

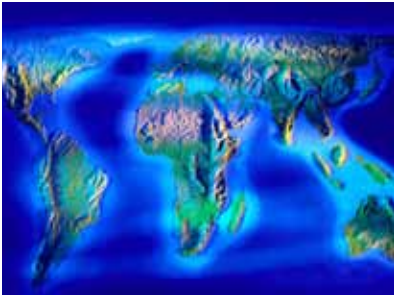


IMPACT ANALYSIS

Issues Impacting Global Business

A Publication of Manzella Trade Communications

May-June 2012



Dear Friends:


New trends are impacting whether manufacturers offshore, backshore or nearshore. Understanding these trends and their implications are essential not only for producers, but also for organizations that wish to attract this investment. (p1-2)

The Obama Administration made proposals to create a special trade enforcement center and increase supply chain security. Although the proposals contain minimal details, they provide insight into the Administration's trade priorities. (p3)

Chinese companies, which have huge cash reserves, are boosting outbound investment. They are looking for new types of projects with "good enough" synergies in smaller, "below the radar" transactions that will be easier to acquire and manage. (p4-7)

I hope you find this issue informative and welcome your comments.

Sincerely,


John Manzella
President
Manzella Trade Communications

New Trends Are Changing Manufacturing Location Decisions

Attracting manufacturing investment today requires much more than an attractive value proposition

By John Manzella

New trends are impacting whether manufacturers offshore, backshore or nearshore—terms used to describe corporate decisions to produce in low-cost countries, bring production back to the United States or establish facilities near fast-growing global markets. Plus, other factors are playing a role. For manufacturers, as well as economic development and other organizations seeking to attract this investment, it's important to understand today's new economic realities and their implications.

Determinants of global manufacturing capital flows have traditionally included many factors. Although labor costs always have been important, proximity to target markets, workers' skills and productivity levels, taxes, transportation infrastructure and costs, government regulations and in-

centives, regional supplier capabilities, currency exchange rates, and political stability are factors weighed heavily in the decision-making process.

That's why 61 percent in 2010 and 68 percent cumulatively of U.S. manufacturing outbound foreign direct investment (FDI) went to Canada, Europe, Japan, Australia and New Zealand—high wage countries. It's also why the U.S., with the 14th highest hourly manufacturing compensation costs, remains the top destination of the world's FDI.

But new trends and factors are impacting manufacturers' investment decisions, especially:

- New innovations and technologies that boost productivity and reduce the labor component,
- Rising labor costs in emerging markets,

A strategic communications firm focusing on global business and today's leading economic issues



- Custom Publishing • Public Affairs • Speaking Engagements

www.ManzellaTrade.com www.JohnManzella.com info@ManzellaTrade.com

- Projected increases in the cost of fuel and long-distance supply chain functions,
- Shifting demographics based on the desire to locate near fast-growing markets, and
- The emerging skills shortage.

Interestingly, many of these trends and factors impact one another and add a degree of complexity. For example, over the next few years, many manufacturers plan to more closely match supply functions with demand location by nearshoring or moving manufacturing and distribution facilities closer to faster-growing markets. This action is designed to better serve consumers while reducing transportation costs, which are likely to rise significantly in the years ahead.

To make this a success, manufacturers will need to grasp changing demographic data, which can identify where tomorrow's fastest-growing markets will be, how much cash consumers likely will spend, and based on other factors, what they are likely to buy.

According to Accenture, a global management consulting firm, "Although offshoring will continue to play a role in the supply location strategy of companies, it will be largely done in the context of chasing the demand location. This new trend of moving more supply closer to demand location appears to be a new shift for many manufacturers."

From one perspective, this trend is nearly opposite of backshoring, which involves American companies relocating previously offshored production back to the United States due to rising costs abroad. This is projected to boost manufacturing activity in the United States. In certain industries, new innovations and technologies have successfully automated much of the manufacturing process for what was previously labor-intensive work. In turn, the labor component, as a percentage of

a product's total costs, has been considerably reduced. Consequently, for many companies, this has limited incentives to move facilities to low-cost countries and increased incentives to backshore to the United States. But for certain industries, like textile and apparel, where functions are too cumbersome to automate, production likely will continue to be completed in low-cost countries regardless of where the target markets are located.

China, which seems to dominate manufacturing news, also is impacted by these trends. Thus, as the labor component continues to shrink, and Chinese labor rates, fuel costs and expenses related to long distance supply chain logistics continue to rise, it makes sense for some U.S. produc-

To attract investment flows today, economic development and other organizations need to produce much more than attractive value propositions—they also must create very persuasive and compelling communications programs to convey the message.

ers to reconsider where to establish production facilities. And depending on the types of products made, and many other variables, including where target consumers live, the decision to backshore from China, for example, or nearshore could be two choices one company makes for different product lines.

