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New kid on the block learning the rules

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CHINA has arrived in the global outward foreign-direct-investment (FDI) market. The country's outflows, which doubled between 2007 and 2008 to US$54 billion, held steady during the Western economic and financial crisis—at a time when world FDI outflows halved. When the country's outward investment flows reached US$68 billion in 2010, China became the world's fourth-largest outward investor (not counting Hong Kong). The country's outward FDI stock in 2010 stood at US$298 billion, invested in more than 34,000 foreign affiliates controlled by some 12,000 Chinese parent companies. This is an impressive performance when one considers that, only a decade ago, China was a very marginal player in the global outward FDI market.

Because Chinese multinational enterprises (MNEs) are new kids on the block, they face various challenges. To begin with, they lack experience in establishing and managing integrated international production networks, and so they need to function on a steep learning curve. Meeting the internationalisation challenge means they not only have to learn how to enter foreign markets successfully, but to operate and prosper in them as well.

The principal entry mode for many firms looking to access international markets is through mergers and acquisitions—but achieving success can prove difficult. Even experienced enterprises frequently fail in this respect: Daimler Benz's unsuccessful acquisition of Chrysler is a case in point. Being a foreigner abroad is another liability that Chinese enterprises have to overcome. This is particularly challenging for Chinese firms because the gap between the operating environment in China and that in many host countries (especially in developed ones, in which ever more non-natural resource foreign investment is taking place) is particularly wide. Finally, foreign firms need to be good corporate citizens in their host countries, which requires all sorts of activities—some of them involving corporate social responsibility. Chinese firms typically are not familiar with these challenges, so their success is tied to retraining their executives and staff.

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Another set of challenges relates to the FDI regulatory environment, as this environment is becoming less welcoming in a number of host countries, especially in developed countries. The host country challenge is particularly acute when it comes to inward mergers and acquisitions in sensitive industries, or when these involve national champions, or when mergers and acquisitions are being undertaken by state-controlled entities—be they state-owned enterprises or sovereign wealth funds.

CHINA suffers in this respect, as some countries regard Chinese inward investment with suspicion, especially when it takes the form of mergers or acquisitions, because China is a communist country and is often considered a strategic competitor. In addition, most of its outward investment is undertaken by state-controlled entities (mostly state-owned enterprises) that, rightly or wrongly, are seen to pursue interests beyond the commercial domain, and many believe they benefit from all sorts of (financial, fiscal, competitive) advantages. It is difficult to gauge the extent to which this might be the case and to speculate how the situation differs from state-controlled entities and private firms headquartered in developed countries. But it does raise the question of 'competitive neutrality' in the global outward FDI market, an issue that is likely to garner more

