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Foreword

China’s economic growth is creating exceptional opportunities for greater engagement between Australian and Chinese public and private organisations. Identifying and capitalising on these opportunities may not be easy, but doing so successfully is likely to produce extraordinary rewards. The strategic partnerships that arise from greater engagement between the two nations are likely to determine our prosperity in the decades ahead.

*Australia & China: Future Partnerships* is the first result of a strategic cooperation between KPMG Australia and the University of Sydney China Studies Centre to create unique business intelligence reports for engaging with China.

Our report provides insights into the long-term demographic and social forces reshaping China and Australia. It analyses the implications of China’s 12th Five Year Plan for Australian-Chinese economic cooperation. It identifies the drivers of future alliances and importantly, focuses on opportunities for stronger engagement in the priority areas of infrastructure, banking, and energy and natural resources.

Our analysis yields a clear conclusion: that a new approach to engaging with China is required.

China’s enduring interest in securing the supply of resources offers new opportunities for the sector beyond the mere export of raw materials, such as joint ventures, jointly financed projects, joint investment in third countries and Asian commodity trading. However, we must continue to broaden our trade and investment relationship to encompass other key areas of strategic interest to China. Education, finance and corporate services are among the sectors where opportunities are growing for Australian organisations as China’s economy matures.

This new engagement involves governments and corporate players and questions of reciprocity. Australia’s corporate sector will have to find a consensus on how to best absorb increasing flows of inbound Chinese capital. In turn, Chinese regulators and investors will have to clarify their corporate structures, ownership and strategic allegiances. These efforts require skilled intermediaries and experts in corporate and financial services who are firmly established in both economies.

Getting our China strategy right is essential for Australia’s future growth. We are proud to share with you our inaugural joint perspective on expanding and deepening the Australia-China business relationship.

Geoff Wilson     Michael Spence
CEO     Vice Chancellor
KPMG Australia    The University of Sydney
OVERVIEW

It’s time for a new narrative about the future of Australia’s relationship with China.

China is Australia’s largest trading partner and will remain so for the foreseeable future. The investment relationship – especially the movement of investment flows from China to Australia – is becoming increasingly important for both countries. It is likely that China will shape our economic future and our prosperity more than any other country.

Australia needs a coherent strategy that sets out what we seek from China, recognises what China seeks as its economy matures and defines a mutually beneficial partnership that will be sustained for the long-term. Australian businesses are still inclined to view China as tomorrow’s opportunity: the reality, however, is that action is required today.

Few, if any, global players can afford to sit still in a world where China’s economic development ambitions are moving ahead at a remarkable pace, driving the country on a global quest for resources well outside the historical focus on raw materials and commodities.

For Australia, the imperative is clear – we must establish a comprehensive and well-articulated strategy to manage our relationship with China well beyond the supply of commodities, or be left behind.

To achieve a clear China strategy, Australian businesses should:

• Map a scenario of the opportunity and what it means for your business. Assess what China will look like over the next five-to-ten years and the revenue potential for your business. Prioritise business opportunities and a thorough understanding of challenges, including cultural and language differences. A five-to-ten year execution plan should include investment and marketing strategies and a means of ensuring that the business has the right skill sets and advisers to capitalise on and realise the China opportunity.

• Look for opportunities to collaborate with Chinese companies, not just in the Chinese domestic market but importantly, in markets outside China, including the Australian market. Australia is seen as a natural partner for China, offering world’s best practice in many areas which are of importance to China’s long-term core interests.

• Understand that the key to the successful execution of a China plan will be obtaining a foothold in the China market and securing the right people to execute the strategy, both in Australia and in China.

Complexities and challenges will persist in our collaborations with China. These, however, pose a far lesser risk than ignoring the opportunities to partner with China. In the future, it may be difficult to have strong global, or even domestic operations without a strong business relationship with China.

