European climate for foreign investment

The changing political and regulatory environment in the European Union

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BRUNSWICK

As an increasing number of voices from the political and the business world are asking Europe to take a more hawkish approach to foreign investments targeting European know-how and strategic industries (along the lines of CFIUS, the Committee on Foreign Investment in the United States), recent political activities certainly indicate substantive policy change in this field can be anticipated at some stage. It remains to be seen whether action will be taken at pan-European level or unilaterally by some countries.

What has happened?

- In a policy paper on tackling globalisation presented on 10 May, the European Commission raises concerns about foreign investors, notably state-owned enterprises, taking over "European companies with key technologies for strategic reasons". It also regrets the lack of reciprocity for investment conditions in some countries. While no mention is made of China, this is a clear nod to several recent calls from politicians across the Union for a united front in dealings with Chinese investment.
- In February 2017, the governments of France, Germany and Italy sent a letter to the European Commission, calling on it to rethink rules on foreign investment into the EU and to allow Member States to block outright a specific foreign investment or make it subject to conditions. In March, the European Parliament called for the creation of a European-level committee to review "sensitive" foreign investments, with a particular focus on China. These actions come at a time when Chinese investment in Europe increased significantly in 2016, and the effects of globalisation and free trade are being questioned by populists in many countries.
- While the Commission's 10 May paper includes no concrete legislative proposal, it has been interpreted as a request to Member States for a political mandate to address this issue. The Commission is expected to give a stronger indication of its intentions in the President' State of the Union speech in September, which may include a common approach to regulate such investments.

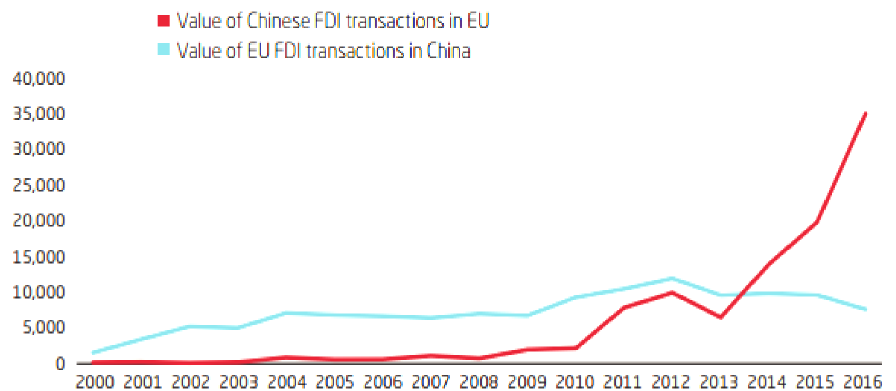
European Context

- The backdrop to this political rumbling is the rapid increase of Chinese Direct Investment into Europe over the last few years. The China Manufacturing 2025 strategy, which aims to drive an upgrade in China's manufacturing and industrial sector and to assert its leadership in high-value and highly innovative segments of the global economy, has drawn many to see political motives alongside investment considerations. A key component of this plan is to achieve domestic content of core components and materials of 40% by 2020 and 70% by 2025 across ten key sectors, or so-called 'indigenous production'.
- This strategy, together with other economic drivers, has led to a wave of deal making by Chinese companies in Europe and beyond, focusing on acquiring know-how and technology in highly strategic sectors such as new energy vehicles, industrial robotics and semiconductors.
- The EU is an important destination for Chinese investors, with more than €35 billion of completed transactions in 2016, an increase of 77 per cent from 2015. Chinese investment in Germany rose from €1.1 billion in 2015 to almost €11 billion in 2016. It should be noted that this comes after substantive investment from EU Member States across China over the previous 20-30 years.

Investment flows between China and Europe

- While China's efforts to upgrade its industrial base are welcomed by European businesses and politicians, some are wary of the perceived interventionist role played by the Chinese government in this strategy, which they say is driven by the government's agenda rather than pure market forces.
- This perception of Beijing's close involvement in outbound investments has stoked twofold fears in European countries: that their own national security could be compromised; and that the Chinese Government's directives together with financial aid, tilt the playing field in favour of Chinese companies. Some politicians argue Beijing is making use of tools such as subsidies, continued support for state-owned enterprises, and state-backing for acquisitions of foreign companies on one hand while limiting market access for foreign business.
- Indeed, while private companies are perceived to be working closely with the State on the goals of China Manufacturing 2025, investment by European companies in China continues to face many barriers, such as joint venture requirements resulting in a comprehensive transfer of technology in certain industries for example, all of which contributed to European investment in China falling this year to a 10-year low. These concerns peaked in Germany with the acquisition of robot maker Kuka by Chinese appliance maker Midea, and are now widely shared by other large Member States such as France and Italy.

