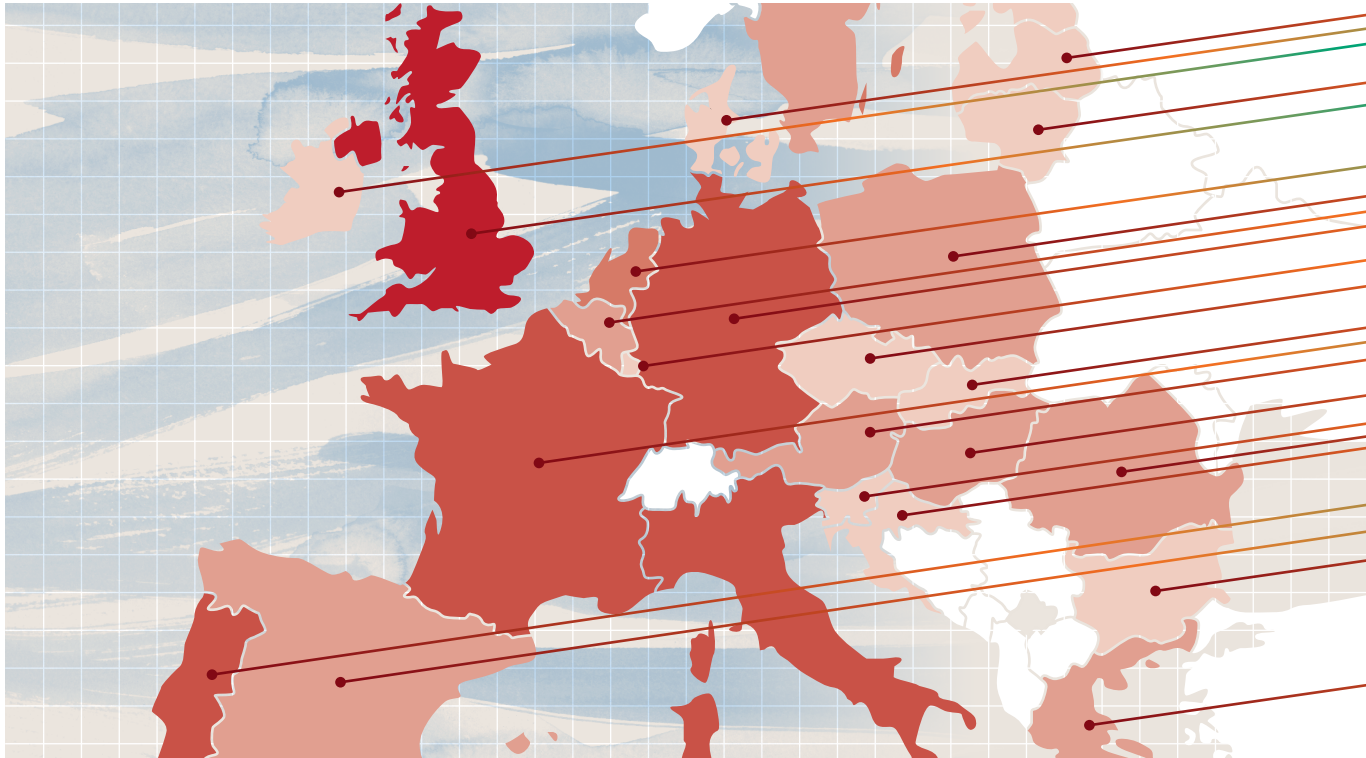


A New Record Year for Chinese Outbound Investment in Europe

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- China's global outbound FDI continued to surge in 2015 and the Chinese leadership touts investment as a new pillar of China's positive contributions to the global economy.
- Chinese OFDI in Europe hits another record high in 2015, highlighting the potential for China as a source of productive capital but also reinforcing existing concerns.
- The new realities of slower growth and transition to a new economic model explain Chinese investors' focus on advanced industrial assets, modern services, and real estate.
- State-owned investors continue to account for a majority of China's EU OFDI, and new

financing entities could further boost the role of state capital.

- Chinese investment increasingly extends beyond the "Big Three" economies (Germany, France, UK), fuelling the intra-European competition for Chinese capital.
- Germany remains one of the most appealing destinations for Chinese investors looking for technology, consumer markets, and safe haven assets.
- China's global investment boom is unlikely to end any time soon but China's fight against capital flight and bad debt pose short-term risks for 2016.

