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# China's geoeconomic strategy: firms with Chinese characteristics: the role of companies in Chinese foreign policy

## Report

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# ➤ Firms with Chinese Characteristics: The Role of Companies in Chinese Foreign Policy

Jie (Cherry) Yu

**In recent years, Western media and governments have portrayed Chinese companies as soldiers in an economic Trojan horse, quietly buying up the world in an attempt to challenge the prevailing order. Indeed, in 2006, the Chinese government had launched a national campaign to encourage Chinese firms to 'Go Global', part of a strategy to increase China's competitiveness and help rebalance China's export-oriented growth model, as well as gaining political capital overseas. Chinese companies have acquired natural resources and purchased sophisticated technologies from their business partners and competitors. Meanwhile, the scope of Chinese foreign policy has expanded enormously, with its economic aspects given equal weight to Beijing's security concerns. As a result, Chinese firms have become an indispensable part of China's foreign policy making process.**

However, whilst Chinese companies are clearly one vehicle of China's great power ambitions, its firms' overseas activities deserve more nuanced analysis. Chinese firms play a crucial role in China's geo-economic strategy, but despite their sheer size, Chinese companies are short of global business exposure. Moreover, their very close relationship with the Chinese government has constrained their ability to become influential players in world economic affairs.

## **A TYPOLOGY OF CHINESE FIRMS**

The Chinese firms analysed in this article are divided into three categories: the China International Investment Corps (CIC); the State Owned Enterprises (SOEs); and large privately-owned companies. The most distinctive characteristic of all three types of companies are their close associations with the Chinese government, either in terms of funding or in terms of the strategic direction of their business activities.

### *The China International Investment Corps*

The China International Investment Corps is China's own sovereign wealth fund (SWF). The CIC was set up in 2007 by the Chinese government as an investment institution tasked with generating higher returns on China's \$3,200 billion of foreign reserves than those offered by the US Treasury. The CIC's formidable size, with a \$200 billion seed fund and later \$400 billion under its management, has attracted unprecedented attention around the world, and helped stimulate debate about the international role of SWFs more generally.

The CIC has been particularly active in Europe and Africa, to the extent that it has become a representative of the Chinese government in conducting its economic statecraft. Around the world, SWFs are paying particular attentions to the type of industry they want to invest in, and measure their returns on investments over three to five years cycle. CIC has concentrated on industries such as civil aviation, civil nuclear technology, bio-tech, infrastructure and oil and gas. In financial year 2009-2010, the average Return on Investment (ROI) for CIC's portfolios was around 11 percent, with a focus on high-technology portfolios in Europe and energy portfolios in Africa. In 2011, CIC seized opportunities to invest in European infrastructure portfolios, mostly via the easier route of equity purchases rather than directly managing the targeted companies. This is because directly management requires related industrial expertise, which the CIC often lacks. Moreover, investing in infrastructure programmes provides local employment opportunities, which CIC hopes will help mollify any hostility to its investments within the countries involved, as for example in the case of CIC's 8.6 percent equity purchase of Thames Water in January 2012. CIC has been particularly active in the UK since its market is more open to foreign investment than comparable economies on the continent.

The CIC's activities in Europe are mostly based on commercial merit, and focused like any other private investors on profit maximisation and risk avoidance. However, its opaque management structure and its direct links with the State Council have caused great discomfort and at times outright hostility in hosting countries. The head of the CIC, Lou Jiwei, and most of its senior management, are directly appointed and assessed by the Chinese Communist Party's Department of Organisation, and its investments are the subject of significant public political scrutiny. For example, the CIC's very first investment, in Blackstone Corporation, a US private equity firm, made a huge paper loss and was much criticized domestically, resulting in the State Council ordering CIC to withdraw from the investment, turning a 'paper loss' into a 'real loss' of \$1.9 billion. The head of the CIC was subsequently asked by the CCP Department of Organisation to explain the reasons for the loss during his annual performance assessment meeting.

Thus the CIC's close ties with both the government and the Party have distorted its portfolio management and may undermine CIC's foundational goal of better utilising China's foreign reserves.