In addition, should the production of a skills-intensive product be hampered due to a shortage of local talent, which will become a significant problem in the years ahead, a high-tech manufacturer may have to move to where the right mix of worker skills exists.

An additional factor to consider is the ability of U.S. government policy to position the United States as an export platform. By doing so, the world's largest exporter of goods and

services will become a more attractive investment destination for foreign-based manufacturers who also wish to tap into American financial and intellectual resources that can boost the desirability of their products.

But to attract investment flows today, economic development organizations responsible for states, counties and cities, and others, need to produce much more than attractive value propositions. In fact, they must create very persuasive and compelling communications programs to convey the message. If not, intended recipients may not grasp the significance of the value proposition—which likely will be buried under hundreds of others seeking the same investment. And that's not all. Organizations also must

demonstrate tremendous credibility and reliability, and build *real* relationships with prospects based on trust. This is especially true with Chinese prospects, who are increasingly investing in American brick and mortar.

According to the Rhodium Group which monitors such investment, in 2008, 2009, 2010 and 2011, Chinese firms spent \$1.1 billion, \$2.3 billion, \$5.2 billion and \$4.5 billion in 110 greenfield projects and 107 acquisitions in many American states. This is just the beginning. ■

John Manzella is a world-recognized author and speaker on global trends, international business, China, and today's new economic realities, and President of Manzella Trade Communications, a strategic communications and public affairs firm. www.ManzellaTrade.com.

White House International Trade Initiatives

Challenging intellectual property violations and unfair trade practices

By David Forgue

January was a busy month for international trade initiatives in Washington. The Obama Administration made proposals aimed at creating a special trade enforcement center and increasing supply chain security. The proposals contain minimal details. Nevertheless, each proposal gives some insight into the Administration's trade priorities.

During the State of the Union address the President indicated he intended to create an Interagency Trade Enforcement Center ("ITEC") to pursue unfair trade practices around the world. Some of the details of ITEC are set forth in the Executive Order issued February 28, 2012. The Center brings together representatives from the United States Trade Representative's office ("USTR"), Departments of State, Justice, Agriculture, Commerce, Homeland Security, and Office of the Director of National Intelligence. The Order indicates that the Center should use United States law to quickly and efficiently challenge trade policies that the Administration believes are unfavorable to U.S. companies.

The challenged trade policies include a broad range of intellectual property violations and unfair trade practices resulting in illegal subsidies abroad. The Order lists eight specific laws, but also leaves open the possibility to pursue cases under other laws as well. It is likely that China is one of the main targets of ITEC activity.

Taken together, the departments and laws in ITEC represent the "more aggressive whole-of-government approach to addressing unfair trade practices" promised by Commerce

Secretary Bryson when ITEC was proposed. However, it should be noted that ITEC requires budget approval to start operations. While the amounts in question are small by government standards—\$24 million for Commerce, \$2 million for USTR—it is not clear that ITEC will receive sufficient support in Congress. In addition, there is no indication that ITEC would address antidumping fraud on entries into the United States. Over the last few years, this sort of activity has been one of the major complaints among U.S. manufacturers, and has been the object of several bills introduced in Congress.

The White House also recently released its National Strategy for Global Supply Chain Security. This

The administration's national strategy is likely to rely heavily on information sharing, risk assessment, layered defense, and targeted security.

document sets forth two overarching goals for the future of the global supply chain. The first is to promote the efficient and secure movement of goods. The second: to foster resiliency in the global supply chain. Interestingly, the strategy does not so much propose a federal program to achieve these goals as a framework for various groups to "integrate and spur efforts" to meet these goals.

At this point, there do not appear to be specific supply chain security measures proposed by the government. In part this makes sense, since the sorts of threats the strategy is meant to address include not just intentional,

man-made disruptions like terrorist attacks, but also natural disasters like Hurricane Katrina, the eruptions of Iceland's Eyjafjallajökull volcano, and the earthquake and tsunami in Japan last year. The goal of a resilient supply chain is meant to address these types of events as much as terrorist disruptions.