Chinese FDI in Europe surges, while EU FDI in China declines
Value of FDI transactions between EU-28 and China, EUR million

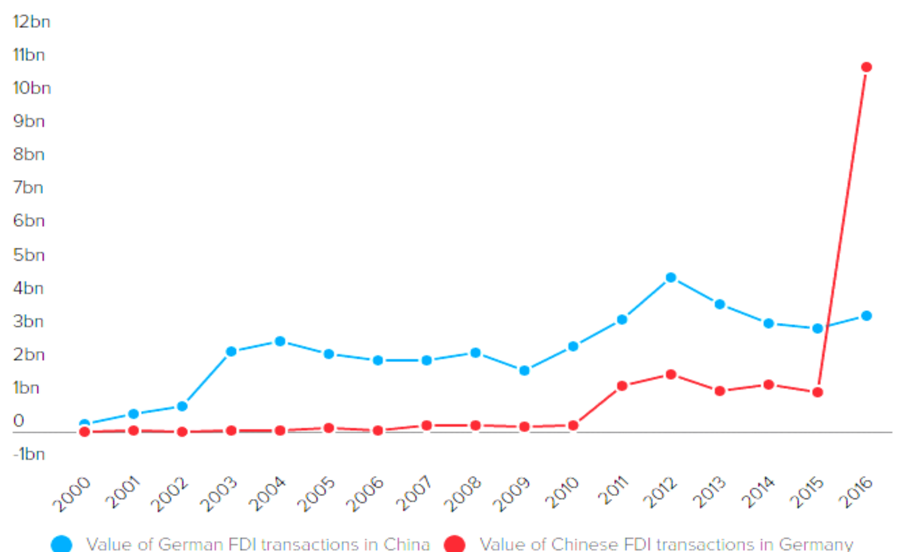


Source: Rhodium Group. Combined value of FDI transactions includes completed acquisitions resulting in ownership stake of 10 per cent or more and greenfield projects that have broken ground.

Source: Rhodium Group/MERICS

FOREIGN DIRECT INVESTMENT FLOWING BETWEEN GERMANY AND CHINA

Value of Chinese transactions in Germany and German transactions in China, in billions of euros.



Source: Rhodium Group/MERICS/Politico

STX France shipyards: How the French government dissuaded Hong Kong's Genting from bidding

In the second half of 2016, the sale process of the STX France shipyard revealed the French State's interventionist practices when it comes to M&A in strategic sectors. The shipyards are considered a national "industrial gem" and are representative of a European expertise that the French government is unwilling to see transferred to another country, and even less to China. The French state holds a 33 percent stake in STX France.

The sale of STX France formed part of the broader sale of the collapsed South Korean STX shipbuilding group led by the Seoul Central District Court at the end of 2016. Seoul's Commercial Court identified four interested parties in November 2016, including Italy's Fincantieri SpA and the Netherlands' Damen Shipyards. The Hong Kong-based group Genting HK, Malaysian in origin but seen as a "Chinese" company in France, had to renounce their formal bid even before it was filed after facing opposition from public officials and representatives of the c. 7,000 employees.

Whereas two of the bidders quickly dropped out of the competition, Genting HK was "very enthusiastic about Saint-Nazaire after having taken over four shipyards in Germany in 2016", according to France's most influential daily newspaper Le Monde. The same article, however, quoted three sources reporting that "French public authorities managed to dissuade them". Another source even added that "two or three weeks were enough to explain to Genting's leaders how unpopular their intervention was, and to detail the measures the State would implement if they were to proceed [with their intention to bid]".

Interestingly, the ultimate success of the Italian group Fincantieri did not put an end to the STX saga. Indeed, Fincantieri is currently in a joint venture with the state-owned China State Shipbuilding Corp., raising concerns of potential technology transfers to China. The French State intervened to prevent Fincantieri from holding a majority stake, and brought in another French group, DCNS, into the shipyard's capital to secure "French interests".

