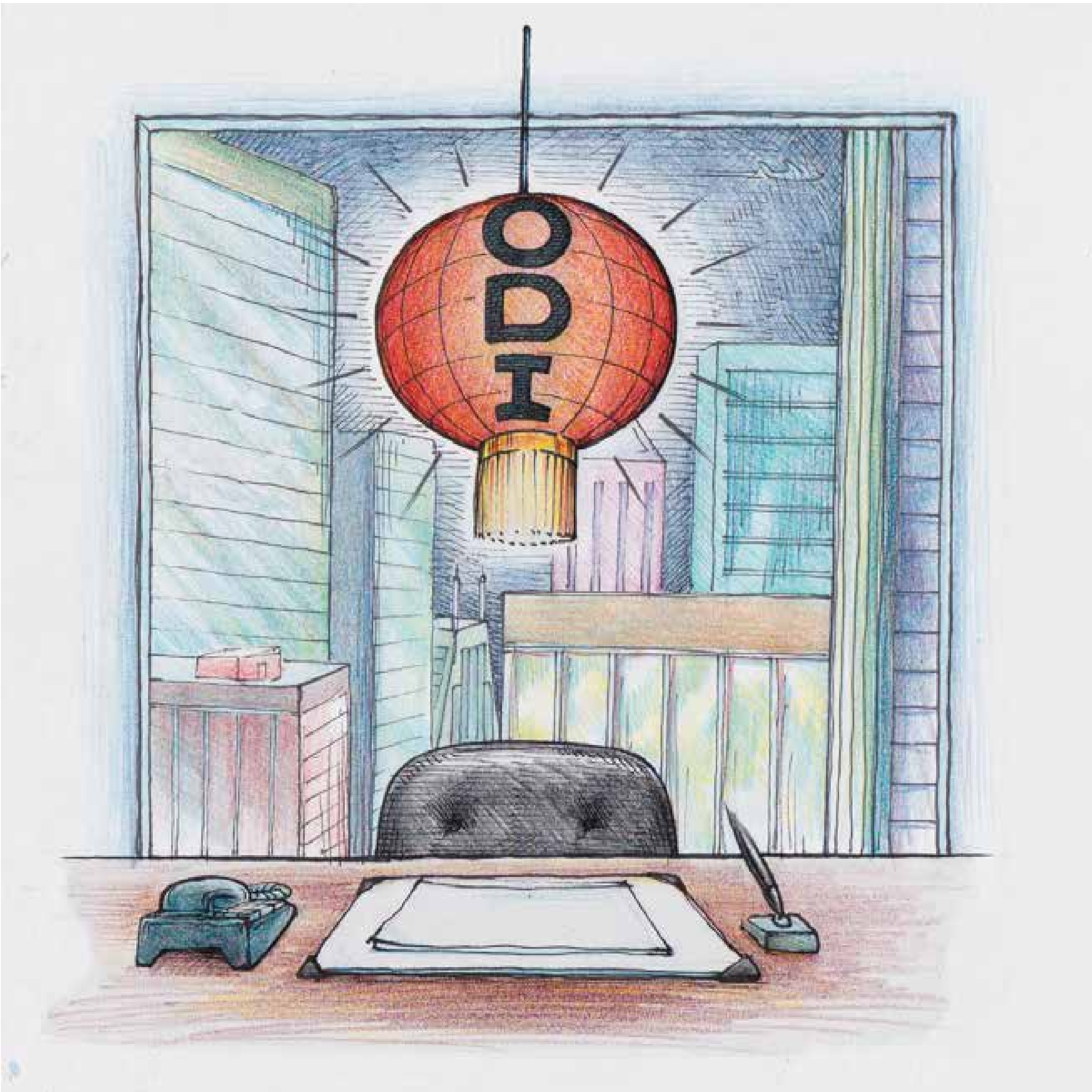
# CHINESE INVESTMENT IN DEVELOPED MARKETS
## An opportunity for both sides?

**A report by The Economist Intelligence Unit**




Commissioned by HSBC

# Contents

# Introduction

Investment into China has long been under the spotlight, as have the country's investments into other developing markets such as Africa. But China's overseas direct investment (ODI) into developed markets is becoming an increasingly important element of the economic giant's overall advancement. Developed markets have received a growing share of China's ODI since 2009 (see chart below).