Ultimately, the national strategy as proposed by the Administration is likely to rely heavily on information sharing, risk assessment, layered defense, and targeted security. For such a strategy to work it will be necessary for new and improved means of communication to be opened between the government and the trade. In addition, the government will have to share information across borders,

as well as create a means to quickly evaluate whether information can be shared without compromising national security sources. This balance of communication, while evaluating national security needs, has historically been a difficult one for the government to strike. For more information on the national strategy, copy and paste <http://www.barnesrichardson.com/?t=40&an=10748&format=xml&p=3731> ■

David Forgue is a partner in the Chicago office of the law firm Barnes, Richardson & Colburn. For more information about these proposals and how they might impact your business, contact David at (312) 297-9555 or dforgue@barnesrichardson.com.

Chinese Outbound Investment Is Rising: What You Need To Know

Buying Assets Below the Radar

By Eduardo Moricillo

In this age of financial austerity, an increasing number of U.S. and European companies are seeking financial backing from and alliances with cash-rich Chinese companies. Those same Chinese investors however, are keen to snap up assets at what are sometimes bargain basement prices.

Chinese outbound investment is definitely on the rise: the Chinese Ministry of Commerce predicted in January that Chinese outbound investment will reach \$560 billion annually by 2016, up from a record \$60.1 billion in 2011. The Heritage Foundation's China Investment Tracker shows that China invested \$34.7 billion in the U.S. in the seven-year period from 2005 to 2011 and \$52.1 billion in Europe in the seven-year period from 2005 to 2011, accounting for about 28 percent of the country's total accumulated overseas investments, excluding bond purchases.

During these years, the bulk of China's outbound investment has been aimed at enhancing China's presence in key countries within Latin America, Africa and South East Asia, while developing a global platform for China that ensures competitive advantage in the long term (energy, logistics and infrastructure). Outbound investment has been characterized by high profile and politically motivated investments by Central Government State Conglomerates—mostly the "Big 100," other Central Government State Owned Enterprises (SOEs) and Chinese sovereign wealth funds.

Although all experts agree that from a macro economic and high-level perspective, outbound investment



growth trends will continue over the next decade, we see a very differentiated reality from a micro perspective.

I remember clearly a conversation I had recently with a senior director involved in outbound investment at a Chinese financial institution. "People expect large and politically powerful SOEs to lead Chinese outbound investment, but this will be a challenging task. Most of these state companies are not ready for outbound

that ends sometimes in total improvisation with sudden changes. These companies rarely recognize the need for help and support. They have unrealistic expectations: at the beginning they are very aggressive, but in the end they want guarantees, and no down-side risk. The SOE system does not reward success, but punishes mistakes very aggressively."

I agree. These large players will find it difficult to successfully ac-

From a macro economic and high-level perspective, outbound investment growth trends will continue over the next decade. However, we see a very differentiated reality from a micro perspective.

investment," he said. "The managers of those SOE's are pure politicians, not businessmen; they do not know what they want, have no strategy and change their ideas all the time. The decision-making process is unclear and there are new people emerging in the decision process all the time."

Moreover, he added, "Very few SOEs have structures or formal processes for international investment, a fact

quire foreign companies. Based on my experience, success with these players requires an understanding of their real underlying motivations. One must have a sound business and political end-game in mind and deftly handle the complexities of the internal and administrative project approval processes.

My belief is that the future of Chinese outbound opportunity lies in a differ-



ent arena, with different players that will bring new dynamics.

A New Playing Field: Private Enterprises and Provincial SOEs

Many new groups of players are emerging in the Chinese outbound M&A arena, bringing a new level of dynamism and growth prospects to this market.

The first group includes listed public and private companies that are already leaders in China. They are increasingly motivated to expand globally to enhance their competitive advantage within China and position themselves for growth in global markets. Hangzhou Wahaha Group is a good example. This is a privately owned and listed corporation with total assets of \$40 billion. It is seeking M&A in the food and beverage sector in Japan and Australia as part of its quest to become a global brand and to diversify into other sectors, such as mining.

Another newly emerging group involves medium-sized private players, recently listed corporations and smaller corporations that have traditionally focused on domestic sales growth, or those with revenues above \$300 million that have recently gone public raising considerable amounts of cash. For example, privately owned Suzhou Dongshan Precision Manufacturing Co. Ltd, a sheet metal making, die-casting and surface treating manufacturer, has become a

major global supplier of sheet metal components for telecom base stations and is currently seeking a compatible overseas target that would have synergy with its core business.

Finally, a major emerging sector includes provincial, state-owned corporate leaders from rich provinces such as Beijing, Shanghai, Jiangsu, Guangdong and Shandong. There are

We also see opportunities in the services sector, with companies like Beijing Capital Airports Holding Co. (BCAH). Through its various operations, BCAH has become the number two player in China's airport management sector, reporting throughput of 143 million passengers in 2010. It is seeking majority or minority investments in airports in both North and South America and in Southeast Asia

These newly emerging groups of Chinese companies often have huge cash reserves and are looking for new types of projects, quite different from the past, that have "good enough" synergies.

numerous examples, such as Shanghai Pharmaceuticals Holdings Co. Ltd, a state-owned regional player and China's third-largest pharmaceutical company.

