Community Reference Groups
DOJ	Department of Justice
DRC	Development Research Centre of the State Council
EIS	Environmental Impact Study
EPA	Environmental Protection Agency
FAI	Fixed Asset Investment
FDI	Foreign Direct Investment – direct investment to other countries
FIRB	Foreign Investment Review Board

Abbreviation	Full name
FTC	Federal Trade Commission
FTA	Free Trade Agreement
FTE	Full-time employee
GDP	Gross Domestic Product
GRAM	Guangdong Rising Assets Management
ICA	Investment Canada Act
ICBC	Industrial and Commercial Bank of China
ICT	information communication technology
IPO	Initial Public Offerings
JV	Joint Venture
KGA	Kreab Gavin Anderson
KPI	Key Performance Indicator
LNG	Liquefied Natural Gas
MITI	Ministry of International Trade and Industry
MNC	Multinational Corporations
MOF	Ministry of Finance
NDRC	National Development and Reform Commission
NZD	New Zealand Dollars
ODI	Outbound Direct Investment – specifically refers to direct investment from Chinese entities into Australia
OIO	Overseas Investment Office
POEs	Privately Owned Enterprises
PRC	People's Republic of China
QIA	Qatar Investment Authority
SASAC	State-owned Assets Supervision and Administration Commission
SD	Singapore Dollars
Sinopec	China Petrochemical Corporation
SOE	State Owned Enterprise
SWFs	Sovereign Wealth Funds
USD	US Dollar
UNCTAD	United Nations Conference on Trade and Development





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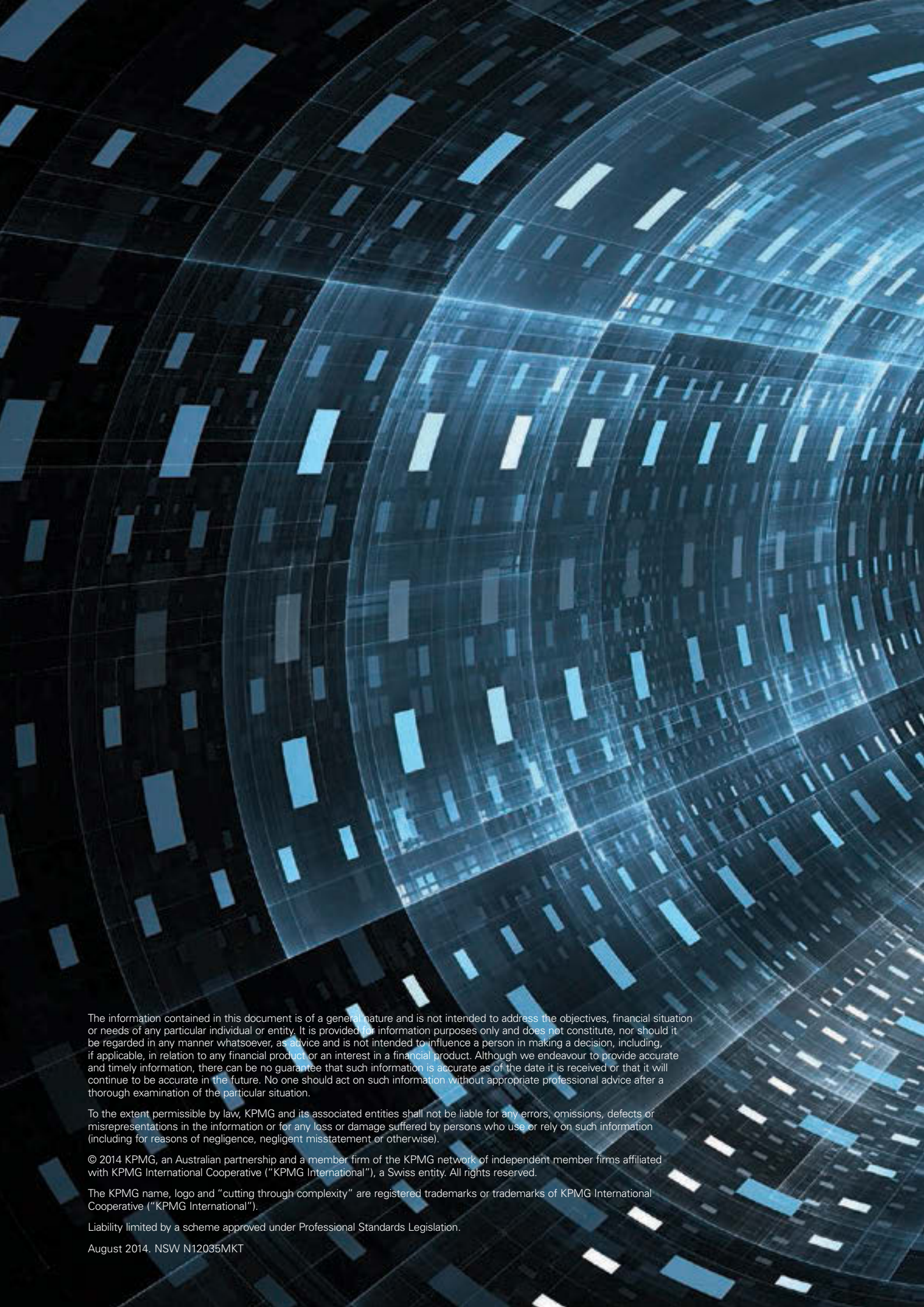
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