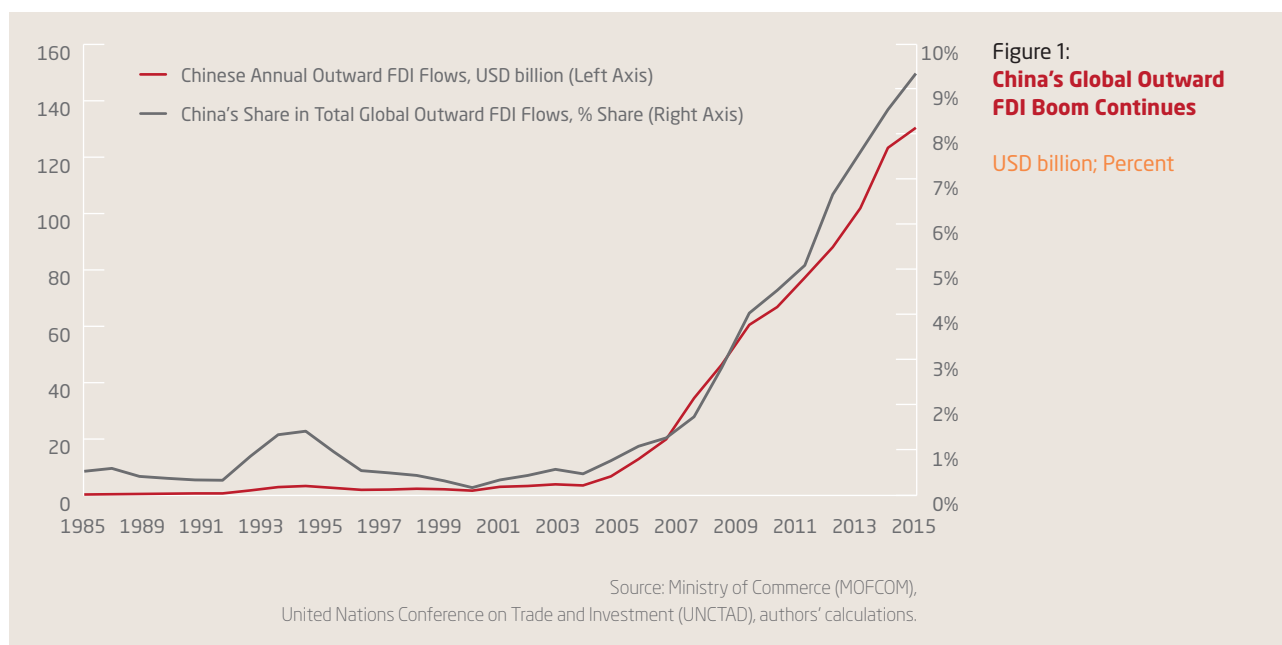
A New Record Year for Chinese Outbound Investment in Europe

Chinese investment in Europe has grown exponentially in recent years, as discussed in our in-depth **special report** (“Chinese FDI in Europe and Germany – Preparing for a New Era of Chinese Capital”) released last year. This note provides an update on Chinese investment patterns in Europe in 2015. We find that Chinese outbound foreign direct investment (OFDI) hit a new record high of EUR 20 billion last year, illustrating China’s potential to become an important source of capital for Europe. At the same time, the competition among EU states for Chinese capital has intensified, which already weakens European leverage vis-à-vis China on important strategic questions. Moreover, investment patterns in 2015 further aggravate existing economic concerns related to Chinese investment, most importantly the lack of equal market access for European companies in China and potential market distortions through state-owned and state-supported enterprises. Addressing those concerns now is critical as China expects to deploy an additional USD 1 trillion in outward FDI in the coming five years in Europe and globally.

China’s global outbound FDI continued to surge in 2015 and the Chinese leadership touts investment as a new pillar of China’s positive contributions to the global economy

China’s global outward FDI has been on an impressive growth trajectory for the last decade and flows climbed to a new record high last year. While official full-year data is not yet available, we estimate that outward FDI flows hit USD 130-140 billion in 2015, up from USD 123 billion in 2014. China’s global OFDI stock now exceeds USD 1 trillion, triple the amount compared to just five years ago. This impressive growth has turned China from a small player to one of the world’s largest exporters of FDI, accounting for almost 10% of global OFDI flows.