### *The State Owned Enterprises*

The second category of the Chinese firms is the State Owned Enterprises (SOEs), which are mainly located in the energy, utilities, telecommunications, chemical, transportation and construction sectors. The firms constitute the main corporate tax-payers in China, and their activities and performance are supervised by the PRC State Owned Assets Supervision and Administration Commission (SASAC), which is currently responsible for 125 large SOEs. Like the CIC, the Chairmen of large SOEs are appointed and assessed by the CCP Department of Organisation. They are also party secretaries of their respective companies, and their overall management performance is evaluated by SASAC and Department of Organisation. Most subsidiaries of large SOEs are publicly listed, on either or both of the Hong Kong and Shanghai stock exchanges depending on different types of stocks. Unlike Western multinational companies, their non-state shareholders play little role in determining their corporate strategies and overseas investments plans. Instead, their party secretaries usually possess final decision-making power to initiate corporate strategies. Given their direct ties to the government, it is difficult to judge whether SOEs' overseas investments plans are political decisions or based purely on commercial merit. Their close links with the state has become a double-edged sword for Chinese SOEs, providing support for overseas expansion but also hindering growth and profit-making in foreign markets, where their direct links with Beijing have often provoked suspicions and hostility.

### *Large Privately Owned Companies*

The final category of Chinese firms is the large privately owned companies. Many of these are the most well-known Chinese companies worldwide, including brands such as Huawei, Lenovo and Geely. Unlike the SOEs, they are private companies

with powerful individual shareholders who decide corporate strategies. They are independently run but are supervised by Ministry of Commerce (MOFCOM), and despite their operational independence, some of their senior management previously served in governmental institutions or the PLA. Doubts about the authenticity of their independence was emphasised by the deep suspicions in Western media (and among their potential clients) that marked a series of large scale overseas acquisitions were advertised yet necessarily supported by Beijing, which were seen as successes of Chinese companies 'Going Global'. This has hindered their business operations overseas, especially in OECD countries.

## **'GOING GLOBAL'**

China's foreign economic policies have largely been directed to serve domestic economic and developmental interests. As Chinese growth has developed, those interests have become focused around the need for internal and external rebalancing of the economy. Over the past decade, the Chinese economy has been stimulated largely by ever-growing volumes of exports and major infrastructure investments. However, given the persistence of financial and sovereign debt crises, Beijing has acted on the realisation that relying upon the export of low value-added manufactured goods cannot ensure the sustainable growth of the Chinese economy. Similarly, simply building more infrastructure is likely to aggravate overcapacity in the absence of significant sectoral reform. The Chinese economy therefore requires restructuring both in an immediate timeframe and over the longer term.

At the immediate level, foreign consumer demand for manufactured goods has fallen drastically in the aftermath of the 2008 financial crisis, whereas labour and raw materials costs have risen disproportionately high, allowing lower-wage countries such as Vietnam and Cambodia to present substantial challenges to Chinese manufacturing. Over the longer term, expanding production scales and volumes are no longer sufficient to fuel growth. Instead, Chinese firms need to move up the value chain of the global manufacturing sector. Currently, for a typical

manufactured product, less than 20 percent of the first profit margin is captured by its Chinese manufacturer, with the remainder shared by the product designers and downstream distribution, marketing and end-customer support. 'Going global' aims to equip Chinese firms to compete with foreign competitors for this remaining 80 percent. The short-cut employed has been to utilise China's large amount of foreign reserves and companies' cash to acquire financially distressed companies in developed countries, which are already equipped with the industrial and commercial brilliance that requires to make breakthrough.

Alongside this economic adventurism in the developed world, soaring energy demand has led Chinese firms to explore opportunities in resource-rich but politically unstable areas, particularly for new sources of oil and gas, as documented elsewhere in this report.

A further rationale behind the strategy of 'going global' is to ease political pressure on renminbi exchange rates with the rest of the world. Currently, foreign currency earned by Chinese exporters must be exchanged for renminbi once it arrives back on China's shores. This fixed mechanism requires that the People's Bank of China (PBOC) holds an enormous amount of foreign reserves in order to manage renminbi transactions, and keep exchange rates at a level that provides a hedge against the volatility of global currency markets. Reducing China's reliance on exports and investing abroad will alleviate the political pressure on Beijing when it crafts its foreign policies. The more foreign companies the Chinese acquired, the closer economic links with investment destinations will induce. This in turn will reduce the economic and political pressure to allow renminbi to rise. As a result, the renminbi exchange rates will be less likely to be a priority of China's relations with other economies.

