Bringing Third Parties into China Investments

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An increasing number of foreign companies, including large firms, are beginning to find that direct investment in China is far more complex than initially perceived. Firms are mainly having difficulty in:

1) identifying real investment opportunities that conform to public policy directions (as opposed to the whim or circumstance of agents' connections)
2) preparing potential projects to international standards. given the scarcity of accurate and reliable market information in many parts of China
3) obtaining both direct and indirect approvals from local, provincial and state-level agencies.

Investors who have succeeded in these three steps – i.e., bringing a project to the prospectus stage – then encounter the single biggest challenge in investing in China: obtaining financing.

Given the huge volumes and stiff competition for project financing in China, Canadian firms might need to turn to banks from other countries, many of whom are represented in Hong Kong. Most project financing is done through syndications of lenders already familiar with limited recourse financing in China and elsewhere in Asia.

We recently interviewed Hong Kong, Japanese, American, and Korean merchant and commercial banks to try to get a feel for their current lending criteria in China. The consensus is that, although the situation is in flux, project financing requests need to be backed up by:

1) professionally prepared feasibility studies and project designs to international standards
2) potential for annual net returns on investment competitive with other countries in the region, supported by suitable guarantees on income streams and foreign exchange risk
3) all project approvals, including State Council approvals for projects under its purview
4) Bank of China head office or acceptable senior ITIC guarantees of local share of debt financing (other selected national bank guarantees might be acceptable, but only from headquarters' offices)
5) a strong foreign partner with demonstrable sector experience outside its home country and full guarantees or acceptable collateral
6) minimum 20-25% equity investment in the project
7) participation, if possible, by a major multilateral agency
8) a domestic partner incorporated to international standards (i.e., able, if necessary, to secure a recognized credit rating).

While some Canadian companies have the right combination

of credibility, market knowledge, experience, and financial capacity to satisfy increasingly strict financiers, many should consider turning for equity to third parties who have more experience in China, more extensive contacts, greater market knowledge, and better credibility in the eyes of lenders. Even though this will dilute equity, Canadian companies will find that bringing in the right third partner can, aside from reducing risk, open many doors to approval agencies and project financiers without whom investment intentions will simply remain as well-meaning "memoranda of understanding." In our view, the best third-party partners for China projects can be drawn from companies in Hong Kong, Taiwan, Singapore, Japan, and the U.S., from direct investment funds (most of which are run out of Hong Kong), and from international financial institutions such as the World Bank and the Asian Development Bank through their respective private sector agencies and programs.

Hong Kong

Although all major foreign investors by now have some form of representation in Hong Kong, by "Hong Kong companies" we refer to those that were founded in and are based in the territory. Even though about 20% of investment from Hong Kong in China is thought to be by de facto China firms, and another 10-15% by Taiwanese companies, the share of true investment by Hong Kong companies is still by far the largest among foreign investors (see Figure 1).

Many Hong Kong companies have much experience in China and, for historical reasons, are well connected in various parts of the country. Even though the largest share of Hong Kong investment has been in Guangdong Province (e.g., 80% of Hong Kong's manufacturing capacity has now relocated to the Pearl River Delta), in recent years Hong Kong money has flowed northwards to Beijing and then to Shanghai and the Yangtze Delta Region.

Some large companies are now investing heavily inland in Sichuan and Hubei Provinces in particular. Although much of this investment has been in Hong Kong-style speculative real estate development [which is now reeling from State-level credit constraints, restrictive taxation, and, in many parts of the country, over-building), large and medium-size companies have increasingly become active in industrial, retail, distribution. transport, power, and infrastructure investments.

In our view there are two major issues that Canadian firms will encounter when approaching potential Hong Kong partners:

1) being able to clearly demonstrate the added value that the Canadian company brings to the venture
2) working fast enough to keep up with busy Hong Kong firms' limited attention spans.