Chinese investments in these markets are also becoming increasingly important for the target markets. For example, although it is a relatively recent phenomenon for Chinese companies to invest in Germany, by 2011 China was already that country's largest investor.

This greater focus on developed markets has been accelerated by the 2008-09 global financial and economic crisis, as such markets offer less political risk and a better regulatory environment. Developed markets are also seen as strong and stable.

China's 12th five-year plan, which covers 2011-15, aims to move the economy away from low-end manufacturing and exports and up the value chain. This entails not just a greater focus on the consumer, but also the production of higher-value, more innovate goods and services.

Tu Xinquan, associate director of the China Institute for WTO Studies at the University of International Business and Economics in Beijing, says that Chinese businesses have sharply increased their international competitiveness, adding: "China has reached the stage for capital exports."[1]

Hiroki Miyazato, deputy chief executive officer of Haitong Securities—a Shanghai-based brokerage which recently acquired an investment bank, BESI, from Portugal's Banco Espirito Santo—summarises this trend: "China has gone past the stage of consumers buying new airconditioners and washing machines. Consumers now want to access higher-value goods and services. Working

## Chinese ODI flows by geographical destination

(US$ m unless otherwise stated)

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|
| Developing markets (DM) | 211 | 336 | 731 | 520 | 2747 | 2787 | 7043 | 10864 | 13423 | 13508 |
| Europe | 113 | 74 | 190 | 130 | 1050 | 467 | 2991 | 6129 | 7597 | 6137 |
| US | 65 | 120 | 232 | 198 | 196 | 462 | 909 | 1308 | 1811 | 4048 |
| (Europe+US)/DM in % | 84 | 58 | 58 | 63 | 45 | 33 | 55 | 68 | 70 | 75 |

Source : UNCTAD FDI/TNC database, based on data from the Ministry of Commerce (MOFCOM) with partners outside China gives the country access to new industries and technologies, allowing the country to bring these back to the domestic market, and so move up the value chain."

In order to make this transition successfully, China has to tackle a variety of obstacles, as Hua Bai, founder of China Going Global Think-Tank (CGG), explains: "you are faced with many different problems such as political risks...legal differences [and] financial risk. When a company goes overseas to invest...processes such as the disclosure of financial information, investment and financing the audit and tax will be very important."[2]

Experience over the past few years indicates that Chinese businesses are becoming more proficient at engaging with these factors, driving greater, and increasingly successful, expansion.

This paper will uncover key insights on potential collaboration between Chinese companies and businesses from the developed world. It will look at the historical stages of Chinese ODI, the main drivers of Chinese ODI in developed countries, and key trends in flows, sectoral focus and evolving modes of co-operation. It will highlight the implications of China's growing role as an investor in these markets and provide an outlook for the future.

# 1 Chinese ODI in historical perspective

If, in terms of ODI, China still punches well below its weight, it is because it barely existed when China's then leader, Deng Xiaoping, began tentatively opening the country to market forces in 1978. Levels remained insignificant until 2004. By 2007, annual ODI had grown to about US$25bn, doubling to more than US$50bn by 2008 and the onset of the global financial crisis.[3]

The 2008-09 global crisis was a particularly important inflection point for China. Global ODI activity was badly hit, but China helped to keep the world afloat. Although global ODI fell by 43% in 2009, Chinese ODI into developed markets, boosted by government financial support, leapt threefold.[4]

Although the crisis proved to have sometimes fatal consequences for some Chinese businesses, it also presented an opportunity for others to expand overseas. Between 2001 and 2007 average deals in the US were worth well below US$500m, with the exception of 2005, when China's Lenovo acquired IBM's personal-computer unit for US$1.8bn. Deal size has increased[5] since 2007—a trend matched in Europe, where the number of deals has shot up after a post-crisis dip in 2009-10.[6]

## Important policy developments

Recent policy developments by the ruling Chinese Communist Party (CCP) under the president, Xi Jinping, have also been shaping the current stage of Chinese ODI. The CCP's third plenum, held in November 2013, pushed the economy further towards market liberalisation, with a commitment to simplifying regulations and having state-owned enterprises and private companies compete on a more level playing field.