"Currently, the government has the capacity to oppose an acquisition that we believe is bad for the economic and social stability of the company"
Michel Sapin (Minister of Economy)

In a number of Member States, we see anti-Chinese rhetoric being taken up by companies involved in deals in an effort to gain political support for their bid. This was the case recently in France for example, where one of the companies bidding for the acquisition of the STX France's shipyards was successfully sidelined by the other contenders because of its proximity to China. Similar rhetoric is now being used by the French government to dilute the stake of the final bidder, Italian company Ficantieri, who has very close links and a technology transfer agreement with China State Shipbuilding Corp., a Chinese state-owned enterprise.

What are the implications?

- Companies wishing to invest in Europe need to ensure their strategic and financial rationale for any proposed acquisition is well understood by political and business stakeholders in Europe, so as to counter any concerns it may be part of an orchestrated campaign/"sponsored" by the Chinese Government.
- They must also invest in communicating the company's mission, its origins, its values and its business model. Chinese companies in Europe often suffer from an understanding deficit from the European public and political world, which can contribute to negative perceptions of a specific deal.

European responses to Chinese investment to date

- Currently, EU legislation allows Member States to prohibit foreign investments which threaten public security and public order, but it does not let them take into account economic criteria or the reciprocity of the investment conditions. A number of Member States also have specific legislation in place allowing them to review foreign investments but the use of these defence mechanisms is less frequent than in the case of the US, China and Australia. France has a long history of vetting and potentially blocking foreign acquisitions under certain conditions, but most other European countries limit themselves to reviewing investments which are linked to national security, such as defence industry enterprises or companies that are involved in IT security and the processing of state-classified documents, as is the case in Germany, for example.
- The German government has been spearheading a movement in Brussels to broaden EU rules to allow Member States to protect companies working in strategic sectors from approaches driven by industrial policy or aiming for technology transfers. While Germany has considered implementing stricter rules bilaterally, its government has concluded that only an EU-wide approach would be efficient. In February 2017, it received the support of the French and Italian governments, who co-signed the aforementioned letter to the European Commissioner for Trade asking it to create the legal basis for national governments to be able to "intervene in direct investments which are state-controlled".
- At the same time, Germany is preparing a new strategy for its trade relations with China, which suggests that there are two conversations taking place within the Government– one protectionist; and one supportive of increased trade.
- In response, the European Commission is said to be preparing a proposal to allow Member States to block an acquisition that is "politically motivated". In particular, it would focus on the following sectors: airports, ports, railway infrastructure and related suppliers as well as high technology, investments in raw materials, strategic projects such as the European satellite program "Galileo" or companies active in the nuclear industry. This proposal may be announced by the Commission President in September.
- For its part, the European Parliament has also been watching closely developments relating to Chinese investment in Europe. The recent proposal by a group of EPP MEPs for a new Union act allowing EU intervention in the case of foreign investment that "does not comply with market rules or is facilitated by state subsidies resulting in a likely market disturbance" or in the absence of reciprocity for European investment in the third country is the latest response to the situation. Note that as the European Parliament does not have a right of initiative, any proposal would need to be made by the European Commission to be considered for implementation.

EU Legislative Process

The legislative process of the European Union is rather complex. The European Commission is the executive body responsible for proposing legislation, which must then be adopted in a co-decision process by the European Council (the representatives of the Member States) and the European Parliament (with directly elected members). Any EU-wide legislation on this matter would need unanimous support from all Member States which would be incredibly difficult to achieve given the diverging interests.

Indeed, Member States currently have little appetite to give more powers to the European Commission. They are also competing among each other for attracting new foreign investment, making it unlikely that the adopted legislation will be very robust – if any agreement will be reached at all.

The paper released on 10 May is an invitation by the European Commission for Member States to give it a strong political mandate on this matter, but also to consider other possible actions instead of protectionist measures.

Midea-Kuka: How the Chinese takeover of a German "pearl" transitioned from a threat to a blueprint for future Chinese-German deals

Midea is a private, listed, Chinese white-goods company with a strong international footprint and previous outbound deal experience. Kuka is a robot manufacturer occasionally called a "pearl" of German industry. A partnership looked promising, with mutual benefits for both companies. In May 2016, Midea formally announced its intention to increase its 13.5% stake in Kuka to above 30%.

One week after the announcement, Kuka hosted their annual general shareholder meeting, during which various shareholder representatives expressed their concerns about the sale of German technological know-how and potential job losses. Within days of the shareholder meeting, EU and German politicians publicly commented in opposition to Midea's offer. EU Digital Commissioner Günther Oettinger commented: "Kuka is a successful company in a strategic sector with important significance for the digital future of European industry. Since there was no call for help to China, we should be allowed to consider whether a European approach could be a better solution for Kuka." Blocking actions such as an investment cap of 49% were also considered.