This company is searching for new pipelines in Europe and the U.S. for generic antibiotics, cardiovascular and oncology drugs. It plans to use 30 percent of the proceeds from its May 2011, Hong Kong IPO, to fund global M&A. Another example would be YAPP Automotive Parts Co. Ltd., a state-owned player that specializes in the development, manufacture and sale of automotive fuel tanks. Yapp is looking for equity investments in Europe, the U.S. or emerging markets such as Brazil to expand its international business.

to expand its airport management business overseas.

These newly emerging groups of companies often have huge cash reserves and are looking for new types of projects, quite different from the past. InterChina suggests these companies often prefer to invest in or buy industrial companies with "good enough" synergies that can be used in China to enhance their competitive advantage. They will look for smaller, non-political transactions "below the radar," that will be easier to acquire, integrate and manage.

These companies will buy majority stakes and be open to strategic acquisitions abroad (involving minor-

ity stakes), linked to JVs in China in which they hold controlling stakes.

InterChina expects middle-market investment by Chinese companies in Europe and the U.S., with deal values of \$300 million or less, to increase in the next few years. These deals will most likely be concentrated in the auto, machinery, clean-tech, energy and consumer goods sectors.

How To Deal with These Investors

InterChina is a partner in IMAP, one of the leading global M&A corporations and I serve on its Board of Directors. In this role, I face an important challenge: how to explain to my colleagues from more sophisticated markets, the unique mix of factors that shape the development of relationships with Chinese corporations investing abroad.

The level of vitality, energy, drive and passion found in Chinese corporations embarking on overseas investments is unique. This is a new area for them and Chinese shareholders and managers are adamant about becoming global leaders. This is a very subjective factor, but in today's depressed global economy, this attribute should not be disregarded as a source of global competitive advantage.

On top of this, all these corporations still are rooted in a growing economy that is increasingly being driven by domestic consumption. They are thriving in industries with growth rates in the range of 10-20 percent, in a context of great liquidity and strong government incentives. Such players can afford to bet on global expansion, and to make mistakes, since their underlying business is healthy and will remain healthy in the short to medium-term.

Apart from the vitality of domestic consumption in China and its evolving growth model, we also forecast that the Chinese yuan will appreciate an estimated 15-25 percent over this



decade. This will greatly enhance Chinese corporations' acquisition power.

Finally, China has a lot of money. This is reflected in credit lines granted by State Banks to its leading corporations. Some striking examples include a \$7 billion credit line granted in 2011 by the Chinese Development Bank and Chinese Exim Bank to Sinovel Wind Group Co., the largest wind

management tools needed to grow abroad. They mostly act opportunistically and not based on any formal strategy developed in advance. This can have a great impact, since western competitors for good M&A deals will know exactly why they want to acquire a target, enabling them to be more efficient and convincing toward the various stakeholders involved in a transaction (shareholders, workers,

Many Chinese companies want and need to grow abroad, but are completely at a loss for how to do so. Many of these players know how to act in China, but are unfamiliar with formal management tools.

turbine company in China, to expand in the U.S. and Europe. Another example: a several billion dollar credit line to China HNA Group, a Chinese aviation, shipping and hotel industry investing group, to grow globally. Deep pockets always help to frame successful acquisition strategies.

Despite this bright scenario, there are significant challenges. Below are the most significant obstacles facing Chinese outbound investors.

1) Lack of Strategy

Many companies want and need to grow abroad, but are completely at a loss for how to do so. Many of these players know how to act in China, but are unfamiliar with the formal