## The waning dominance of SOEs in ODI

Although their overall share is decreasing, state-owned enterprises (SOEs) still dominate China's overseas direct investment (ODI), amid private companies' "limited access to funding, technology and market influence".[7] However, during the third plenum of the ruling Chinese Communist Party in November 2013 it was decided that SOEs should increasingly have to compete on a level playing field with private companies. Hence, these differentials should erode, as emphasised by Shi Ziming, commercial counsellor at MOFCOM: "Private enterprises will definitely play a more and more important role in the process of the nation's outbound direct investment activities. They will probably surpass SOEs as the major force of China's investment wave."[8]

Although SOEs account for a greater aggregate value of China's ODI, there are more deals in volume terms by private companies. SOE-made acquisitions accounted for around 72% of the total deal value of all Chinese acquisitions in Europe in 2002-12. However, the figures are skewed by some large-scale acquisitions in capital-intensive industries, such as China Investment Corporation's acquisition of the exploration business of a French electric utilities company, GDF Suez, for €2.3bn (US$3.2bn) in 2011. In Germany, where acquisitions are smaller and engineering- and technology-oriented, only 34% of the Chinese companies involved were state-owned.[9]

As a result, most domestic firms will no longer need to seek approval from the Ministry of Commerce (MOFCOM) prior to making an overseas investment, but will now instead register the investment with regional regulators.

## Is China buying the developed world?

High-profile acquisitions—from New York's Waldorf Astoria hotel to Swedish carmaker Volvo, US pork producer Smithfield Foods, restaurant group PizzaExpress and food processing company Weetabix of the UK—have created an impression that China is buying the developed world. But this is far from the truth.

In late 2014 Zhang Xiangchen, an assistant minister at MOFCOM, announced measures to simplify ODI. He said that, although he expected Chinese ODI to reach US$120bn in 2014, Chinese firms' holdings were equivalent to only one-tenth of the assets held by US companies and only one-half those held by Japanese ones.[10]

Indeed, at end-2012 the ratio of China's ODI stock to GDP stood at 5%—significantly below the world average of 33%.[11] In 2011 China accounted for 15% of the world's GDP growth, but the value of its ODI was ranked only ninth globally, according to UNCTAD.

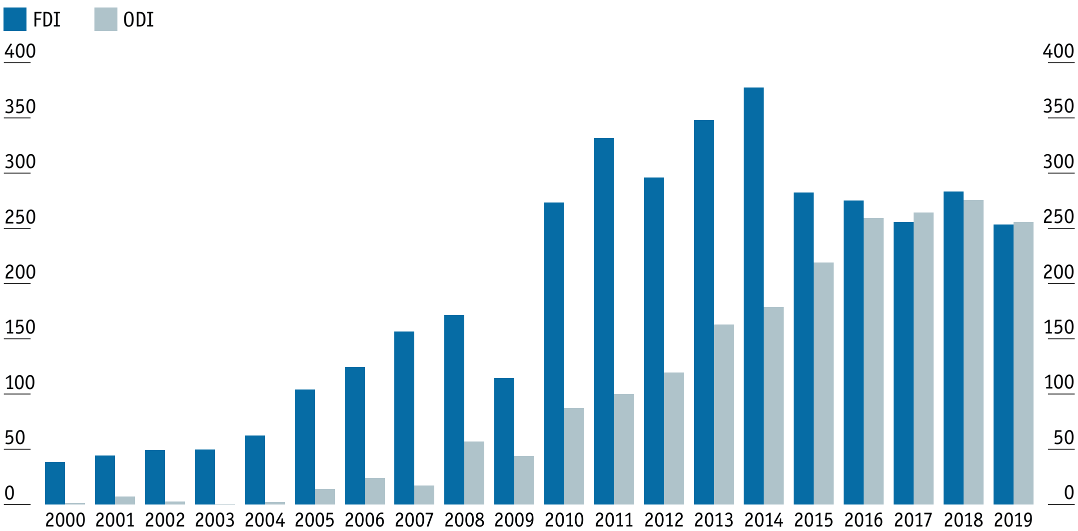
## Rising ODI flows

That said, although China's ODI stock is still relatively low, flows are increasing. For example, in 2014 Chinese investment into the US exceeded American investment into China for the first time.[12] China's ODI and foreign direct investment (FDI) into China have converged (see chart below).