Some in the political community in Germany, led by then Economics Minister Sigmar Gabriel, wanted to examine the deal under Germany's Foreign Trade Law. Upon review, the government determined that the Law's scope did not cover companies such as Kuka, which is not considered part of a critical industry. Political risks then escalated as Angela Merkel flew to China for an official visit; the deal ran the risk of becoming a symbol for imbalanced trade and investment between China and Germany.

However, fears were allayed once Midea and Kuka formalized their partnership in an Investment Agreement, in which conditions alleviated concerns by securing jobs and sites through 2023 – far beyond the industry standard. With the successful end of the tender offer period, after which Midea gained 95% of Kuka's shares, the media regularly named Midea's investment in Kuka as a role model for other ongoing Chinese-Germany takeover offers. By December 29, 2016 the Midea-Kuka deal had passed all antitrust and foreign investment clearance globally.

"The Kuka model suggests that cash alone won't be enough. Midea pledged to keep jobs, management and customer data in Germany for seven and a half years, far outstripping typical local standards. That allayed German fears of technology theft and reassured clients such as Daimler that blueprints were in safe hands."

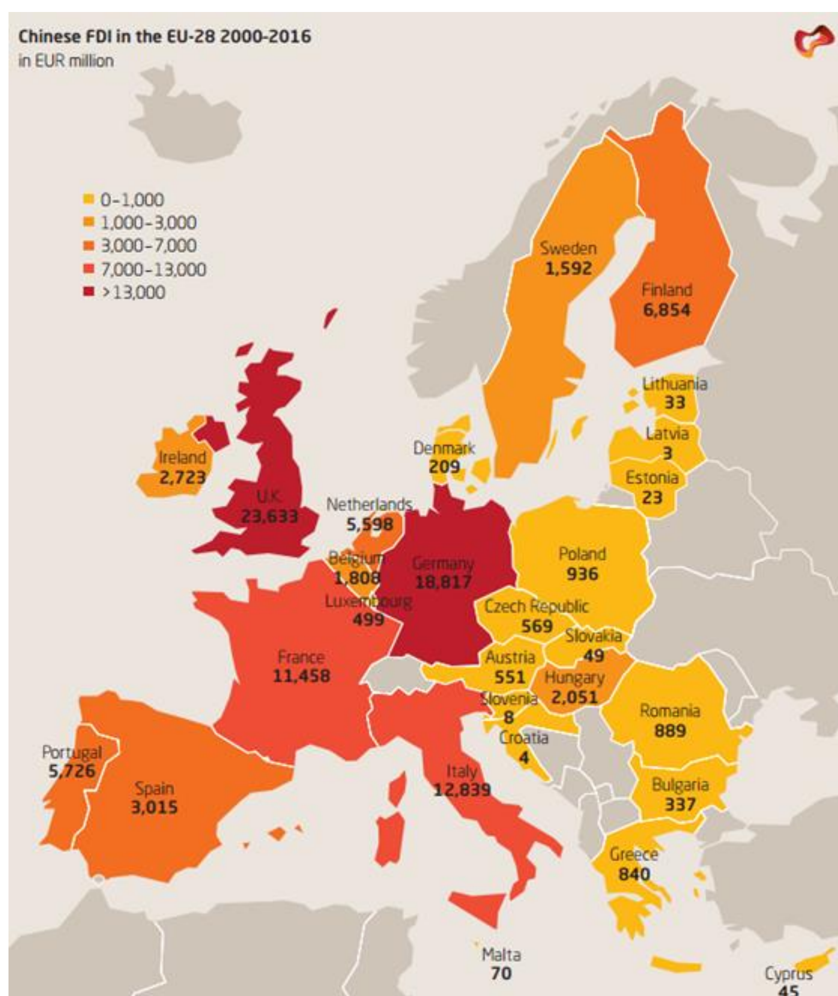
Reuters Breakingviews (11 October 2016)

Broader political considerations

- Generally speaking, the EU and Member States like Germany tend to be in favour of free trade. The backlash against state-driven foreign investments is specifically directed at China, and is balanced by a strong belief that foreign direct investment is positive for a country. The European Commission in particular is strongly committed to free trade, and relies on it as a political tool to bring its trading partners closer to its own model. The Commission considers reciprocity as crucial for any free trade policy, however is also adamant that this should aim for China to become as open as Europe, rather than Europe closing itself to imitate China. It nonetheless accepts certain security concerns and is closely monitoring the recent Chinese acquisitions.