Indeed, Chinese firms 'Going Global' may be considered a better alternative than holding governmental bonds. This has been particularly the case during the eurozone crisis. China faces a dilemma of whether to follow its economic interests as the EU's largest trading partner and increase its holdings of euro-denominated bonds, with the consequent risks that increasing its holdings will only further trap Beijing in this troublesome monetary union. On the other hand, reducing

Chinese exposure by reducing its holdings will certainly alienate political allies and more importantly threaten vital sources of imports of advanced technologies. The alternative is to encourage companies investing in the EU, particularly in areas such as aviation and civil nuclear sectors which would not have been open to foreign investors before the crisis.

For Chinese firms, 'Going Global' will ultimately increase their exposure to mature market economies, allowing them to learn sophisticated management skills and to create long-lasting brand value for their products. These intangible assets are abundant in developed countries but relatively scarce in China, and their development by Chinese firms will boost sales volumes and profits. Moreover, those companies that invest themselves of the opportunities of global expansion will reap the benefits in competitive advantage over other Chinese firms both in the domestic market and abroad.

## **THE LIMITS OF 'GOING GLOBAL'**

Chinese firms are determined to become some of the most important players in world economic affairs. However, their close association and somewhat submissive relationship with the Chinese government have impeded their overseas business plans. Moreover, Chinese firms often lack the requisite management skills to operate successfully in their investment destinations.

The policy of Chinese firms 'Going Global' has been eagerly supported by national and local governments, as well as by policy banks, such as China National Development Bank and China Exim Bank. However, their close links with the government posed fundamental challenges to their overseas investments plans and existing business operations. All three types of Chinese firms need to gain approval from corresponding governmental institutions in order to carry out investment plans. Official documents from the PRC Ministry of Commerce (MOFCOM) require that 'all outbound investment plans must be submitted to MOFCOM for approval', centrally if the investment volume exceeds \$100 billion, and at the provincial level for smaller investments. In addition to MOFCOM's

approval, investors must consider the interests of other governmental departments, such as the National Development and Reform Commission (NDRC), SASAC, PBOC and China's Banking Regulation Commission. Even if a project is approved, the involvement of various government bodies with divergent attitudes towards overseas projects can cause delays, and any of the key governmental bodies I mentioned above can veto particular projects that they regard as unviable or which pose threats to their departmental interests.

The intricacies of the approval process are not the only domestic constraint Chinese firms have faced. There is considerable evidence that Chinese firms have on occasion made clearly loss-making investments at the behest of government, which uses the deals as instruments to develop Beijing's bilateral relations with other countries. Moreover, the government does not take responsibility for firms' financial losses that result from signing such investment deals.

Alongside the hurdles of initiating overseas investments, Chinese firms have also encountered difficulties when high profile investments run into trouble abroad, with firms suffering losses provoking a strong sense of public anger and nationalistic sentiment. SOEs that have failed to acquire foreign companies or made significant financial losses are treated as traitors, and their management have occasionally been forced to apologise to both the public and Party elites. For example, CNOOC's high profile, failed bid for Unocal, the seventh largest American oil and gas company, led to the company's CEO cutting his annual salary and submitting a letter of self-criticism to the Department of Organisation and SASAC to apologise for his 'mistake' and explain why he failed in the bid. Such interplay between high-level politics and overseas investment decision-making has done more harm than good for Chinese firms' global expansion plans.