Not only is the number of deals increasing, but so is deal size itself, particularly after a post-crisis dip.

**Chart 1**

**China's FDI-ODI convergence**
(US$ bn)



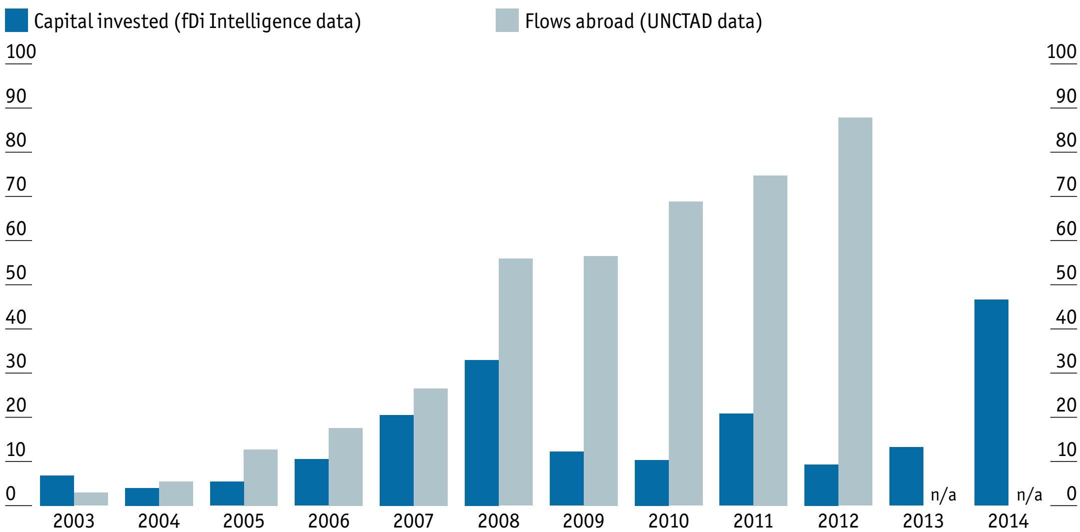

Source: The Economist Intelligence Unit.

# A word (or two) on numbers

Chinese ODI estimates vary wildly (see chart below). Companies often list the initial port of call of their capital, rather than its final destination, thus falsely inflating the importance of stop-over locations such as Hong Kong and various tax havens. Countries also use different definitions of FDI, thus creating comparability problems.[13] Chinese statistics record approved projects rather than actual money transfers. Given these problems, it is therefore simpler to determine trends, rather than focusing on absolute levels of Chinese ODI.

## Chart 2

**Chinese ODI by data source**
(US$ bn)




Sources: fDi Intelligence from The Financial Times Ltd.; UNCTAD FDI/TNC database, based on data from the Ministry of Commerce (MOFCOM).

# 2 Key drivers of Chinese ODI in developed markets

Chinese investors' reasons for targeting acquisitions in developed markets have shifted over time. James Wilkinson, a partner working in the UK equity capital markets practice of a US law firm, Reed Smith, which has advised a number of Chinese corporate clients, comments: "There were a number of investments in European automotive and then financial institutions before the crisis that didn't do so well in its wake. Two-to-three years ago, there was a rise in natural-resource and brand acquisition. We've seen particular interest in AIM [Alternative Investment Market]-listed miners with operations in interesting parts of the world. We're now seeing a move away from this, with Chinese investors looking at technology, manufacturing, consumer and infrastructure sectors."

Recent shifts in the pattern of China's ODI can be seen in the tables below. There is an increasing preponderance of higher-skilled projects, such as automotives. And, importantly, ODI is increasingly flowing into alternatives and renewables projects. The latter will become increasingly important as China strives to wean itself off its coal dependency and mitigate the effects of climate change through developing and buying new technologies. China is already held to be the global leader in solar power, and Chinese firms Renesola and Trina Solar are making strategic investments in Europe and North America.