The costs to Australia of a failure to develop an effective China strategy could include a loss of new capital inflows, new markets and new technology.
China’s increasing clout

China’s development has been astounding. Its economy grew at more than an average 10 percent annually in the past couple of decades. Per capita gross domestic product was more than 26 times higher in 2009 than it was in the late 70s, the beginning of China’s era of reform and opening up. To date, 500 million people have been lifted out of poverty, and an estimated 380 million jobs have been created since 1978. China is now the world’s second largest economy, after the US. Still, its per capita GDP remains less than one-tenth that of the US, indicating significant potential for further growth. An increasing shift of economic activity to the country’s inland regions could help boost output and incomes there more than expected, as new capacity is added to take advantage of lower labour costs.

China’s 12th Five Year Plan – the government’s most recent blueprint for economic development and growth – aims to ease the rate of growth to an average 7 percent a year from 2011 to 2015. Notably, this rate far exceeds the 2.3 percent and 2.8 percent projected growth rates for 2011 and 2012 respectively for the Organisation for Economic Cooperation and Development’s member countries in total.

For Australia, China is now our largest source of export demand and international students. In 2010, there were more than 150,000 Chinese students at tertiary institutions in Australia compared with 15,000 ten years ago. In 2009 China overtook Japan to be Australia’s largest trading partner. Trade with China now accounts for over A$100 billion, or 20 percent, of total trade with Australia. Merchandise exports to China have accelerated sharply in the past five years, particularly iron ore exports. Exports of travel services have also increased substantially in the past 10 years.

The underlying realities that these data represent and the future they herald should serve as a wake-up call for Australian businesses to get their houses in order and develop strategies to engage effectively with China for the long-term.

1 International Monetary Fund Working Paper: Transforming China: Insights from the Japanese Experience of the 1980s, December 2010
2 OECD Economic Outlook, 2011
3 OECD Economic Outlook, 2011
China’s evolution – the next phase

With China’s global influence growing inexorably, it is critical that Australia achieves a better comprehension of China’s strategic thinking and strives to understand how it may evolve according to China’s interests.

China’s core interests are to promote its sovereignty, security, and economic development simultaneously – a highly complex policy. The 12th Five Year Plan marks a significant shift in the country’s preoccupation with headline growth; the government’s focus is on quality of growth, and on solutions to ensure long-term prosperity for the entire nation. Moving its economy up the value chain is critical. Priorities now include economic efficiency and sustainability, correcting economic imbalances through higher domestic consumption and a reduced dependency on exports, product quality, environmental protection, the creation of a social safety net, and technological innovation. Population growth and urban migration have been, and will continue to be, supported by extensive investment in infrastructure, housing and transportation. According to government forecasts, the country’s urban population will grow from 665 million to 721 million by the end of 2015.

To serve its domestic economic priorities, China is placing an emphasis on encouraging foreign direct investment (FDI) into the country as follows:

- preferential sectors for FDI include modern agriculture, high-technology industries, advanced manufacturing, energy conservation and environmental protection, new energy sources and modern services;
- preferential areas for FDI are the central and western regions of the country;
- increased types of investment including participation in domestic enterprises’ merger and acquisitions (M&A) or restructuring activities through the acquisition of shares or assets, and equity and venture capital.

The acquisition of expertise is a strong focus – key objectives include recruiting talent, importing advanced technology and leveraging overseas advanced management concepts, systems and experience. The effective utilisation of foreign preferential loans and international commercial loans, and the improvement of debt management are also priorities.

China’s expanding overseas direct investment footprint in recent years reflects its rising foreign exchange reserves and a more explicit policy to ‘go global’, primarily for ensuring security of mineral resource and food supplies but increasingly, to acquire the new technologies, managerial know-how, and distribution networks that will bolster domestic growth.

However, China’s outbound investment patterns should remind Australia and other advanced nations that China is not yet an across-the-board peer in many respects. Chinese companies are late to globalise, compared with those of advanced economies and their overseas activities are still at an early stage of development. Most are motivated mainly by access to improved distribution networks and advanced technology.

To stay on track with its economic development plans, China will need help from more experienced companies and individuals who know how to operate away from home, and cooperation from other governments to not only sustain but enhance openness for cross-border investment.