Yet despite the political difficulties that Chinese firms face, the biggest obstacle to their 'Going Global' is that they are not equipped with the sufficient management skills to take on complex and long-term investments abroad. Many Chinese firms have enough cash to acquire foreign companies, but have lacked the confidence and knowhow to deal

with the challenges involved. Such hurdles co-exist on both the production side of their operations and downstream distribution channels. Most of the senior management teams of large Chinese SOEs appointed by the Party are equipped with industrial expertise, but not the necessary management skills and general market knowledge. These SOEs are unfamiliar with the market environments of investing destinations and have little understanding of their end-customers in foreign countries. As a result, they hire leading global consulting firms and investment banks to develop their overseas expansion plans. Some Chinese companies believe that outsourcing professional services firms is equivalent to possessing sound overseas project-management skills themselves. However, the strategies offered by management consultants need to be tailored to the Chinese firms' own requirements, yet are often based on the assumption that these companies have established and transparent corporate governance frameworks. Chinese companies may also hire professional services firms on the basis of their reputations rather than their deep industrial knowhow. In part, this reflects the fact that engaging such major multinationals shows that Chinese firms can afford to employ consultants and investment bankers for their overseas projects, and in so doing validates their balance sheets.

On the production side, some Chinese firms, in particular SOEs, are unaccustomed to operating in a mature market economy. Over the past decades, Chinese firms have operated a model based on large-scale investments, an uncompetitive domestic market and low returns on investment (ROI). Their profits have at least in part been derived through government interventions and protection. Chinese firms that operate abroad do not have 'the Umbrella' of the state, often operating in mature market economies where government interventions are minimal. Firms sometimes naively assume that smooth bilateral political relations between China and their investing destination countries will automatically produce good business environments, and believe they can therefore conduct 'business as usual' in those countries as they would in China.

This of course is far from the reality. Most Chinese firms have had difficulties dealing with local labour unions in their investment destinations and with respect to the cultural differences of local employees. Independent organised labour is a relatively new concept in China. China's All Labour Union is affiliated to the CCP, whereas unions in OECD countries are often formidable forces in salary and welfare negotiations with their employers. Chinese companies have believed that simply retaining local labour forces following an acquisition will be sufficient to maintain good industrial relations, and are not accustomed to labour unions asking for salary increases or going on strike. Chinese firms' lack of experience in negotiating with unions has had detrimental effects on their overall operations abroad. For example, Shanghai Automotives (SAIC) managers began cutting hundreds of Ssangyong workers in 2006, and their relations spiralled downward. Ssangyong employees went on strike for nearly two months. Workers barricaded themselves inside the factory and locked the managers out, with the result that SAIC was forced to withdraw its management from the Ssangyong plant.

On the downstream distribution side, Chinese firms also need to develop their understanding of local customs in order to succeed in their business abroad. What is seen as customary in China may be considered very strange on another continent. Thus understanding consumer behaviour has been a genuine difficulty for Chinese firms, which may not easily be discovered after entering the new consumer territory. For example, one of the most famous Chinese automotive SOEs set a very aggressive annual sales target for the year in which it entered the European market, but it had not observed consumer habits well enough before establishing its sales channels. In China, car purchases are mostly made as one-off payments to dealers, whereas European customers habitually use finance to divide their payments and use local banks to transfer their funds to dealers. Having not understood this market dynamic, the SOE had not put in place deals to make finance options or loan services available with either a local bank or foreign branch of a Chinese State-owned bank. As a result, their actual annual sales were 10 times less than what they had targeted.

## CONCLUSION

In the light of their increasing overseas activities, there is no doubt that Chinese firms play a significant role in China's foreign-economic policy. On the one hand, most Chinese firms benefit from both monetary and political support from the government. They are encouraged to act aggressively across the world to acquire natural resources and cutting-edge technologies. On the other hand, as firms, their close links with the government have hindered their business plans, as they have made economic and political compromises both at home and abroad in order to fit with Beijing's priorities.

Chinese companies are particularly vulnerable – not to mention complacent – when they operate abroad. Some Chinese firms simply assume that acquiring a foreign company represents success, and treat it as an end by itself. However, the really tough challenges they have faced arise from post-merger management and market entry, as firms struggle to adapt to new and unanticipated situations without the Chinese government's interventions and protection. Chinese firms are relatively new players in initiating foreign direct investments in other countries, having previously been more accustomed to being recipients of Foreign Direct Investments. As investors, they still have had a long way to catch up. China's competence in 'buying up the world' has been grossly over-estimated by the West. ■