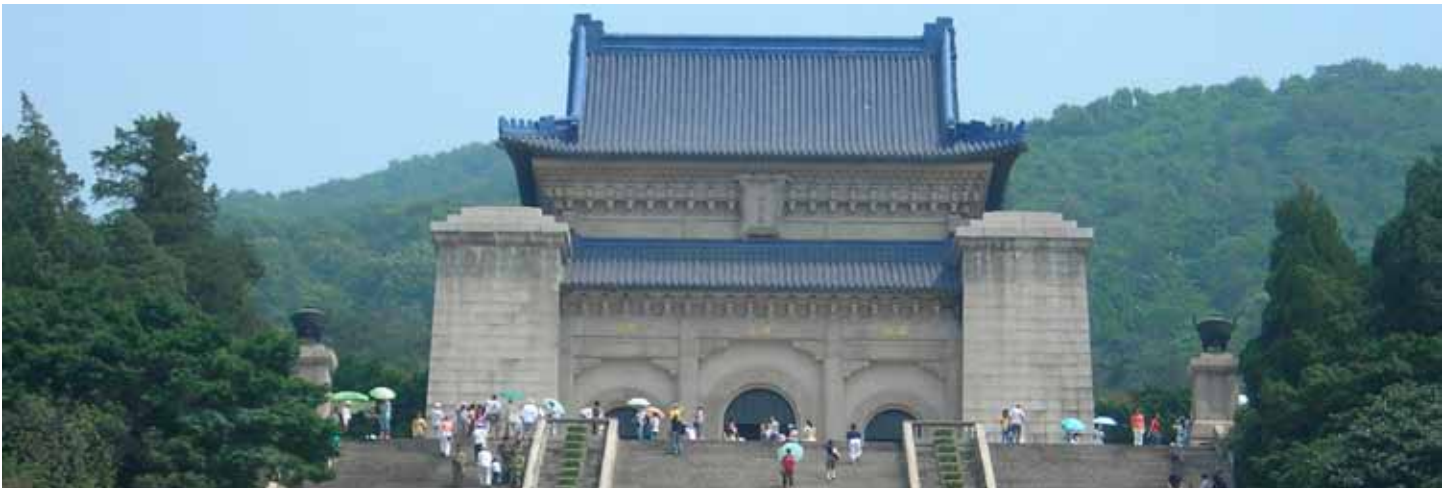
clients, local governments, etc).

2) Cultural Clashes

There are certain rules of conduct and accepted global styles that most Chinese investors disregard, giving priority to cash. A "Money Talks" approach and the resulting cultural clashes can be a serious handicap for Chinese investors, often leading to failure.

3) Complications and Process Issues

The global M&A market operates under a clear set of norms. There are rules for structuring nearly every step of a deal, reflecting both format and content principles that many Chinese investors, with the exception of the more sophisticated and experienced



ones, do not yet grasp. Moreover, the Chinese foreign exchange regime, in which the RMB is not yet freely convertible, and the complicated and cumbersome M&A approval process (NDRC and MOFCOM driven), can make Chinese transactions exceedingly complicated. Both issues are clear disadvantages for Chinese investors seeking overseas acquisitions.

4) Lack of Knowledge

Although there is a clear flow of western and returnee talent from the M&A and investment world in the U.S., EU, Japan, etc., into China, most prospective investors lack the basic capacity to drive a global M&A process and to integrate and get value from those acquisitions.

Western companies need to be aware of the potential pitfalls of dealing with Chinese companies that are still finding their footing as overseas investors. Both sides need to seek a common understanding on what to expect and how to best ensure that deals will succeed.

Although InterChina has been an active player in China's M&A arena since 1994, we only began our outbound M&A practice in the mid 2000s. Over these years, we have made many mistakes and have learned how to adapt global practices to the realities of the Chinese market.

Key Success Factors

In our view, the key success factors for working with Chinese corporations are twofold. First, prior to initiating conversations and formal negotiations, apply the "Motivation & Capacity Acid Test." If a Chinese corporation or investor is not able to explain the business case or rationale behind the deal, or cannot prove a basic alignment of internal resources

billion in 2011, up 10 percent from the prior year. We expect deals to continue to increase as Chinese companies take advantage of the ongoing economic downturn and crisis in Europe and the United States to carry out even more mergers and investments in western companies over the next 5 years.

The race to tackle the immense oppor-

Western companies need to be aware of the potential pitfalls of dealing with Chinese companies that are still finding their footing as overseas investors. Both sides need to seek a common understanding on expectations and how to succeed.

to support the transaction, the opportunity cost of getting involved may be too high.

Secondly, once a transaction process has been initiated, it is essential to engage a Chinese team in order to enhance communication channels. Flexibility also is essential, as well as a willingness to adapt western and global M&A approaches to Chinese realities, while helping Chinese management understand the norms of global M&A transactions.

Chinese-based companies completed a record 207 deals valued at \$42.9

tunities for outbound M&A from China has begun. Understanding the complexities of this developing opportunity is only the start. Adapting to them and developing appropriate methods to engage Chinese enterprises will yield competitive advantages that will maximize the chances for success for enterprises that are able to adapt. ■

Eduardo Morcillo, a Spanish national, is Managing Partner of InterChina Consulting. He has vast experience in investment banking and China-specific transactions. For more information, contact David Hofmann, DavidJ.Hofmann@InterChinaConsulting.com, in the Washington, DC office.