Australia’s Foreign Investment Review Board (FIRB) approvals indicate continued strong growth for Chinese FDI flows into Australia, with investment likely to be heavily concentrated in the mining sector. That said, the Chinese Government seems increasingly intent on encouraging investment abroad in a greater variety of areas.

The government has heavily promoted investments in oil and gas, mining and metals, and financial services, but also in almost every other economic sector. There is a growing push to acquire knowledge, skills, technology, brands and distribution channels.

Chinese enterprises of all types are being guided more thoroughly on their foreign investment and cooperation activities, in an ongoing drive to develop global marketing networks, globally-recognised brands, and Chinese multi-national companies and financial institutions. In this regard, the emphasis is on:

- deepening cooperation in the international energy resources sector;
- encouraging leading manufacturing companies to invest overseas effectively;
- increasing international cooperation in the agriculture sector.

There is no question that the regulatory restrictions on overseas investments by Chinese companies will be relaxed in the future, restrictions which have to date hampered Chinese global investments. This will be a dramatic game changer. One potential change is that government approval will no longer be required for resource-related investments of less than or equal to A$300 million and for non-resource related investments of less than or equal to A$100 million. In light of the fact that more than 80 percent of announced Chinese deals in Australia are within the A$300 million limit, this one change alone will shift the landscape. The Renminbi can now be utilised in investments abroad: banks can issue Renminbi-denominated loans for overseas direct investments and profits can be repatriated in Renminbi.

China’s evolution includes an examination of its corporate values and those that are – or could potentially be – shared with other nations. A drive to improve China’s international standing is afoot and there is increasing commitment to strong governance, greater accountability and transparency – values that are widely shared among advanced economies.
China’s 12th Five Year Plan: the objectives in numbers

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2010</th>
<th>2015</th>
<th>Annual Growth Rate (%)</th>
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<tbody>
<tr>
<td>GDP (billion RMB)</td>
<td>3,980</td>
<td>5,580</td>
<td>7</td>
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<td>Urbanisation rate (%)</td>
<td>47.5</td>
<td>51.1</td>
<td>[4]</td>
</tr>
<tr>
<td>R&amp;D percentage of GDP (%)</td>
<td>1.8</td>
<td>2.2</td>
<td>[0.4]</td>
</tr>
<tr>
<td>Area of arable land (million hectare)</td>
<td>121.26</td>
<td>121.26</td>
<td>[0]</td>
</tr>
<tr>
<td>Forest coverage (%)</td>
<td>20.36</td>
<td>21.66</td>
<td>[1.3]</td>
</tr>
<tr>
<td>Per capita disposable income of urban residents (RMB)</td>
<td>19,109</td>
<td>&gt;26,810</td>
<td>&gt;7</td>
</tr>
<tr>
<td>Per capita net income of rural residents (RMB)</td>
<td>5,919</td>
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<td>&gt;7</td>
</tr>
<tr>
<td>People participating in basic pension insurance in urban areas (million)</td>
<td>257</td>
<td>357</td>
<td>[1]</td>
</tr>
<tr>
<td>Total population (billion)</td>
<td>1.341</td>
<td>&lt;1.390</td>
<td>&lt;0.72</td>
</tr>
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Note: Numbers with [ ] are cumulative growth rate in five years
Source: Xinhua
Australia-China: the potential shape of future partnerships

China has massive foreign exchange reserves, of which more than one trillion are held in US treasury bonds. Diversification is inevitable. In view of China’s relentlessly strong demand for energy, natural resources and a widening spectrum of inputs required for domestic development and growth, a way of diversifying foreign currency holdings is for Chinese enterprises to pursue overseas investment in countries rich in offerings that satisfy its requirements and have a positive policy and social environment for Chinese investment.

For example, Chinese industrial groups could greatly increase their participation in Australian infrastructure development – especially in the Australian resources sector – if Australia were to reduce barriers to Chinese investment. At the same time, Chinese enterprises would need to adjust their investment philosophy – that is, buying, rather than jointly developing sources of energy and natural resources. Arguably, Chinese industrial groups need to integrate themselves into the Australian mining industry, rather than simply buying Australian mining companies. They should aim for two-way investments to enable the mining sectors of both countries to fully understand the conditions and operations of their respective energy and resources industries, and to develop better understanding and communication mechanisms.