Competing Member States with diverging interests

- In a context where any new legislation would require unanimous agreement by all Member States, diverging interests within the EU will matter enormously.
- Central and Eastern European countries in particular have warmly welcomed Chinese investment as a source of cash for their economies, and resent German efforts to curtail such investment. They are emerging as one of the top destinations for Chinese capital, strongly supported by political initiatives like the 16+1 and the China-Central and Eastern Europe Cooperation Fund. Their need for FDI and weak market position make them an ideal platform for China to leverage its growing influence in the EU as a whole. This enhanced cooperation has already sparked tensions with both bigger Member States and Brussels.
- Some European businesses, including German companies, are also sceptical of their governments' attempts to slow Chinese investment. For them, such investment provides welcome capital in the short term while also helping with market access in the longer term: having a large Chinese shareholder is often a helpful door opener in China.
- Diverging interests are also apparent within individual Member States, with some governments leading the charge against China in Brussels continuing to promote increased Chinese investment in their countries. French Prime Minister Bernard Cazeneuve did so in an outspoken manner during a recent visit to Beijing, just as his government signed the letter to the European Commission. The two conversations taking place in Germany are also clearly apparent in France.
- At the same time, considerations on the role of the Chinese government in trade and investment are also at play in the debate on China's WTO status. Its status as a "non-market economy" (NME), under which it joined WTO in 2001, expired at the end of 2016, causing Beijing to ask to be recognised as a market economy by its trading partners. The EU and the US have been reluctant to grant it this status as it would make imposing antidumping and countervailing duties on Chinese imports more difficult for them.
- China is not a free market by any standards, but it is entitled by WTO rules to access market economy status. This has led the EU to consider other means to address trade distortions. While this is a separate debate from that of investment in strategic sectors, it certainly constitutes a backdrop to European concerns of Chinese state interventionism in all aspects of its industrial policy.



Source: Rhodium Group/MERICS

The view from the U.S.

- **CFIUS -** The Committee on Foreign Investment in the United States (CFIUS) has the authority to review, for national security reasons, any transaction that would result in a foreign entity having control of a U.S. asset. Historically, the U.S. has supported an 'open investment' approach and CFIUS has not taken into account trade considerations or questions of reciprocity. In a recent interview with Bloomberg, Treasury Secretary Steve Mnuchin, said that CFIUS would continue to focus on national security issues.
- **America First? -** However in the same interview he also accepted that in "certain things" the Committee's remit could be expanded and, it is certainly true, that the conditions for CFIUS reform have never been greater. An increase in Chinese investments into the U.S. since 2012 and the convergence of anti-China Republicans and anti-trade Democrats in Congress mean the open investment approach is being questioned by some.
- **The Hill is on the move -** Senate Majority Whip John Cornyn and Senate Minority Leader Charles Schumer are expected to introduce separate bills soon aimed at reforming the Committee. Senator Cornyn's bill is expected to single out investments in particular sectors, such as semiconductors, and investments from particular countries which may require closer vetting, while Senator Schumer's bill is expected to add an economic "net benefit" test to CFIUS review criteria. The only question is whether any legislative effort coming out of Congress will have the support of the White House.
- **Pressure on the Administration -** There have been some noises from the Administration that CFIUS could be used as a tool for dealing with China, but any attempt at reforming CFIUS – especially to include economic considerations – is unlikely to be politically acceptable given the knock on effects to jobs and investment that would result from reducing foreign capital. However, sectors which are particularly sensitive include telecoms, artificial intelligence, robotics, semiconductors and satellites, and transactions, which may require significant mitigation measures to get them approved, face a more difficult time.

