

China Goes Outbound: Overseas M&A and Private Equity in Latin America

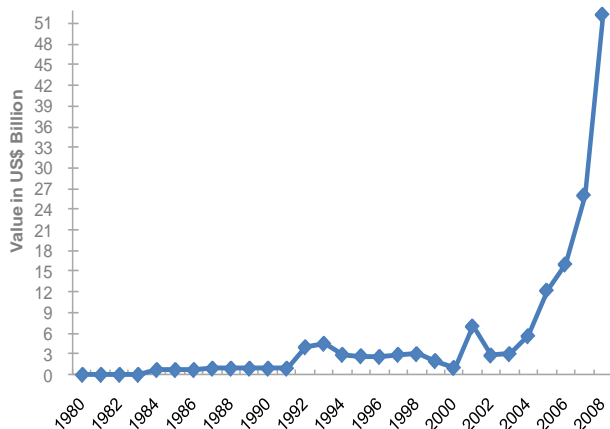
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September 3, 2009

With US\$2.1 trillion in foreign reserves, China has approached the global financial crisis as a tremendous buying opportunity, providing private equity investors in Latin America a great exit opportunity. This year, China is expected to invest between US\$150-180 billion in overseas transactions according to Standard Chartered, an increase of over 200% from 2008's record of US\$50 billion.

This article seeks to illustrate why China is increasingly seeking overseas investment opportunities as well as the scope and dimensions of its efforts. Specifically, it will focus on China's increasing appetite for Latin America and the implications and opportunities this provides the Latin American private equity community.

Figure1: China's Outbound Foreign Direct Investment (1980-2008) in US\$Bn

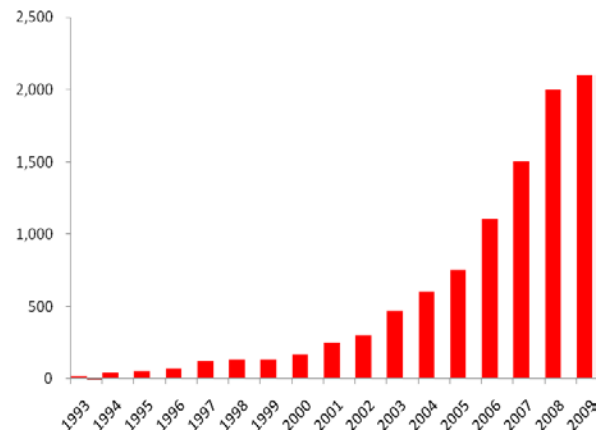


Sources: ODCE, MOFCOM, China Statistics Bureau

Why is China Investing Overseas?

In a recent speech, Chinese Premier Wen Jiabao stated that China will use its foreign exchange reserves, the largest in the world, to support and accelerate overseas expansion and acquisitions by Chinese companies. Today, China has over US\$2.1 trillion in foreign exchange reserves, up from US\$1.9 trillion at the end of 2008.

Figure 2: China's Foreign Exchange Reserves 2009 (US\$Bn)



Source: State Administration of Foreign Exchange

China has three main reasons for undertaking overseas M&A:

- First, Beijing is looking for a way to diversify its massive holdings of U.S. debt securities given the possibility of a U.S. dollar devaluation (yet, ironically, a dollar devaluation relative to the yuan means greater purchasing power abroad—another incentive for outbound investment).
- Secondly, China is tapped out of most major commodities including iron ore, copper, cobalt, oil and timber. The country simply cannot continue to grow at 9% per year (as it has for 30 years) without securing a stable supply of commodities.
- Third, many Chinese firms want to move up the value chain and are looking to acquire retail and distribution assets, or firms that have proprietary technology, in order to complement their manufacturing plants.

The bulk of China's outbound M&A activity is focused on the acquisition of natural resources, whether in Australia, Africa, or Latin America. Within the natural resources sector, Chinese acquirers have been especially active in offshore mining and oil/gas. The calculus behind this sector focus is straightforward: China has 20% of the world's population, an astronomical growth rate, and yet relatively few natural resources.

Who are the Players in China leading the Overseas Investment Charge?

According to China's Ministry of Commerce (MOFCOM), there were over 10,000 documented overseas deals in 2007 (the actual number is likely to be much higher as many firms seek to bypass the registration/approval process). To date, most of the cross-border projects have involved large, publicly traded Chinese state-owned enterprises (SOE's). For most of these companies, the Chinese government is still a substantially large shareholder (in some cases up to 70-80%). Because of these companies' critical mass, and given that they enjoy government policy directives and support, it is logical that they have been in the forefront of China's globalization efforts.

In China, shareholders have less power than the government. As a concrete example, the senior managers of most SOE's are appointed directly by the Communist Party. These issues make it hard to determine the motives and incentives of SOE's. But commercial pressures on SOE's are growing rapidly, and CEO's are increasingly focusing on their stock prices. In short, the semblance between a Chinese SOE and its private-sector western counterpart is growing faster than the differences.