## Increasing interest in foreign technologies and managerial skills

In terms of US-directed ODI, the largest industry by value is oil and gas—playing to China's ongoing energy requirements—and the second largest is electrical equipment and components.[14] And, although natural resources are always

**Chinese ODI by sector, 2003**

| Sector | No. of projects | Jobs Created Total | Jobs Created Average |
|---|---|---|---|
| Financial Services | 18 | 726 | 40 |
| Coal, Oil and Natural Gas | 12 | 1,696 | 141 |
| Consumer Electronics | 10 | 3,492 | 349 |
| Metals | 10 | 7,605 | 760 |
| Food & Tobacco | 7 | 505 | 72 |
| Communications | 6 | 1,142 | 190 |
| Real Estate | 5 | 9,246 | 1,849 |
| Software & IT services | 5 | 389 | 77 |
| Textiles | 4 | 838 | 209 |
| Consumer Products | 4 | 912 | 228 |
| Other sectors | 24 | 5,989 | 249 |
| Total | 105 | 32,540 | 309 |

Source: fDi Intelligence from The Financial Times Ltd

**Chinese ODI by sector, 2014**

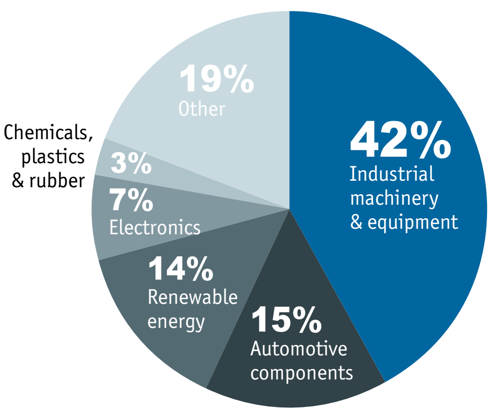
| Sector | No of projects | Jobs Created Total | Jobs Created Average |
|---|---|---|---|
| Communications | 50 | 7,216 | 144 |
| Electronic Components | 34 | 5,396 | 158 |
| Financial Services | 33 | 1,162 | 35 |
| Industrial Machinery, Equipment & Tools | 31 | 7,232 | 233 |
| Software & IT services | 28 | 2,013 | 71 |
| Automotive OEM | 26 | 27,365 | 1,052 |
| Real Estate | 24 | 38,122 | 1,588 |
| Metals | 23 | 10,781 | 468 |
| Alternative/Renewable energy | 20 | 1,463 | 73 |
| Textiles | 17 | 21,035 | 1,237 |
| Other sectors | 142 | 26,632 | 187 |
| Total | 428 | 148,417 | 346 |

Source: fDi Intelligence from The Financial Times Ltd important recipients of Chinese ODI, since the early 2000s more firms have been focusing on acquiring foreign technologies and managerial skills.

Chinese investors in Germany are unsurprisingly attracted by its strong reputation for high-end engineering. The benefit is obvious, as China has been strong in low-cost manufacturing but has lacked innovation capabilities, and is looking to produce more sophisticated goods and services that can provide a higher price on the world and domestic markets (see pie chart below). More than 40% of German companies acquired by Chinese corporations are in the industrial machinery and equipment segments, and once more renewables feature prominently. China is targeting highly specialised German companies that are global market leaders in their niche sectors: examples of this are the takeover of a tool-machine maker, Schiess, by Shenyang Machine Tool Corporation; the purchase by Sany Heavy Industry of a concrete-pump manufacturer, Putzmeister; and the acquisition of milling-machine maker, Waldrich Coburg, by Beijing No. 1 Machine Tool Plant.[15]

**Chart 3**

**Chinese acquisitions of German firms by industry, 2002-12**
(% of total)




Note: Based on number of mergers and acquisitions.
Source: BGM Associates Research.

Throughout the EU, the majority of deals are in communications equipment and services, industrial machinery and equipment, and renewables. Chemicals and manufacturing dominate in terms of total investment flows, but there is an increasing sophistication in the nature of the areas targeted, and a greater diversity than before the 2008-09 global financial crisis.[16]

## Motives behind ODI

Large institutional investors are looking at large manufacturing companies and long-term strategic partnerships in such areas as real estate and infrastructure. Private firms are typically targeting strong brand names, extending Chinese companies' global reach. This allows them to expand their product range and increase market share. Examples of this include the acquisition of a yacht builder, Sunseeker, by Dalian Wanda Group; Weetabix by a food and beverages company, Bright Food; and PizzaExpress by Beijing-based Hony Capital.