The view from China

- **China going global** – Chinese business will continue to seek expansion overseas driven by a cooling domestic economy. However, tightening capital controls and greater scrutiny of investment outside investors' core business will impact the pace of investment in the near term.
- **Belt-Road and "16+1"** – The Belt and Road Initiative, which aims to connect China with Europe, the Middle East and Africa along the ancient Silk Road land and sea routes, will drive significant investment into these countries strategically prioritized by the Chinese government. State owned enterprises may end up leading the charge, with private businesses driven by their own business rationale. A similar situation will apply to the "16+1" initiative, which is China's strategy to engage with Central and Eastern Europe. Investment across both initiatives is focused on infrastructure.
- **Investing in Europe** – Europe will remain a top destination. Chinese investors are confident that there is growth in the European market. Overall, asset valuations are attractive in Europe and there are many technologically attractive companies that match Chinese companies' needs.
- **A challenging year ahead** – 2017 will be challenging for Chinese M&A, as the Chinese government imposes strict control on the use of foreign exchanges to contain the outflow of capital. In addition, the European political climate remains uncertain with elections in key EU member states and Brexit negotiations. In the past many Chinese investors selected the UK as a gateway to Europe. This strategy is now uncertain.
- **Manage challenges** – For all the concerns about Chinese investment in Europe, it remains early days in China's "go global" journey. The volume of successful investments is increasing, but it will be an on-going learning process for Chinese companies to understand the investment and regulatory situation in Europe and navigate local stakeholders and issues.

Looking Ahead

- With elections underway in France, the UK and Germany it is unlikely that the European Commission will get the political impetus it is hoping for to swing into legislative action this year. Although the French and German governments have signalled a will to cooperate more closely on a European level on this issue, their new governments will have other priorities at the beginning of their term. At the same time, the UK's withdrawal from the EU may give the Franco-German regulatory approach a bigger chance to prevail, which could lead to new European regulation on foreign investments during this European Commission's term (which ends mid-2019).
- Further afield, Donald Trump's election is also starting to impact China's approach to Europe. American protectionism makes Europe an even more important trading partner for China, which it cannot afford to lose. President Xi Jinping's call in Davos earlier this year in favour of free trade was – cautiously – welcomed in Brussels, but all stakeholders are now waiting to see whether this will be followed by concrete actions to open up China. In February, the Chinese government released plans to relax restrictions on foreign investment and make it easier for overseas companies to list on domestic markets, which were again welcomed by Europeans.
- However, years of unfulfilled promises by the Chinese Government on economic reforms have weakened European confidence in the ability of Beijing to truly deliver. The shifting global political landscape, slowing growth in China and increasing pressure from European governments may raise the stakes for Beijing to open up and preserve goodwill among its key partners.

What does this mean for companies wanting to invest?

- It remains to be seen whether this is the latest signal of a growing protectionist backlash against foreign investment in Europe's most sensitive industries or merely the development of a more strategic approach to protecting specific sectors. Recent political activities certainly indicate substantive policy change in this field is to be anticipated, although any political action will take time and unity among European Member States. Concerns around Chinese investments are unlikely to decrease however, and may lead to unilateral action by some countries.

- At the same time, the lack of pan-European action leads to the continuation of fragmented national policies. This means foreign investors in Europe face a variety of legislative frameworks and diverse political contexts, which might make the investment landscape more difficult. EU action would create a 'one-stop-shop' and provide investors with more clarity and more transparency as to how their investments will be judged.

- In times of political and regulatory shifts such as these, which can be decisive in driving market outcomes and determining business environments, the need for clear, concise communications between companies and their political stakeholders is ever important.

- For Chinese companies looking to acquire companies in Europe, as much as for European companies welcoming foreign direct investment, well-planned stakeholder engagement and communications can improve trust and have a genuine impact on the potential for the transaction to succeed:
  - Understand the context: identifying and understanding the issues that will impact the transaction in the local market and more broadly across Europe is key to anticipate and addressing concerns early in the process. Political considerations can impact a deal as much as financial ones.
  - Develop a narrative to address these issues: presenting a clear story on the value of the investment proposed, going beyond the pure financial rationale to explain the benefits to the local economy and society will help mitigate concerns and build political goodwill for the proposed transaction.
  - Engage the right stakeholders: staying quiet will not keep the deal away from political attention. Building support among relevant stakeholders who can influence perceptions of the company and the proposed transaction will be decisive. Engagement should be sustained throughout the transaction and be adapted to any political developments.

- Companies thinking about investing in the U.S. should try to situate their investments in the President's "America First" philosophy. They need to be clear about the rationale for their transaction and set the right tone from the start by, for example, being able to make a strong, credible argument about the positive impact on U.S. jobs. This can help to manage the external noise that often exists around CFIUS reviewed transactions in the media, on the Hill and among investors. They should also start to establish early relationships with the Administration – after all, familiarity breeds trust – by engaging early and planning well in advance.

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