China's Outbound Investment in Proper Context

While China's aggressive growth in its overseas investments is causing consternation in certain quarters, leading to accusations that it is "buying the world," it is imperative to put the amounts in a comparative global context. In comparison to the overseas investments made by developed nations, China's overseas investment amounts are still quite small. As an example, the Peterson Institute for International Economics reports that China's overseas foreign investment only *recently* approached that of Finland. And per-capita overseas foreign stock in China was approximately \$70 in 2007, compared to \$9,000 in the United States, and \$15,000 in Germany. "Yet China demands attention given its size, unique public-private hybrid economy, and because it is well positioned to significantly increase its outbound investment in the coming years. China is also notable for the countercyclical nature of its OFDI flows: In 2008 China's overseas foreign investment doubled while global foreign direct investment flows dropped an estimated 20-30 percent."¹

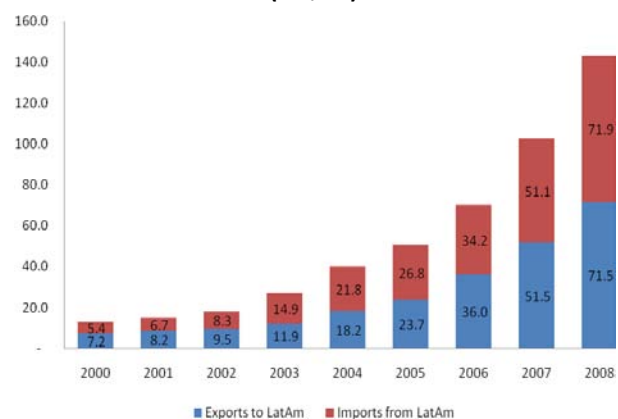
¹ Daniel H. Rosen and Thilo Hanemann. *China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*. Peterson Institute of International Economics. June 2009.

Chinese firms are in an interesting predicament. While their increasing wealth means they can afford to make acquisitions, Chinese buyers are oftentimes regarded with suspicion. After a number of failed high profile acquisitions efforts (including CNOOC's Unocal bid in 2005 and Huawei's bid for 3Com in 2008), many of China's state-owned giants have been cautious about being too visible in acquiring famous firms. Instead, they are focusing on low-profile deals in places like Africa and Latin America where there are abundant natural resources and where building roads, bridges and rail lines helps foster political goodwill.

China Outbound Investment in Latin America

Trade between China and Latin America is not new. From the 1500's until the 1800's Asian commerce was transacted in silver "columnario" coins minted in Latin America and transported to China from Acapulco via Manila. And as recently as 20th century Shanghai, the unit of currency was a silver coin known as the "Mex Dollar." Despite these historic links, Latin America's commercial relationship with China has been virtually non-existent for the last 5 decades. However, this has changed dramatically, with the recent speed and scale of trade over the past several years catching many analysts by surprise. In 2004, Chinese President Hu Jintao declared that he believed Sino-Latin bilateral trade would grow to US\$100 billion by 2010. That record was broken two years ago, a full three years ahead of his predictions. Trade between the two regions rose from \$8.4 billion in 1995 to an impressive \$140 billion last year. Today, China is Latin America's second largest trading partner, Brazil and Chile's largest export market, and the second largest market for Peru.

Figure 3: China's Bilateral Trade with Latin America (US\$Bn)



Source: WIND

In the past two years alone, China has invested billions in Peru's "Toromocho" copper mining project, became the largest foreign investor in the Ecuadorian oil industry, created a multi-billion petroleum investment fund with Venezuela, and spent US\$10 billion to finance Petrobras' offshore oil projects. Three weeks ago, China National Petroleum Corporation and CNOOC bid roughly \$17 billion for a stake in YPF, Argentina's largest oil company owned by Spain's Repsol.

Exit Opportunities for Latin America PE Firms

China's investment in Latin America should have a particular resonance for Latin American private equity firms. As the global economic crisis continues to hinder the ability of PE firms to exit their investments in the western hemisphere, China's strong capital position and interest in the region offers a viable option. Similar to their U.S. or European counterparts, Latin PE Funds should seriously consider portfolio company exit strategies that are in line with the Chinese outbound investment in the region.