Australia has a mature mining capital market while China’s mining capital market is in its infancy. A combination of China’s financial resources and Australia’s mineral resources could yield the world’s most important mining capital market. This would underscore Sino-Australian cooperation in resources and contribute to the internationalisation of the Renminbi.

Australia’s geographical position carries obvious advantages for enhanced cooperation with China, such as relatively short transport distances to China and a time difference of only two to three hours, the shortest with any western economy. If China, Japan and Australia were able to fully develop the respective advantages of their resources industries and agree on the structure of a collaboration, the three countries could create an Eastern Resources Commodities Trading Centre in their time zone with links to the key global trading hubs of London and New York to form a new 24-hour resources commodities trading centre.

For China, the most effective strategy for entering the Australian capital market is to rely on resources companies to establish two-way investment relations. Allowing shareholders of Chinese resources companies to benefit from the participation of Chinese resources companies in the Australian capital market for mining and infrastructure will be useful for building an interactive Australian-Chinese resources investment platform. This will also help to mobilise broad public support and lay a sound political foundation. The establishment of a system of mutual investment cannot be one-way. While the degree of engagement may differ between partners, policies and standards must be consistent on both sides in order for such a system of mutual investment to withstand any potential political storm.

There is also a clear increase in joint venture arrangements between Australian and Chinese companies and a simultaneous easing in focus on M&A. Changing Chinese perceptions of Australia’s reluctance to allow public equity ownerships will result in more joint ventures.
Joint venture arrangements include the following:\textsuperscript{14}:

- between Chinese and Australian companies for operations in Australia, such as the joint venture between Sinosteel and Rio Tinto for iron ore production;

- between Chinese and Australian companies to invest in third countries, for example, the joint venture between Chinalco and Rio Tinto to invest in Guinea. This could be seen as an attempt by Chinese companies to reassure target countries about governance post acquisition, although from the Chinese side this is seen as a way to assist western companies into Africa and Asia. Further, Chinese companies could expect to develop their deal-making and management know-how from such joint ventures, consistent with the broader ‘go global’ strategy;

- between Chinese and non-Australian companies to invest in Australia, for example, the joint venture between PetroChina and Shell to acquire Arrow.

Chinese financial investors in particular are now seeking more indirect investment routes such as using private equity funds and other collective investment vehicles as a way to avoid negative Australian media coverage. Other less direct means are also being pursued, such as the use of US or Hong Kong domiciled Chinese companies, both state-owned and private, as the investor. Another channel is for a Chinese company to acquire a controlling stake in a small Australian company, which is then used as a vehicle to acquire stakes in a much larger Australian company\textsuperscript{15}.

Beyond energy, natural resources and food security, China is seeking inputs to drive priorities including:

- moving up the value chain, i.e. transition its economic focus from low-cost, low-value manufacturing industries to high value-add, high productivity industries;

- developing, or acquiring, new sciences and technologies;

- developing new environmental technologies and solutions to carbon emissions and pollution;

- increasing access to education for the Chinese people and lifting the quality and depth of education;

- acquiring or developing managerial know-how.

These are areas in which Australian companies could easily contribute. Many, in fact, excel and are regarded as having world’s best practices in technological innovation, sciences and environmental technologies.

The last point is critical to the success of Chinese companies’ investment forays abroad. The biggest drag on their success rate is that they lack sufficient execution resources and skills needed for long-term investments abroad. Many are well aware of the challenges involved in integration, particularly in a cross-cultural setting. Some companies integrate management and systems very quickly when integrating consistent systems and policies is a key priority, while some only monitor and evaluate target management performance while interfering less with daily operations. They need to strike a balance between the need to control and the need to let go. There is awareness that they still need to develop experience to effectively manage international businesses\textsuperscript{16}.