China’s rapid ascent to an exporter of capital harbours huge potential for host economies, and the Chinese government has discovered OFDI as the new showcase for China’s positive contribution to the global economy. Chinese investment now takes a top spot on the agenda of major diplomatic occasions as China is eager to counterbalance growing negativism about falling Chinese demand for foreign goods and China’s ballooning trade surpluses. Chinese diplomats also increasingly use the promise of investment and other financial flows as a diplomatic instrument to seek politically favourable outcomes in negotiations with the EU and its member states.



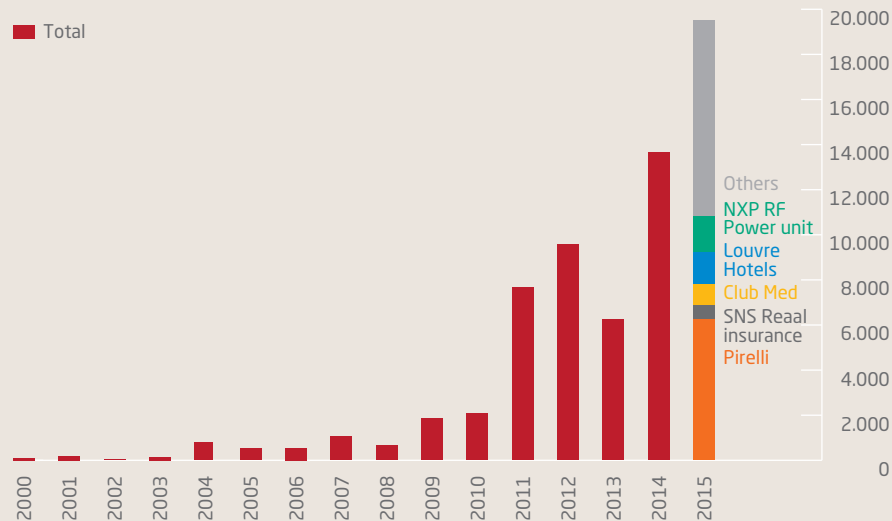
Chinese OFDI in Europe hits another record high in 2015, highlighting the potential for China as a source of productive capital but also reinforcing existing concerns

Europe has emerged as a main destination for Chinese OFDI, in line with a broader shift of Chinese investment from developing and emerging to high-income economies. In 2015, Chinese companies invested EUR 20 billion in the EU, a 44% jump compared to last year's EUR 14 billion. Much of the increase can be attributed to ChemChina's EUR 7 billion acquisition of Italian tire producer Pirelli, the biggest Chinese takeover in the EU to date. In the past five years, annual Chinese FDI in the EU averaged more than EUR 10 billion, compared to around EUR 1 billion annually in the previous five years.

The new record high of Chinese OFDI in 2015 further reaffirms our view that the jump in Chinese investment was not just a temporary episode of opportunistic buying after the crisis, but must be seen as a structural story fuelled by changes in the Chinese economy and Europe's position as a safe haven economy with an attractive asset base. At the same time, the 2015 investment patterns further aggravate existing concerns about economic risks related to these investments. Most importantly, the new record figures for Chinese FDI in Europe are in stark contrast with stagnant or even declining FDI by European companies in China, which further increases the risk of imbalances in two-way FDI patterns. This highlights the urgency to reduce formal and informal barriers on foreign investment in the Chinese economy using instruments such as the Bilateral Investment Agreement currently under negotiation.

Figure 2:
Chinese OFDI in Europe hits a new Record high in 2015
 Value of Chinese OFDI Transactions in EU-28 Economies