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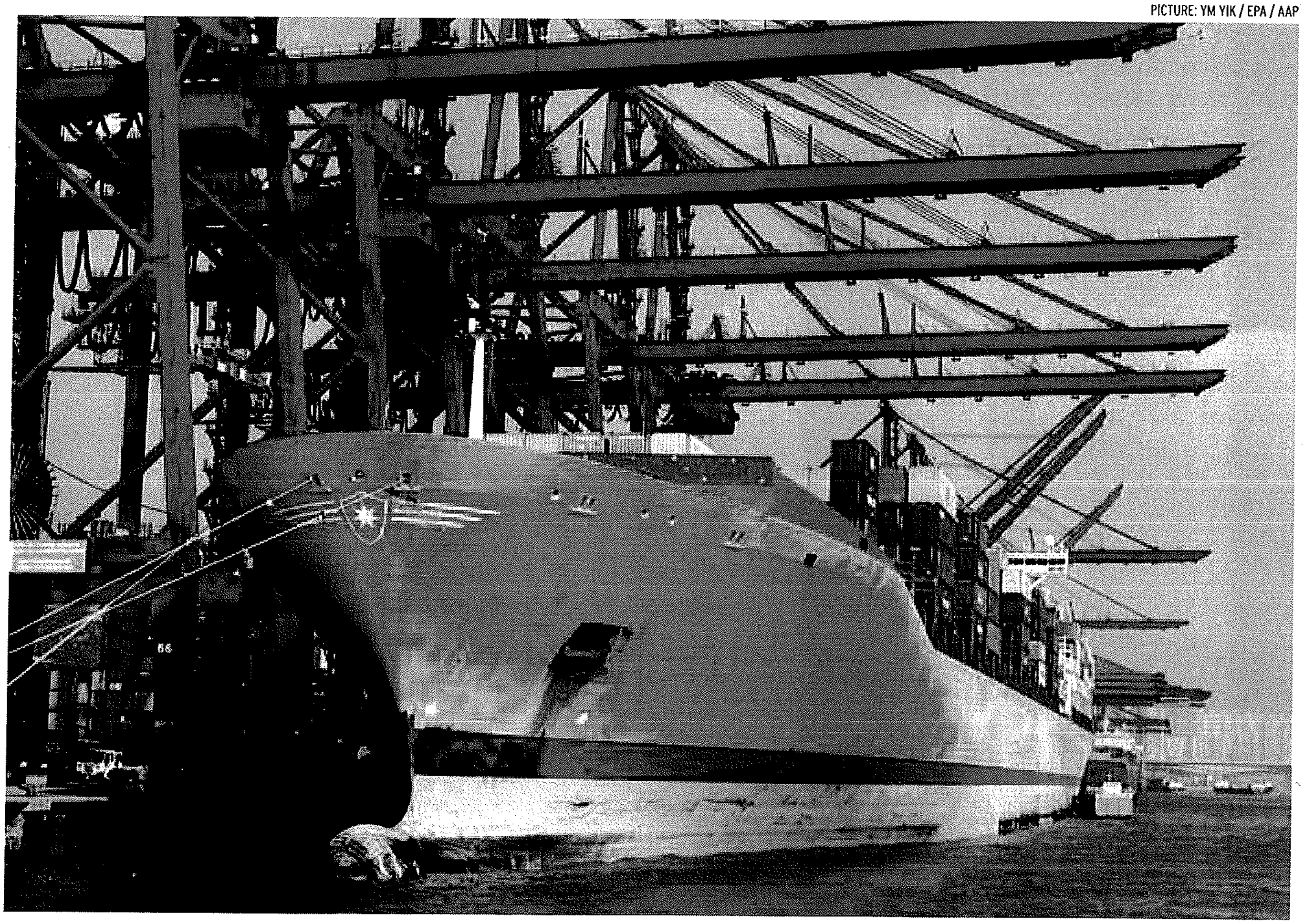

A decade ago, exports were the focus of Chinese commercial activity and the country was only a marginal player in the global outward foreign direct investment market. Now it is among the world's largest overseas investors.

attention in the future. The upshot is that mergers and acquisitions conducted by Chinese firms are receiving more regulatory attention in a number of host countries, similar to Japanese firms in the 1980s. This implies that Chinese firms need to be extra careful when expanding abroad in this way: they have to prepare their moves and they need to learn how to navigate the corridors of power in important capitals.

Finally, there is the home country challenge. Chinese firms are lucky in that they benefit, like their competitors headquartered in developed countries, from a regulatory framework that not only allows outward investment but encourages it. (Firms in most other emerging markets do not enjoy this advantage.) But given the relative inexperience of Chinese enterprises, the Chinese government has a particular responsibility to keep an eye on the manner in which China's outward investment is conducted. Most notably, firms need to be reminded that, since host countries consider foreign investment a tool to advance their development, this investment needs to be sustainable. In other words, FDI needs to take place on the basis of fair-governance mechanisms (especially when it comes to contracts) and contribute as much as possible to the host country's economic, social and environmental development. If the country's FDI is not sustainable in this manner, it may well suffer a backlash in the years to come.

All of these challenges can be overcome, but they need decisive action and good will on the part of all concerned. In time, as with Japanese and South Korean multinationals before them, Chinese firms will cease to be the new kids on the block. They will become regular players in the global FDI market, their outward investments improving corporate competitiveness and contributing to the development of host countries.

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