\textsuperscript{14} Extract from Lowy Institute Policy Brief: Chinese Perspectives on Investing in Australia, John Larum, June 2011

\textsuperscript{15} Extract from Lowy Institute Policy Brief: Chinese Perspectives on Investing in Australia, John Larum, June 2011

\textsuperscript{16} KPMG: World class aspirations: The perceptions and the reality of China outbound investment, 2010
Challenges

Public sensitivities toward Chinese investment were heightened by the extensively-publicised debate in Australia in 2009 about the merits of Chinese investment. Sensitivities have lingered and may persist into the future given China’s intensifying internationalisation push.

The dominance of Chinese State-Owned Enterprises (SOEs) as foreign investment applicants in Australia may explain some of the sensitivities on both sides. Under the FIRB regime, corporate governance of SOEs is examined more rigorously than that of other applicants. The Australian Government has taken steps in recent years to improve the transparency of the approval process for foreign government related investment applications. Confidence building measures and dialogue with potential investors would help alleviate concerns about SOE investments.

The bottom line is that Australia’s foreign investment approval should be perceived as being as transparent as possible. Communication of investment policies, guidelines and decisions to Chinese investors and officials will help Chinese investors to adjust their expectations and to achieve their legitimate commercial objectives. At the same time, Australia can both continue to benefit from access to Chinese capital while also protecting its interests.

China also must play a major part in discussions to alleviate aversion to its FDI – it has a great deal to lose from a failure to maintain international openness. China’s own treatment of foreign investment inflows is far more restrictive and far less transparent than Australia’s treatment of Chinese investment.
Issues to consider for businesses and investors

Cross-border investments are complex. Specialised skills are required to establish business strategies, to manage asset transactions and to manage an overseas operation. The following points should be considered by Australian businesses seeking a foothold in China and Chinese companies seeking investments in Australia.

- Use China-experienced executives or external advisers, from creating a strategy, identifying a target, local networks in the particular market and the initial acquisition through to implementation and integration.

- Ensure you have the skills to understand and bridge any cultural divides, the required market knowledge, the ability to comply with different regulatory standards and a new legal environment, an understanding of the relationship between unionised labour and management, and the ability to manage expatriate and foreign staff. You must be able to meet quality and safety standards, adhere to tax and accounting rules, manage exchange rate risks, and create suitable strategies for marketing, communication and public relations.
The China Story: opportunities and challenges over the next 20 years.

It is thought that the kingdom of China has for at least a millennium been the most populous nation on the planet. Even today, China in its modern form famously remains exactly so. According to World Bank data, China is estimated to contain a population of 1.342 billion at June 2011 – up six million over the previous 12 months. The population of China has doubled since 1960 and is expected to reach 1.462 billion by 2030.

China is the demographic behemoth of our time, just as the US has been the economic powerhouse. Both are set to change, or will at least be seriously challenged in their respective areas of dominance over the next decade.

This changing world has implications for geopolitical alliances as indeed it has for business. And no other country will be more affected by these challenges and changes than Australia – leading supplier of resources to China and leading alliance partner of the US.

Welcome to the China Story of the 2010s and beyond.

BERNARD SALT
Demographics, KPMG Australia
The China trajectory

China initiated a one-child policy in the late 1970s which dramatically reduced the birth rate and which, one generation later, is impacting the labour market. But China has a demographic rival, India, which has 1.185 billion residents and is closing the 157 million population gap on China at a rate of ten million per year. At the current pace of growth, India will replace China as the planet’s, and history’s, largest nation by 2030.

The rise and fall of nations is not solely about demographics. It is about economic power and this is typically measured by gross domestic product (GDP). Some in the West are unconcerned about the competitive threat posed by the rise of China, arguing that the US has and is likely to retain, a far higher GDP per capita than China. This might be all very well in terms of determining consumer demand but the impact of nations is measured by the aggregate resources that a single government can direct. The US for example manages the world’s most powerful economy with a GDP of US$15,000 billion in 2011. The World Bank estimates China’s GDP at US$5,000 billion. In other words, China’s economic power is currently about one-third that of the US (see Figure 1).