EUR million

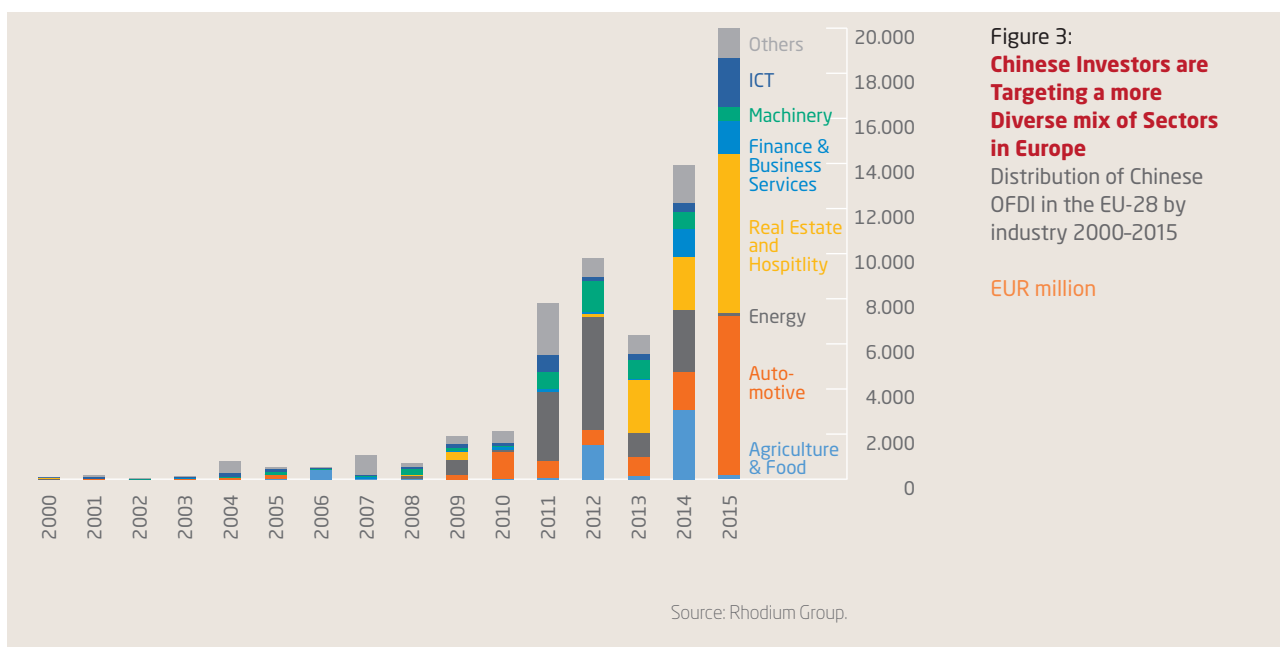


The new realities of slower growth and transition to a new economic model explain Chinese investors’ focus on advanced industrial assets, modern services, and real estate

The industry distribution of Chinese OFDI in Europe in 2015 confirms that the changing economic realities in China are driving these investments. Beginning structural adjustment and growing volatility has increased the pressure on Chinese companies to diversify and gear up for even greater competition at home, which is fostering a greater appetite for international expansion and risk taking. In 2015, Chinese interest further shifted towards a more diverse mix of assets including technology, advanced services, brands, and consumer-related assets. The automotive sector took the top spot (Pirelli), followed by real estate and hospitality (Louvre Hotels, Club Med), information and telecommunication technology (NXP Semiconductors’ RF business) and financial services (SNS Reaal’s insurance unit, Banco Espirito Santo’s investment banking unit).

Importantly, Chinese interest is growing particularly fast in sectors that remain restricted to foreign investors back in China, amplifying the political salience of unequal market access. One example is financial services, where EU companies have long been frustrated in their attempt to compete head-to-head with local players in the Chinese market. The recent growth of Chinese outward investment in these sectors should give Europe greater leverage to demand a level playing field in bilateral negotiations.

Another politically relevant trend is that China has recently become more successful in gaining services contracts coupled with infrastructure investments. Examples for these new ambitions are the Hinkley Point nuclear power plant, the Swansea Bay tidal lagoon, railway construction in Hungary and power plants in Romania. Potential political implications include transnational security concerns and a window of opportunity to integrate China into relevant existing international agreements, including OECD rules on export financing and the Government Procurement Agreement under the World Trade Organization (WTO).



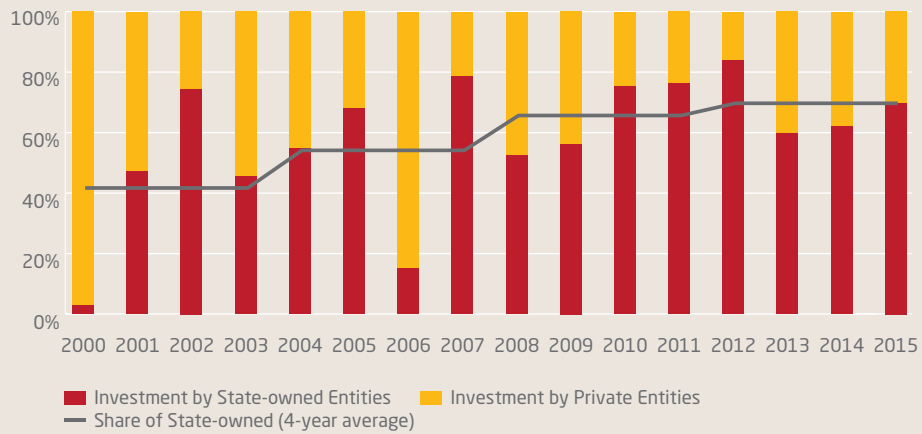
State-owned investors continue to account for majority of China's EU OFDI, and new financing entities could further boost the role of state capital