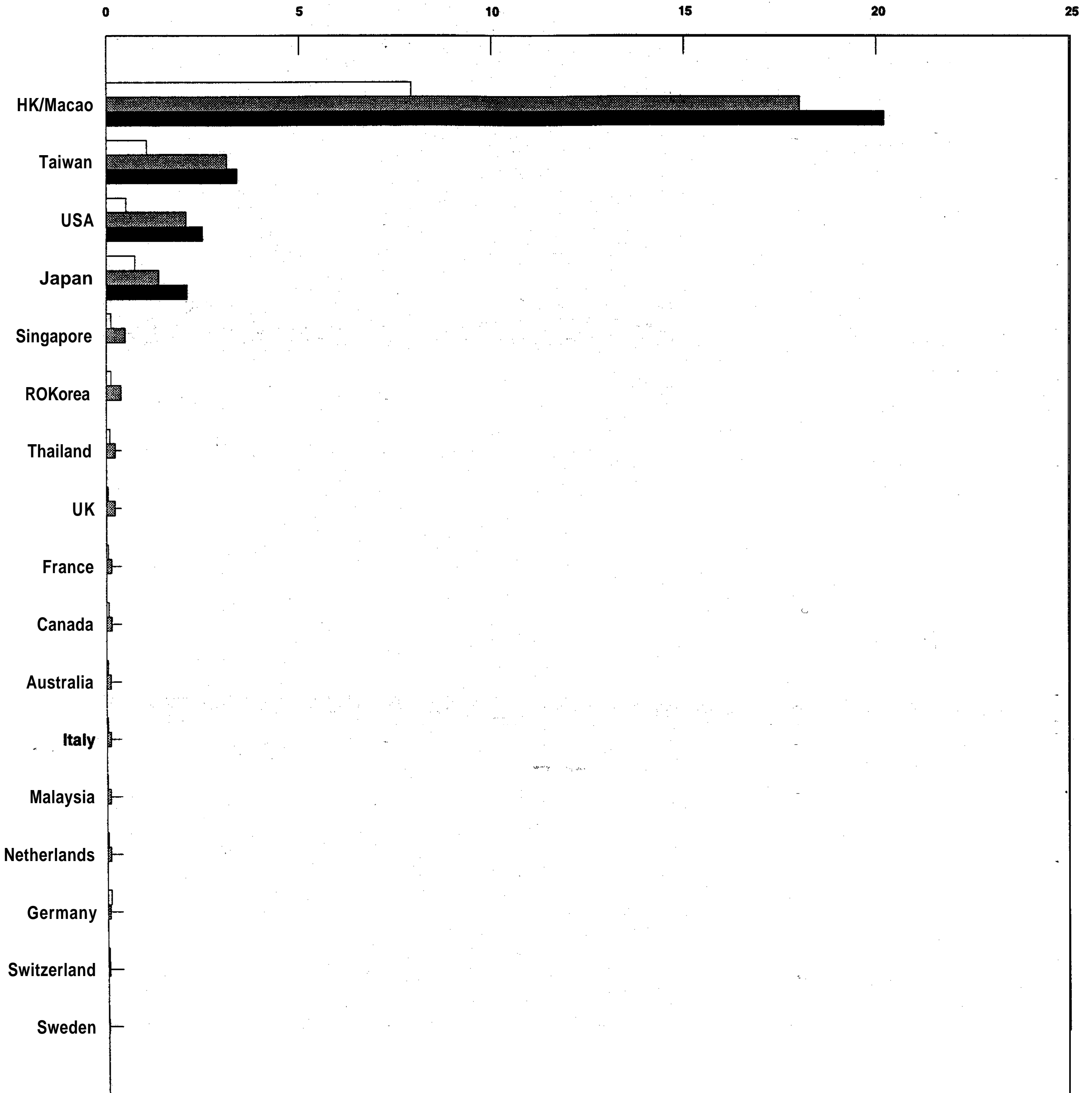
On the other hand, there is growing reluctance in many parts of China to accept Hong Kong investment, which is often viewed as short-term and manipulative; Canadian companies with solid projects can take advantage of this situation by "internationalizing" the investor team, particularly for projects outside of southern China.

Another important source of equity financing in Hong Kong lies in several huge infrastructure investment funds. One of the major funds was recently established by an American insurance company together with the Government of Singapore Investment Corporation; half of its US$1.1-billion capital base is being targeted at China. Other funds focus on industry or on specific regions in China. Most of these funds will only take a minority interest, but the credibility that some of them carry with project financiers is in some cases considerable. In addition to funds, Hong Kong is the regional nexus for several large U.S. and European private pension investment management companies that are constantly looking for viable direct-equity investments in Asia.

Taiwan

Taiwan government sources informally estimate that there is as much as US$20 billion invested in China by Taiwanese firms; investment bankers in Taipei suggest that there could actually be three times this investment veiled in various corporate forms offshore. Although the People's Republic of China cannot yet openly condone widespread investment in the PRC, in reality it is moving quickly to facilitate indirect trade. Taiwan's new economic development strategy is to promote the island as the "Asia Pacific Regional Operations Center" for multinational companies in high-end manufacturing and R&D, sea and air transport operations, international finance, telecommunications, and media. This recognizes that most low- and medium-level manufacturing is

Actual DFI by Country



now rapidly moving offshore to cheaper locations, including China. Aside from government reserves, there is an enormous pool of private capital seeking investments in China. Although Taiwanese investment initially focused on Fujian and Guangdong Provinces, it is now moving throughout the country; there is strong interest now emerging in investing in northern provinces and the Bohai Gulf.