However the crucial point is that China’s economy is closing the gap on the US. In 2000 China’s economy was equivalent to one-fifth that of the US, and in 1990 it was one-twentieth. If recent trends were to continue – and some say that is a heroic assumption – China would overtake the US in aggregate economic power as measured in US dollars (and which may not be the commonly accepted global currency at that time) by the late 2020s. But the precise year in which China overtakes the US is not the point. The point is that the US has been the world’s most powerful single economy for 100 years and the world’s premier military power since 1945.

The China Story is a story of demographic and economic challenge. At no point during the Cold War did the former USSR amass the relative economic power that China has amassed: this means relative to the US. At the time of the disintegration of the USSR in 1990 the collective GDP amounted to less than 10 percent of the US’s economic power. The only way the Soviets could mount a serious and sustained challenge to the US was by directing their limited economic resources to military purposes.

China is a frerer society than the USSR was but, in many respects, it is nevertheless a planned economy. When directed, the resources of a US$5,000 billion economy can have a larger impact than a moderately bigger and frerer economy. Similarly, when directed by the vagaries of the free market and by the inefficiencies (but freedoms) of a liberal democracy, the resources of a US$15,000 billion economy can have the relative impact of a moderately smaller economy.

What this means is that the economic power of China and the US is effectively much closer than is suggested by the fact that the US’s economic output is three times that of China’s. But there is a caveat to this assessment. The reason why the USSR disintegrated is much the same as why many Arab regimes toppled in 2011 – the national direction was not fundamentally supported by a critical mass of the population. And this will be China’s challenge: to maintain social and political cohesion across 1.5 billion people of disparate ethnicities, religions and values during the first half of the 21st Century.

The unified force of modern China might have begun with ideology but has mellowed to economic prosperity. While there are rising living standards, China’s population is less likely to demand changes to the status quo. However as with Maslow’s hierarchy of needs, it could also be that as the community’s basic needs are met (washing machine then motorbike then mobile phone then refrigerator) a burgeoning middle class could begin to expect more. They could well develop lifestyle expectations that extend beyond the material to include changes in the social and political arenas.

The challenge of social cohesion

The threat to the China Story over the next 20 years and beyond may not be conflict with Taiwan, dealing with a belligerent North Korea, or fending off perceived US expansionism. It could well be the issue of maintaining harmony within.

There are very few cohesive collections of a billion people or more: China is one; India is another; both are political constructs. But there are other collections: Christianity and Islam for example each have more than a billion disciples who remain united by belief and who respond – to varying degrees – to leadership. In all instances, both political and religious, there are competing views and factions.

Even in the US there are faultlines based on ethnicity. Broadly the US is 70 percent Anglo; 15 percent African American and 15 percent Latino. Some commentators have argued that given the higher Latino birth rate and the predilection for Latinos and Latin culture (including language and religion) to dominate southern states there may well be, over time, internal pressure for a separate state to secede from the Union. In other words, there are very real and very human issues based around tribe, belief and behaviour that can pose a challenge from within to large political aggregations of people, given the right demographic context.
The challenge of labour
For this reason the assumed China trajectory over the 2010s and 2020s to global economic dominance is not necessarily assured. Social cohesion is likely to be part of the China Story. The other and possibly more pressing issue relates to China’s labour market as the basis to its competitive advantage in the global economy.

A nation’s prosperity is largely driven by a cohort known as the ‘productive population’ and in modern parlance this is defined as the 15-64 age group. It is the 15-64 year olds in the modern world who form households, reproduce, take out loans, buy consumer goods… and who pay tax. It is true that some younger people and some older people do make contributions to the productive process but at a national level these contributions are insignificant.

The issue is not so much the quantum of people in the productive cohort as it is the rate of growth in the productive-cohort population. More people entering the productive phase of the lifecycle at 15 than exiting at 65 is good for an economy and for a tax base. And this is precisely the situation that has prevailed in China since 1950 (see Figure 2). Where there is a continually rising population (due to higher birth rates or ramped immigration) there is a continually rising productive population which leads to more consumers and more taxpayers every year.