Initially a domain of sovereign and state-owned investors, private sector companies have become an increasingly important driver of China's global outward FDI in recent years. In 2015, investment by private Chinese firms in Europe reached EUR 6 billion, the highest level on record. At the same time, state-owned investment jumped as well due to a number of large investments including the ChemChina-Pirelli transaction, the acquisition of Louvre Hotels by Shanghai Jinjiang, and investments by China Investment Corporation in Germany, France, and Belgium. The share of SOEs in total Chinese investment increased from 62% in 2014 to 70% in 2015. China's new strategic "One Belt One Road" initiative could further boost the role of state capital in Europe as China's policy banks, sovereign wealth funds and commercial entities are in the process of setting up a flurry of new vehicles to finance large-scale projects on the continent.

Sovereign and state-related investment from China offers plenty of opportunities for Europe to advance new projects where interests are aligned, for instance, with regard to infrastructure development in Eastern Europe. At the same time, China's new policy-driven financing push has the potential to undermine EU integrity and geoeconomic interests in its neighborhood. It also challenges Europe's long-standing goal of disciplining subsidies and state aid to ensure private capital is not being crowded out by state-related actors not operating on market principles.

Figure 4:
State-owned Investors still Account for the Majority of Chinese FDI in Europe
 Share of Chinese OFDI in the EU-28 by investor type 2000-2015

Percent share



Source: Rhodium Group. State-owned entities refer to companies that are at least 20% owned by the government, sovereign entities, and central SOE's; private entities refer to companies with less than 20% ownership by the government, sovereign entities, and central SOE's.

Chinese investment increasingly extends beyond the “Big Three” economies, fuelling the intra-European competition for Chinese capital

Chinese investors have broadly followed the footsteps of other foreign investors in Europe by putting most of their investments in the wealthiest and largest European economies. The “Big Three” (Germany, the UK, and France) have received a relatively constant figure of 4-8bn EUR over the last five years and they continued to be major targets in 2015. The big story of the past two years, however, is the sharp increase of Chinese OFDI in other parts of Europe. In 2015, Southern European economies accounted for almost half of all Chinese EU investment for the first time. High-profile “flagship deals” (ChemChina’s acquisition of Pirelli, Wanda’s investment in Atletico Madrid, and Haitong’s acquisition of Banco Espirito Santo’s investment banking business) have put China in the role of a significant investor in those economies, amid otherwise sluggish FDI inflows. Investments in the Benelux countries also increased markedly in past two years and pending projects could further boost Chinese presence in Eastern Europe if they materialize.

The broader geographic dispersion of Chinese OFDI across Europe has increased competition between EU states for Chinese investment. In 2015, virtually every EU member state has sought high-level exchanges with China to strengthen bilateral investment and China is increasingly able to use the promise of capital as a carrot for other foreign policy goals. Greater capital flows, for example, remain the core driver of the rapidly evolving “16+1” relationship between China and Central and Eastern European economies. Another example is the UK, where a flurry of high-profile investments has contributed to a visible shift in the UK’s China policy. This race for Chinese investment is also contributing to a division between European economies over important economic policy decisions, most recently whether the EU should grant China Market Economy Status or if the EU should enter negotiations over a potential free trade agreement with China.