Chinese institutional and corporate investors' decisions are being determined by a combination of often interconnected factors.

**Gaining market share in acquisition's market.** According to a survey carried out by a professional services firm, KPMG, of Chinese investors in Europe, 85% of respondents indicated that the main reason for investing there is to gain market share within the EU.[17] Additionally, developed-market acquisitions offer the buyer the opportunity to achieve instantly a strong position on the global stage: combining China's low manufacturing costs with distribution networks and research and development (R&D) resources in developed markets "can provide a springboard to the rank of strong or even dominant global-player status".[18]

**Indirect expansion into strategically important markets.** It is also worth noting that ODI into developed markets can act as a springboard into China's strategic emerging-market interests. For example, Haitong's Mr Miyazato states that the acquisition of BESI gave his company a "strong base in emerging markets that are of strategic importance to China, such as Brazil and India".

**Response to domestic market pressures.** Increasing competition at home is forcing companies both to find new markets and improve technologies. Zhang Xiaoji, a research fellow at the Research Department of Foreign Economic Relations, part of the Development Research Centre of the State Council (an advisory body that provides policy recommendations to China's cabinet), explains that surging Chinese ODI highlights that there are fewer domestic investment opportunities, where industrial overcapacity continues.[19]

**Acquisition of knowledge, technology and brand.** This is perhaps the most significant reason for Chinese ODI into developed markets. Chinese domestic production is shifting towards manufacturing higher-end goods as manufacturers respond to rising factor costs and domestic requirements become increasingly sophisticated. China's top economic planning body, the National Development and Reform Commission, stated in 2012: "By acquiring intensive scientific and technological resources overseas, setting up R&D centres, investing in electronic information, biological medicine, new materials and new energy, as well as advanced equipment manufacturing projects, domestic enterprises have now access to more international advanced technologies and management experience."[20]

**Acquisition of raw materials and energy.** Although this may appear to be a largely emerging-market goal, many resource and energy companies are listed in developed markets. For example, the UK's indices are heavy on oil, gas and miners.

**Diversifying and using foreign-exchange reserves.** Large foreign-exchange reserves provide Chinese investors the opportunity to buy overseas assets. Indeed, from a diversification point of view, it is seen as a wise move, as Haitong's Mr Miyazato explains: "Chinese investors, both retail and institutional, need to diversify their portfolios, and tap into the global market. This is reinforced by the liberalisation of the market interest rate in China, with investors increasingly needing to look elsewhere in search of higher yields."

# 3 Evolving forms of co-operation

The form of ODI transaction is determined by increasingly diverse business requirements. Different modes of investment are associated with different goals: the primary acquisition goals are access to a brand name and distribution network, whereas greenfield projects "focus on the establishment of headquarters, subsidiaries, trade representative offices, trading companies and R&D centres, with a view to facilitating Chinese firms' access to Europe and helping them to customise their products for the local market".[21]

## Mergers and acquisitions vs greenfield

In terms of the type of deals that Chinese investors prefer, mergers and acquisitions (M&As) are becoming more important compared with greenfield development. A study of Chinese ODI in the UK[22] revealed that "greenfield development and expansion of existing sites are the main modes of entry by Chinese companies". One example of greenfield development is the establishment in the UK of Huawei Technologies, China's largest telecommunications equipment manufacturer, in 2004. Huawei's Xu Wen Wei, the firm's EU president, said: "Huawei has recognised the importance of the south-east of England as a cluster for most of the world's biggest telecommunications companies, hence our decision to base our European HQ in the region."[23] Huawei followed this up in 2005 with an R&D joint venture with a British telecoms firm, BT, and in 2007 it established a joint venture with a specialist submarine communications company based in the UK, Global Marine, to provide end-to-end submarine network solutions.[24] Since then Huawei has expanded its operations in the UK, for example by partnering with BT on the provision of fibre optic infrastructure and opening an R&D centre in Bristol in 2014.[25]

However, although far from inconsequential, greenfield development seems to have been eclipsed by M&A activity. In the mid-2000s acquisitions in the UK were centred on the automotive sector. High-profile examples include the acquisition in 2004 by Shanghai Automotive Industry of MG Rover blueprints and the purchase of MG Rover by Nanjing Automobile the following year.

