Why the M&A dragon will not sleep

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Much has been said recently about a possible slowdown in outbound investment sourced from the People's Republic of China and what this may mean for Australia. Central to this has been the oft-quoted downturn in China's anticipated gross domestic product growth.

We have a different view, for while the Chinese dragon may have been challenged by the global financial crisis, it certainly hasn't been slain.

Even at "slower" GDP growth of around 8.3 per cent, this huge economy is still forging ahead.

Taking a step back, it is clear there has been a surge in Chinese outbound investment over a sustained period. From 2007 to 2008, China's overseas investment doubled from $20 billion to $52.2 billion and in 2009, at the height of the GFC, China still managed to generate a record 298 deals in cross-border mergers and acquisitions.

More recently, China's Ministry of Commerce predicted that outbound investment in 2010 could exceed $US60 billion.

And there do not appear to be any plans for China to put the brakes on. China's annual average GDP growth rate over the last 30 years is recorded as being close to 10 per cent (and between 11 per cent and 13 per cent in the last five years).

The political, social and economic changes occurring in China are on a scale far greater than ever seen.

In 2009, China became Australia's single largest export destination and its second-largest source of foreign direct investment. Since November 2007, the Australian government has approved more than 160 Chinese investment proposals worth around $60 billion. Despite recent political tensions, Chinese investments and trade deals have continued in 2010.

On the M&A front, in March 2010, global energy giant Royal Dutch Shell and the biggest state-owned Chinese oil company, PetroChina, jointly signed a $3 billion-plus bid for Australian coal seam gas company Arrow Energy. BG Group also signed a liquefied natural gas sales contract with state-owned China National Offshore Oil Corporation for the supply of 3.6 million tonnes of LNG per annum over a 20-year period.

These deals are significant not only in monetary terms, but also because they point to new directions in Chinese outbound investment. These are trends that we expect to see continuing in the M&A market.

As has been said a number of times, one of the fundamental drivers of the growth in China's outbound investment is the need for energy and mineral resources to sustain its economic development. This driver, coupled with Australia's geographical proximity to China, its wealth of assets and the stability and predictability of its political and legal environment, has resulted in a strong relationship between Australia and China. Realistically, this can be expected to broaden into the long term.

Other recognised drivers of China's foreign investment include the prestige associated with the acquisition of internationally known brands, investment in and development of advanced technology which will enhance China's research and development potential and external economic factors such as the GFC driving down the cost of foreign targets.

It's also useful to look at who is going West.

The majority of China's outbound acquisitions have been dominated by approximately 130 of China's centrally-administered state-owned enterprises (SOEs). However, new players are emerging, including provincial SOEs and privately owned Chinese companies.

The form and regulation of China's foreign investments are also likely to go through a change. Recommendations are being made that equity investments resulting in complete or managerial control over targets should be replaced with cooperative arrangements such as joint ventures or alliances, and that acquisitions of small rather than large equity interests will be preferred.

These investment strategies will give investors the opportunity to better understand the Western culture and style of management, without the requirement for the Foreign Investment Review Board's intervention. This leads us to think we should continue to see an upward trend in Chinese outbound investment. (That said, we will need to wait to determine whether the recently relaxed and decentralised Chinese government approvals process will be effective in dealing with

the delays and uncertainty experienced in the past.)

The increasingly diversified investment profile of China's foreign investment is also a cause for optimism.

Traditionally, outbound investment focused on manufacturing and construction, the acquisition of resources including coal, oil, timber and food products and also new technologies. Now we are seeing activity in the agribusiness, bioscience, clean energy and chemicals sectors and the acquisition of intangible assets such as high technology, brands, patents and know-how.

This year, a $10 million partnership project was negotiated between China United Coalbed Methane Corporation Limited and CSIRO, looking into the development of low-emission coal technology. China has both a vision for clean/green technology and the will to bring about real changes. For example, we expect to see China being a serious adopter of electric vehicle technology.

As for the mineral resources rent tax, the implications for foreign investment in Australia are certainly a negative.

Still, some deals have been signed. State-owned China Development Bank has agreed to provide financing for a number of major mining projects such as a $US1.2 billion facility agreement with Karara Mining and entered into memorandums of understanding in relation to project development with both Aquila Resources and the state of South Australia.

Meanwhile, China National Offshore Oil Corporation has entered into a joint venture agreement with Arckaringa Energy.

The bottom line is that China is still in the early stages of its industrialisation process and with a population of more than 1.3 billion people, its demand for coal, iron ore and petroleum resources – of which Australia is a reliable source – is set to continue.

In our view what this all means for the Australian M&A market is that the Chinese economic dragon is in good health and ready to breathe new fire into Australian M&A deals.

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