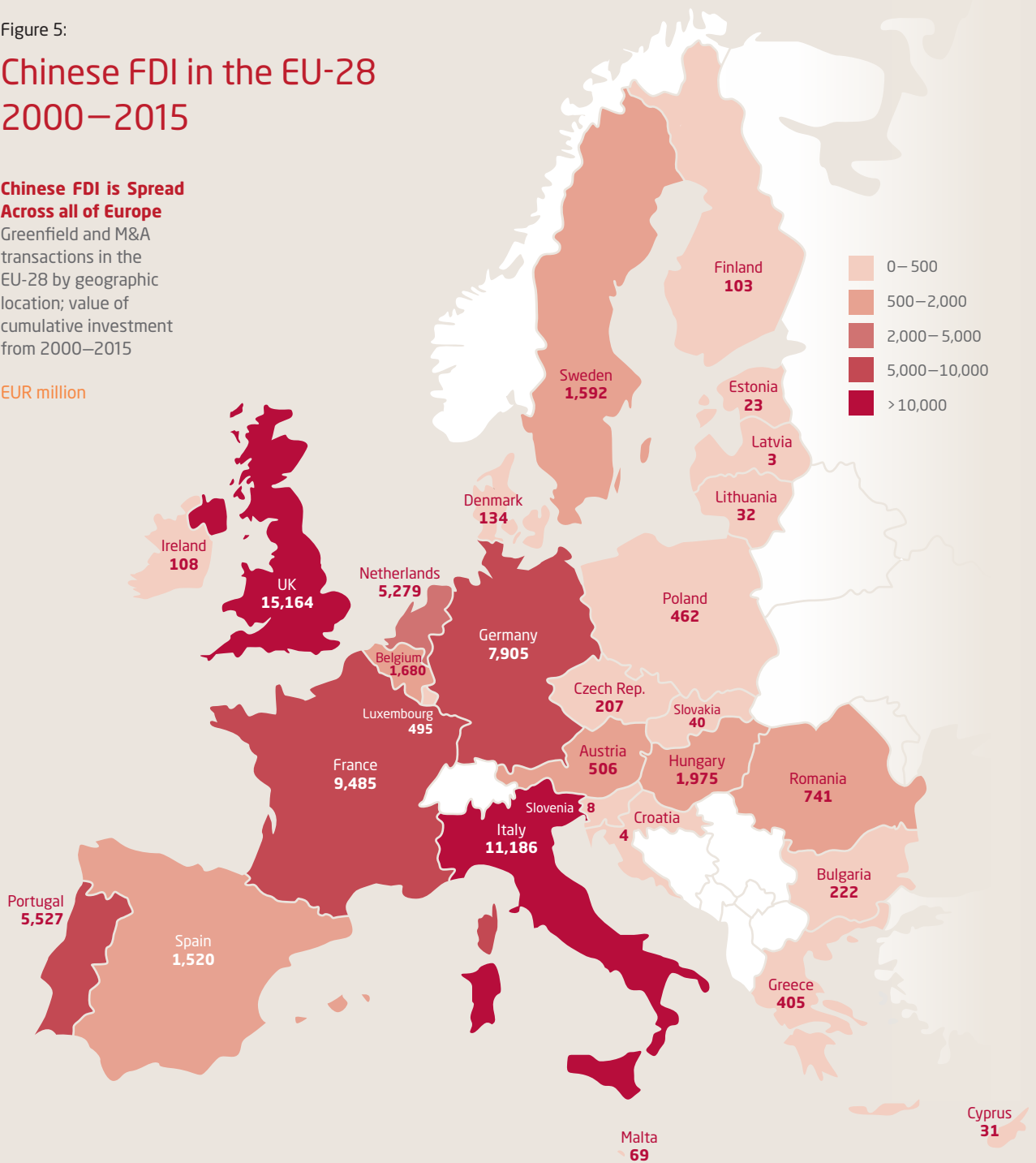
Figure 5:

Chinese FDI in the EU-28 2000–2015

Chinese FDI is Spread Across all of Europe

Greenfield and M&A transactions in the EU-28 by geographic location; value of cumulative investment from 2000–2015

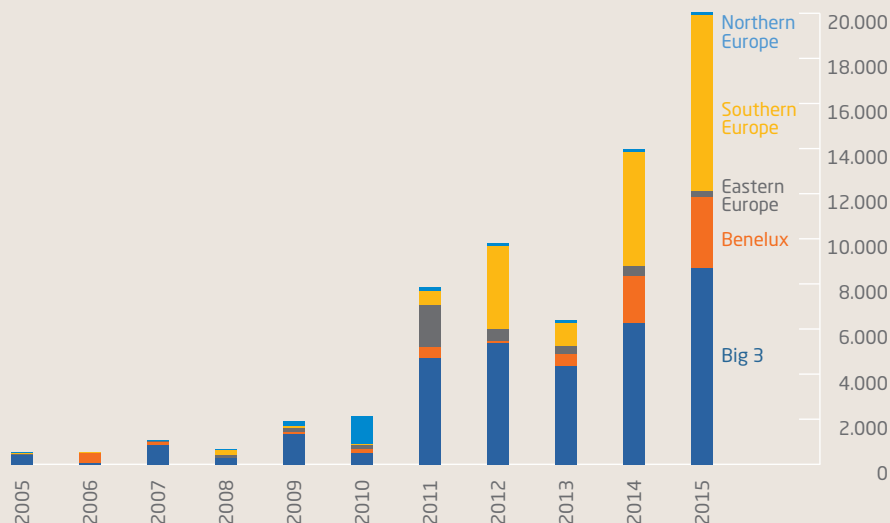
EUR million



Source: Rhodium Group. A detailed explanation of sources and methodology can be found in the Data Appendix of the full June 2015 study available at cofdi.merics.org.