One of the greatest concerns of Taiwanese investors in China is somewhat intangible: ensuring that, given cross-Straits uncertainties, companies from Taiwan will get "fair" treatment and "protection" from Chinese government authorities equal to that provided to other foreign firms. There is a perception that arbitrary actions are less likely to be taken against North American or European companies than against Taiwanese firms. Whether or not this is true, we have been told that many Taiwan companies would invite participation of strong Canadian firms, even to the extent of funnelling equity investments in China through Canada. Problems that might be encountered are:

1) the generally small (under $5 million) investments Taiwanese firms typically make in generally low value-added manufacturing facilities
2) communication in English, which is still not widespread, particularly in small and medium-size companies, despite the heavy American influence in Taiwan. On the other hand, the cultural and linguistic advantages of working with Taiwanese companies in China have immediate and obvious benefits.

Singapore

Although half the size of Hong Kong, Singapore enjoys a particularly good reputation in many parts of China. The "Singapore model" of economic and social development appeals to many Chinese authorities, especially at the local government level. Singapore's current economic strategy is to encourage local firms to invest offshore, including in China, which represents a major market with strong cultural ties.

Senior government leaders in recent years have led trade and investment missions as far afield as Guangxi and Shandong Provinces, and, given the unique relationship between government and business in Singapore, are spearheading some significant "private sector" projects. For example, "Singapore Inc." is taking the lead role in developing an advanced industrial township in Suzhou and a business park in Wuxi, and has invested heavily in long-term commercial real estate projects in strategic parts of Shanghai and in transport projects in the Yangtze Delta.

Despite its small population base, the government of Singapore has amassed a large pool of investment capital through its Central Provident Fund and internal operations. Separate companies have been established to manage the investment of this capital internationally.

Unlike in Hong Kong, Canadian firms will find Singapore investors more cautious and strategic in the sense that investments, even by private firms, should support the public policy initiatives of the Singapore government. In our view, this bodes well for Canadian firms in certain high-technology sectors, in shipping, and in infrastructure where Canadian strengths can complement those of Singapore firms.

Japan

Significant Japanese investment in post-war China dates back to the end of the Cultural Revolution. While most of the relocation in the 1980s of Japan's low and medium value-added manufacturing capacity was to Southeast Asia, interest has recently shifted to China, which, aside from being closer to Japan, has (for now) lower labour, land, material, and energy costs. Although focused on northern regions of the country, Japanese companies have begun to spread throughout the coastal regions and, to a more limited extent, inland as well. China is viewed by many Japanese firms in a paradoxical way: it is a huge domestic market with enormous potential, yet the country is also viewed as a long-term economic competitor. Major trading companies have established large-scale manufacturing facilities in China, and this has led to a rapid increase of medium-size supplier firms relocating in order to reduce production and transportation costs.

Japanese investment in China is probably the most strategic investment by any country in Asia. Linkages between government and business (particularly the large trading companies) are strong. The Import-Export Bank of Japan (equivalent to Canada's EDC) has a facility for direct equity investment in offshore projects and is one of the few agencies that has issued third-

country buyer credits on "build-own-operate" projects. The Overseas Economic Cooperation Fund (Japan's window for official development assistance, which ranks first in world ODA contributions) began working in China in 1980 and now has a portfolio of 1 trillion yen. Aid is still heavily tied to Japanese procurement although this is increasingly opening up to third countries. Unlike CIDA, Japan's ODA programs in China are determined at the highest political level in close consultation between Chinese and Japanese leaders (who are in turn heavily influenced by the large trading companies).

Japan is probably the most challenging source of third-country equity for Canadian firms seeking to invest in China. In addition to the marked cultural differences in doing business, Japanese trading companies already have extensive networks of personnel in the field in China and do not require capital. Canadian companies must have very solid projects and a unique niche in order to demonstrate the added value that they bring to the investment team. They must then be very careful in selecting one of the top trading companies. Given their size and complexity, Canadian firms should in fact specifically target the operating entity in their sector from among the myriad divisions and associated companies in the chosen conglomerate. A major advantage to linking up with a Japanese firm is that, once established, business relationships are enduring and can spread quickly to other markets in Asia.