In recent years there have been a number of noteworthy, if small, joint ventures by Chinese companies in developed markets. For example, in December 2013 a printing-technology manufacturer, Hangzhou Cron Machinery and Electronics, set up a joint venture with Ryobi, which makes power tools, in Düsseldorf.[26]

In 2014 M&As by Chinese companies in Europe remained popular. According to research by professional services firm Deloitte, a total of 79 M&A deals in Europe involved Chinese investors and companies in that year, compared with just 54 deals in China involving European investors. Top destinations for Chinese ODI in Europe were Germany (16 M&As) and the UK (12), while the most popular sectors were industrial and automotives (31), consumer (13) and hospitality (7). Chinese private equity funds are playing an increasingly important role in China's M&A activity in Europe, accounting for 45 of the 79 deals in 2014.[27]

Notable deals in 2014 included Hony Capital's £900m (US$1.5bn) acquisition of PizzaExpress;

the sale of a German automotive supplier, Hilite, to the Aviation Industry Corporation of China (AVIC) for €522m; the £480m takeover by a Chinese conglomerate, Sanpower, of a UK department-store chain, House of Fraser; and AVIC's acquisition of a German cement plant manufacturer, KHD Humboldt Wedag, for €285m.[28] Chinese companies have also increased investment in countries that fared poorly during the euro zone sovereign debt crisis—such as Italy, Portugal and Spain—and have some reasonably priced companies on offer.[29]

Chinese M&A activity in major developed markets other than Europe has also been on the rise. In the US, for example, Lenovo's acquisition of the handset division of a telecoms firm, Motorola, for US$2.9bn in 2014 was the biggest purchase ever made by a Chinese company in the technology sector.[30]

Globally, crossborder M&As accounted for just 18% of China's ODI in 2003, rising to 34% in 2009 and 43% in 2010.[31] Since 2010 China's total outbound M&A value has exceeded its total outbound greenfield investment value cumulatively by 33%, according to Deloitte. Both the volume and value of Chinese M&A deals have grown since 2010, while the volume and value of China's overseas greenfield investment have been stagnant. In 2014 Chinese investors made the majority of its M&A deals in Western Europe, while the largest share of its greenfield investment was made in the US.[32]

However, whereas US-bound ODI initially has had more of a greenfield character, often involving the setting-up of sales offices or distribution channels, M&A is "growing faster and [is] poised to surpass greenfield projects."[33]

When it comes to developing its own capabilities, China need not reinvent the wheel. It is much quicker to get skills and technologies by buying them in, rather than developing them independently and internally.

A shift from greenfield investment to M&A activity could therefore reflect a growing focus of Chinese companies on gaining a competitive edge within their domestic market. Greenfield projects do not in and of themselves entail acquisition of new technologies. As Chinese firms gain confidence in their own inherent technical capabilities as they move up the value chain, we could see a return to this mode of operation in developed markets.

## The changing character of acquisitions

Chinese investors have been characterised as targeting distressed assets, often getting their fingers burned in the process. A US-based business magazine, *Fortune*, recently quoted the former chairman of the supervisory board of China Investment Corporation, China's sovereign wealth fund, as asserting that 70% of the country's investment overseas is "unsuccessful."[34]

Almost one-half of Chinese investments in Germany folded within their first year or moved production to China in the period before the global crisis erupted in 2008.[35] In the early phase of China's M&A activities in developed markets, major mistakes were made that caused many of these deals to fail. For example, the acquirers often underestimated the large investments of time and money needed to turn around unprofitable businesses, and they often focused on the financials rather than important intangibles such as systems, people, processes and brand values.[36] The takeover of ailing or insolvent German companies combined with a "light touch" approach to integration (see below) was rarely successful, as such takeovers often required stronger intervention and restructuring.[37]

However, the character of acquisitions has changed in the wake of the 2008-09 global financial crisis, where the falling number of acquisitions of insolvent companies can be seen as the result of a learning process. Reed Smith's Mr Wilkinson states: "Things are coming full circle. In areas where China burnt its fingers, such as in the European automotive industry, there is a return of investment. But Chinese investors have learnt an awful lot. There's much more of a focus on wider deal issues, proper due diligence and post-merger integration."