Figure 6:
**Southern Europe now
 Receives a Significant
 Share of Chinese FDI**
 Chinese OFDI in the
 EU-28 by country group
 2000-2015

EUR million



Source: Rhodium Group.

The "Big 3" includes France, Germany, and the UK.

"Benelux" includes Belgium, Netherlands, and Luxembourg.

"Eastern Europe" includes Austria, Bulgaria, Czech Republic, Hungary, Poland, Romania, and Slovakia.

"Southern Europe" includes Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, and Spain.

"Northern Europe" includes Estonia, Denmark, Finland, Ireland, Latvia, Lithuania, and Sweden.

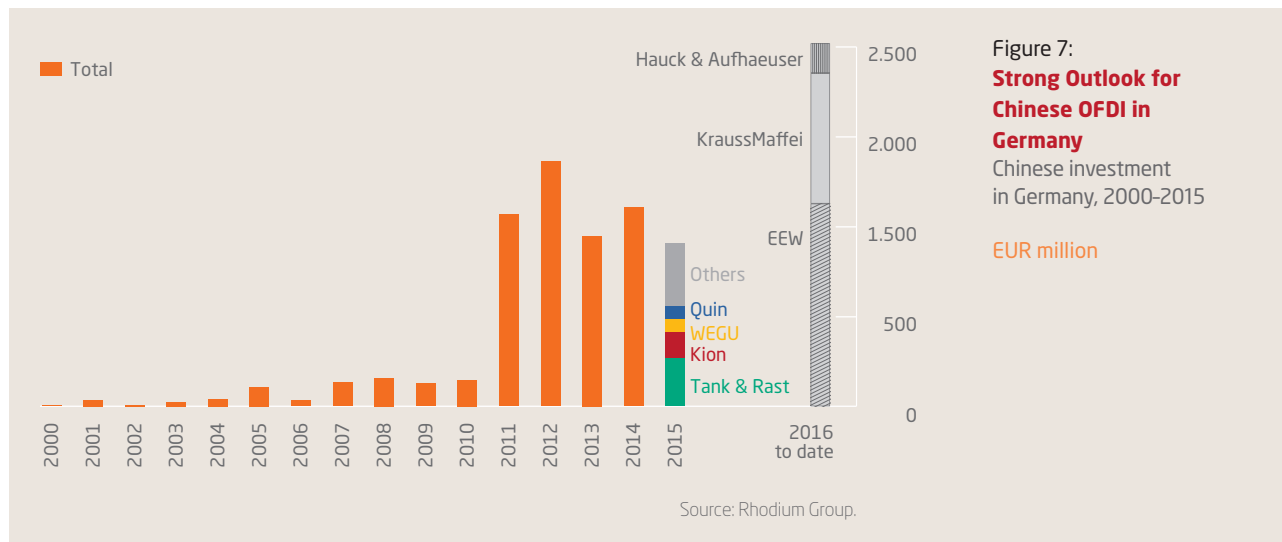
Germany remains one of the most appealing destinations for Chinese investors looking for technology, consumer markets, and safe haven assets

Among all EU economies, Germany has seen the most constant inflow of Chinese investment over the past five years. In 2015, Chinese FDI in Germany dropped slightly to EUR 1.2 billion (compared to EUR 1.4 billion in 2014), in the absence of large-scale takeovers observed in other EU economies. However, a strong pipeline of pending transactions (reaching EUR 2.5 billion as of February 2016) confirms that Germany has not lost its strong appeal to Chinese investors.