International Financial Institutions

Most businesses, if they are aware of them at all, view the World Bank and the Asian Development Bank simply as large dispensers of soft loans to national governments for projects that are not commercially viable. While this may have been true in the past, in China these multilateral agencies are becoming increasingly aggressive in supporting private sector initiatives, particularly in sectors and parts of China in which commercial equity and debt financiers are reluctant to enter.

The International Finance Corporation (IFC) is a member of the World Bank Group and operates as a link between emerging markets and sources of foreign equity and debt financing, largely by co-ordinating project finance. It is the largest source of direct equity and debt financing for private firms in emerging markets. IFC has a resident mission in Beijing handling all China projects; it acts both as an investor (minority interest) and as a catalyst or "mobilizer of additional long-term funding for eligible projects."

In our discussions on project finance issues in China with commercial lenders in Hong Kong and North America, all lenders that we met indicated that they would look much more favourably on a project in which IFC has committed equity or debt financing. IFC's China portfolio has more than tripled in size over the past two years; so far very little has been committed directly to infrastructure projects. Once a project has been formulated with a reputable sponsor, IFC can work to mobilize additional project funding through:

1) co-investment and co-financing
2) arrangement of loan syndications, underwriting, and placement of debt securities (where appropriate)
3) credit enhancement.

IFC, after due diligence to World Bank standards, is prepared to accept commercial and economic environment risks that other financial institutions are not prepared to consider. Once IFC takes on this risk, other institutions have tended to "come on board" in other countries in the past. We have been advised that IFC should be approached after:

1) pre-feasibility analysis has been completed
2) reputable project sponsors — both domestic and foreign — have signed on with some equity investment
3) at least a memorandum of understanding or letter of intent has been signed

The World Bank itself has recently begun direct support to private sector projects in China through its guarantee program, which is essentially directed to large infrastructure projects "where the demand for funding is large, political and sovereign risks are significant, and long-maturity financing is often critical to a project's viability." This program is designed to attract new sources of project financing by covering risks that commercial lenders are typically not prepared to consider.

The Bank provides two types of guarantee:

I) a partial risk guarantee that covers specific risks from non-performance of sovereign contractual obligations or political force majeure
2) a partial credit guarantee

that covers all commercial risk during a specified part of the financing term, generally by extending the maturities beyond what private lenders typically provide. For example, the Bank has recently provided a partial credit guarantee for longer maturities for the Yangzhou Thermal Power Project, which helped project proponents raise US$120 million from commercial banks and insurance companies. The Asian Development Bank, which has a smaller capital base, provides similar support to the private sector in China and elsewhere in Asia.

The World Bank and ADB generally look to large projects. Their guarantees also require counter-guarantees from the Chinese government, which count as part of the total country lending program. China is beginning to approach the World Banks limit of 10% of total lending to any single country. Therefore, projects will need to have a clear public policy advantage and strong central government support to get World Bank guarantees. In the case of IFC, although its equity investments are generally in the order of $10-50 million, the Corporation will only become involved in a project if at least 50% of equity is in domestic and/or foreign private hands. This automatically precludes investment in strategic sectors in China in which the government wishes to retain ownership control. However, aside from the comfort level given to project lenders, one of the biggest advantages to foreign investors in linking up with these multilateral agencies is their extensive market knowledge derived from over a decade of very professional work in China. These banks have been "investing" in China longer than most organizations and now have detailed information and widespread contacts in central agencies.

Conclusions

Finding a truly viable investment opportunity in China is, despite a continuing deluge of "deals." still hard work. Incubating an opportunity from the "letter of intent" stage to a project prospectus requires firm equity commitments, access to solid market information. connections at various levels of government, and often a wide array of approvals before project proponents can expect to get even mild interest from commercial lenders willing to take on project risks in China. And, as many Canadian firms are finding, without both equity and debt financing, the final deal cannot be signed.

Third-party partnerships provide one route that might serve to shorten the project cycle for some Canadian companies. They require considerable strategic thinking. What specifically does the Canadian proponent need from a third party? What does the Canadian firm bring to the deal that a third party can't? Which community of potential partners is best suited to the deal? What kind of third party would project lenders feel most comfortable with? Which party would be acceptable to partners in China? Answers to these question are of course deal- and company-specific. However, the prospect of third-party co-operation may provide some encouragement to Canadian firms stalled in the uncertainty and complexity of China's various markets. ■

Resume File Service

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For more information on this service, please contact Deborah Hancock by telephone at (416) 954-3800 or by fax at (416) 954-3806.