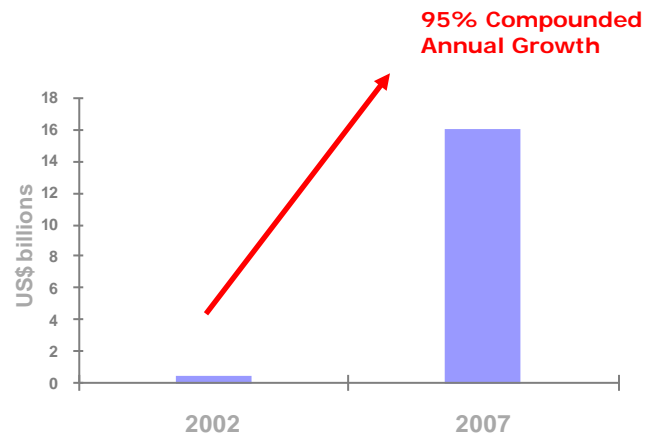
There are several sectors of Latin America business that lend themselves to Chinese investment. One is obviously natural resources. Another is infrastructure, including railways, utilities and ports. But areas that are becoming increasingly interesting are investments that provide opportunities to Chinese consumer companies looking to break into Latin America. China realizes consumers in the U.S. and Europe are tapped out, and Latin America has over 500 million people who are logical consumers for Chinese products. The financial services industry is another sector that is of growing interest to Chinese investors. Last year, China's ICBC Bank invested US\$5 billion in South Africa's Standard Bank, a platform that gave Chinese firms access to financing and relationships throughout the continent of Africa. There is definite interest on China's part to acquire minority equity positions in banks and those Latin American private equity firms with stakes in commercial banks should definitely consider China as a potential buyer. Together, these sectors represent a significant amount of the private equity investments made in Latin America.

China's Involvement in Latin American Private Equity

Compared to Latin America, private equity investment in China is very new. Other than a few adventurous firms, it wasn't until 2001-2002 that there were any serious amounts of private equity money in China. In 2002, the total amount of money raised for venture capital and

buyouts was roughly US\$500 million. By 2007 the figure had grown to more than US\$15 billion.

Figure 4: PE/VC Money Raised for China (2002 vs. 2007)



Source: Zero2IPO Research Center, APER Research

Given the fact that the private equity industry in China is very new, it should come as no surprise that Chinese private equity looking to do outbound deals is an even more recent phenomena. At this point, only a handful of Chinese investors have the necessary knowledge necessary to do deals outside of China. To date, there has been no Chinese private equity activity in Latin America.

Having said this, China is coming. It is only a matter of time before institutions such as CIC (China's US\$200 billion sovereign wealth fund) open offices in Latin America. We also see multilateral institutions such as China Development Bank and China Export-Import Bank getting strongly involved in Latin American deal making.

Developing Outreach Strategy Critical to Success

We believe that the Latin American private equity industry needs to think about having a China strategy. There are a number of ways to leverage China. For some firms, this could involve exits of portfolio companies to Chinese strategic buyers. In other cases it could mean courting Chinese sources of capital such as CIC as LP's for future funds. Those funds with portfolio companies in the manufacturing arena should also consider sourcing component manufacturing to China and doing the final assembly in Latin America.

Recently, the Shanghai stock market created a tremendous buzz when it announced that foreign firms would be allowed to IPO in China as early as next year. For certain

types of Latin American portfolio companies, particularly in natural resources where there is a tangible link to China, an IPO in Shanghai might provide the highest exit valuation. A Shanghai stock exchange listing could help tap into China's enormous pool of liquidity (analysts estimate that China has over US\$4 trillion in savings). Stocks would also be listed in the Chinese RMB which could be a huge benefit to Latin companies concerned about a U.S. dollar devaluation.

In short, there are numerous ways to forge bonds between China and Latin America. And for those Latin American private equity firms with appropriate levels of foresight and determination, the rewards to creating a link to China are huge. A word of caution: without adequate

preparation and commitment, the results can be very disappointing. Developing relationships in China takes time and (most importantly) follow-up. Distances are great and flights on average range 30-35 hours. Time zone differences, language barriers and different business norms all pose great challenges. In theory, having a China strategy makes sense. But in practice, it requires a serious commitment of time and resources. The Chinese word for crisis, "Wei Ji" (危机), is made up of two characters: danger (危) and opportunity (机). This is an excellent concept for Latin American private equity funds to keep in mind when considering any China strategy.

Industry	Hong Kong	Asia	North America	Europe	Oceania	South America	Tax Havens*	Africa	Total	% of Total
Financials	52	15	5	1	0	0	4	1	78	19%
Raw materials	9	8	16	8	22	6	1	4	74	18%
Energy and power	7	16	8	7	4	4	2	4	52	13%
Industrials	14	10	9	16	2	0	0	0	51	13%
High tech	17	12	10	1	2	1	1	0	44	11%
Consumer Prods.	6	5	7	5	0	0	0	0	23	6%
Media	14	1	4	0	1	0	2	0	22	5%
Consumer Staples	7	5	2	4	0	1	0	1	20	5%
Telecom	8	2	4	3	0	0	0	0	17	4%
Healthcare	3	2	5	0	0	0	1	0	11	3%
Retail	6	0	1	0	1	0	0	0	8	2%
Real Estate	5	1	0	1	0	0	0	0	7	2%
Total	148	77	71	46	32	12	11	10	407	100%

* Tax havens include Cayman, Bermuda, BVI

Source: Thomson Financial (Chinese transactions from 2000-2008)