## Culture: Light touch vs fuller integration

Having bought their company, Chinese businesses are then faced with what to do with it: to what degree should they integrate? Greater integration should lead to greater synergies, but risks destroying the culture and operating procedures that made the acquisition attractive in the first place.

In the context of the German market, a number of acquirers are "disrupting the target firm as little as possible and keeping it almost as a completely separate organisation with the original management and brand name", as for example what Beijing No. 1 Machine Tool Plant did with its acquisition of Waldrich Coburg.[38] Much of this is down to the acquirers' lack of crossborder M&A experience and often the "acquirer was severely behind the target firm in respect to managerial capabilities, process know-how as well as technological know-how."[39] Given that the goal of such acquisitions is the buy-in of know-how, it makes sense to absorb this first, before integrating at a later date.

However, Reed Smith's Mr Wilkinson does not see as much of this light-touch approach. Instead, he notes how Chinese companies are grappling with—and learning quickly about—the cultural barriers of fuller integration with acquired firms.

Haitong's Mr Miyazato also says that his company is going for a more thorough integration with BESI: "We have worked on building good contacts with the BESI team, sending people from Haitong to BESI, and vice versa. The more communication, the greater the success. We are quite sure that the greater the cultural similarities, the more successful the integration is."

# Conclusion

As Chinese ODI in developed markets is becoming more common, especially in the wake of the 2008-09 global financial crisis, success stories are starting to emerge. The acquisition of Volvo from Ford (US) by a Chinese automotives manufacturer, Geely, in 2010 is a potentially positive example of China's evolving approach to ODI in developed markets. Initially seen as a shaky start, with friction between the management of the two firms, it now seems to have shifted gear, with leaner production and expansion in the Chinese market and record sales reported in 2014. Whereas Volvo's sales in the US have fallen, China looks to be overtaking them, with production facilities being developed in China (where the company has produced cars since 2013).[40] This is an example of both the repatriation of foreign-bought expertise and brand strength, buying access to foreign markets and expanding Chinese market share. An investment of US$11bn was committed to build the Volvo brand.[41]

China's ODI will continue to accelerate in coming years. Wang Lezhi, president of Beijing New Century Academy on Transnational Corporations (a non-profit organisation), says that "after years of development, Chinese companies have the motivation to build up their global industrial chains and gain a competitive edge internationally."[42]

Mr Wilkinson of Reed Smith predicts "an increase in bigger transactions, and Chinese investors targeting companies in leading positions in their markets. There will undoubtedly be more high-profile investments. In addition, minority stakes in areas where we haven't seen investment historically are a way for Chinese companies to build their knowledge."

For Haitong's Mr Miyazato, the success of China's developed-market investment has profound and positive implications for the world economy: "The global economy is experiencing significant deflationary pressure. Monetary easing by central banks should continue for some time, and the world needs to digest its debt mountain. In this slow-growth environment, industries need to find a solution that is more collaborative globally, to improve services and counter deflationary pressure."

Against this backdrop, he adds, "China—and Chinese ODI—provides good liquidity to markets globally, particularly those that are suffering from deleveraging."

However, challenges remain. For example, government policy could be more supportive, according to Hua Bai of CGG: "I think our government should establish [a] policy which will guide Chinese enterprises to invest abroad. Not only in the national strategic plan industries such as energy, mineral resources." He also suggests that Chinese enterprises should make more use of professional consultancy services to evaluate risks and opportunities.[43]

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LONDON
20 Cabot Square
London
E14 4QW
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

NEW YORK
750 Third Avenue
5th Floor
New York, NY 10017
United States
Tel: (1.212) 554 0600
Fax: (1.212) 586 1181/2
E-mail: newyork@eiu.com

HONG KONG
6001, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

GENEVA
Rue de l'Athénée 32
1206 Geneva
Switzerland
Tel: (41) 22 566 2470
Fax: (41) 22 346 93 47
E-mail: geneva@eiu.com