Automotive and machinery continued to attract Chinese interest in 2015, with a total of more than EUR 400 million in completed transactions. The most important deals were the acquisitions of automotive suppliers WEGU Holding and Quin, and Weichai's increase of its stake in KION, a producer of forklift trucks and warehouse technology. Chinese investors also continued to expand their research and development (R&D) footprint with new facilities in advanced component materials (Kangde Xin), biotechnology (KTB Tumorforschung), and other areas (rail technology, mobile device innovation, and electric vehicles). Another important trend is that Germany is becoming increasingly attractive for Chinese financial investors seeking stable long-term returns. In 2015, China's sovereign wealth fund acquired a stake in German's largest operator of gas and service stations (Tank und Rast), and conglomerate Fosun acquired a significant (but non-FDI) stake in KTG Agrar, one of the biggest agricultural companies farming food crops in Eastern Germany and Europe.

Recently announced and pending investments point to a substantially growing Chinese footprint in machinery (ChemChina's acquisition of KraussMaffei), environmental technologies (Beijing Enterprises acquisition of EEW Energy) and financial services

(Hauck & Aufhaeuser). Government encouragement and the creation of financing vehicles such as the new "Industry 4.0" fund will likely further boost Chinese spending on German R&D and advanced manufacturing assets in coming years.



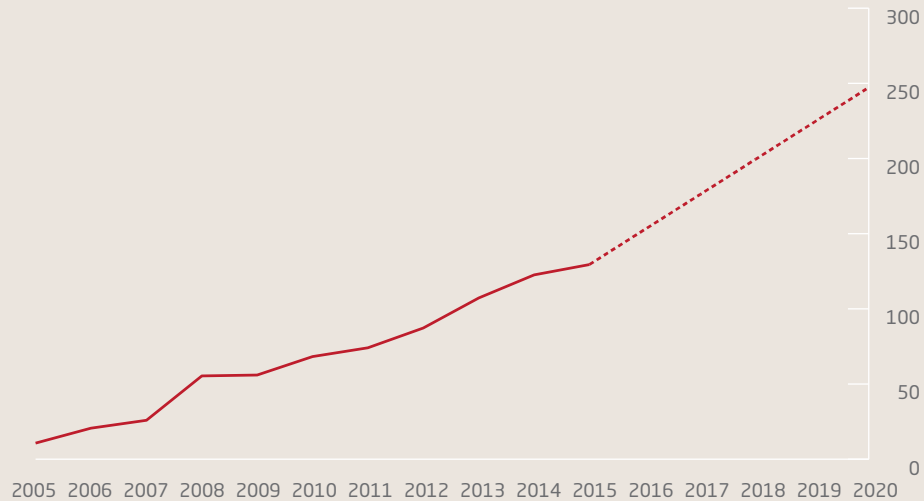
China's global investment boom is unlikely to end any time soon but China's fight against capital flight and bad debt pose short-term risks for 2016

New record deals in early 2016 in Europe and the pipeline of transactions suggest that China's recent buying spree will continue in 2016. At the same time, the current economic and political situation poses some downside risks for Chinese outbound investment in 2016. The volatility in China's markets and continued downward pressure on the USD/CNY exchange have forced Chinese officials to further ratchet up capital controls to stop the massive outflow of capital, and there is anecdotal evidence that these measures are increasingly impacting Chinese companies' access to foreign exchange, including for OFDI projects. Reforms aimed at improving credit allocation and cleaning up bad debt could also pose a medium-term risk for outward FDI if they threaten firms' credit lines for overseas expansion. Finally, the temporary disappearance of Fosun Chairman Guo in December 2015 pointed to the risk of China's anti-corruption crackdown shifting to private companies, which could impact their appetite for deals in the EU and elsewhere.

Figure 8:
**China's Leaders Project
 USD 1 Trillion of
 Outward FDI Flows in
 Coming Five Years**

China's annual outward
 FDI flows

USD billion



Source: MOFCOM, author's calculations.

MOFCOM figures are used as State Administration of Foreign Exchange (SAFE) no longer provides directional data on Chinese investment abroad since transitioning to IMF's BPM 6 manual. 2015-2020 are projections; 2016-2020 estimated using USD 1 trillion as total and assuming constant growth.

In the long run, however, the structural drivers for continued expansion of Chinese outbound FDI – stronger commercial rationales for companies to venture overseas and supportive policy – remain firmly in place. Pressure on Chinese companies to internationalize will increase further in light of structural reforms, higher input costs, and shrinking margins at home. High-level rhetoric also remains highly supportive, despite the short-term crackdown on capital outflows. China's Premier Li Keqiang recently touted that China expects to deploy USD 1 trillion of OFDI over the next five years globally, which would boost annual outflows to an average of USD 200 billion per year, making China the second largest exporter of FDI behind the United States.

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