With a continually rising working-age population there is also likely to be a continually rising workforce. And if there is an ever-rising pool of labour then that labour loses its bargaining power in negotiating wages. This is because “if you don’t sell your labour for a dollar a day there’s always someone else who will”. It is evident that between 1990 and 2015, China’s productive population has been growing and will continue to grow, providing the nation with a rising pool of cheap labour and a rising pool of tax to fund major projects and investments.

Follow this trajectory for a generation and soon enough the locals become addicted to government projects, government largesse, and the material bounty that flows from a rising and prosperous economy. Everyone’s happy. But there is a fundamental shift in China’s demographic bedrock in the back-half of the 2010s. All of a sudden there is no growth in the working-age population. This comes about because of falling birth rates due to the one-child policy (effected in the 1970s) combined with an exiting of the workforce by workers born in the late 1940s. It is this interplay between workers coming in and workers going out of the workforce that changes China’s demographic trajectory.

Over the decade to 2025 growth in the productive population will plateau. There will be less depth in the market for labour and skills. All of a sudden labour is in a stronger bargaining position and can leverage better wages and conditions more akin to Western expectations. China then begins to lose its competitive advantage (of cheap labour) in the global economy.

One short-term response might be for China-based businesses to seek out untapped and unskilled labour deep in the rural interior. But eventually, and certainly within the 2020s, China’s labour market begins to contract around 50 years after the introduction of the one-child policy. Less labour means less tax, less spending, and less consumption, all foisted upon a generation (within a single tumultuous decade 2015-2025) that has become used to a rising consumer largesse, admittedly off a low base.

Another outcome of this process might be dissent and civil unrest. One outcome could be that the final drive to topple the US in terms of economic power might elude China. Perhaps by the late 2020s China will be riven by such internal conflict that this very process distracts leadership from the efficient use of resources. In this scenario China falters prior to, or soon after, overtaking the US in terms of aggregate economic power.
Opportunities of Australia

Whether China actually manages to develop and sustain an economy that is technically bigger than the US’s economy is not really the issue. The fact is that China has mounted a serious challenge to the US’s primacy and dominance over world economic output. Even if the Chinese economy never matches the US economy (perhaps for reasons of demography and social cohesion) the closing of the gap between the world’s most powerful economy and second most powerful economy is both the issue and opportunity for Australia.

The opportunity for Australia is straightforward. Over the coming decade China will require from resource-rich nations such as Australia (but also from similar nations in Africa and South America) food, energy, resources and commodities. The challenge for Australia is to maintain a warm commercial relationship with China and a warm military-support relationship with the US. This is clearly the relationship that Australia enjoys at the beginning of the 2010s; the challenge is to retain and develop both relationships without disaffecting either over coming decades.

But China will also generate and disseminate regional wealth through what might be termed The Dubai Effect. This is the idea that the middle class in any wealth-generating region requires nearby lifestyle retreats. Dubai fulfilled this role in the late 1990s and early 2000s: make money in Saudi Arabia or Kuwait but buy an apartment and live part of the year in the lifestyle retreat of Dubai.

The same logic applied to Russia during the 1990s: Russian billionaires don’t just live in Moscow, they also live in London’s Belgravia. Switzerland performed a similar function for Western Europe in the 20th Century. And so it is with China in the early decades of the 21st Century. Make money in Shanghai and Guangzhou but buy an apartment in a lifestyle city such as Sydney or the Gold Coast and spend part of the year there; educate your kids; have a medical procedure; shuttle between your lifestyle retreat and your workplace.

The island of Sentosa off the coast of Singapore is now being developed as a lifestyle retreat, not so much to service local Singaporeans but to service the needs of a rising Chinese middle class. Melbourne’s Crown Casino has responded to what can only be described as the ‘wealthification’ of China’s middle class by opening a casino in Macau. China will continue to demand Australian resources; Australia will continue to evolve as a lifestyle and service-based (especially education) retreat for the Chinese middle class.

The Chinese community is well represented in Australia. In June 2009 there were 320,000 people in Australia who had been born in China. Many of these (estimates suggest around 40 percent) would have been students and the number since that time has most likely swollen to closer to 400,000. If Australians with some form of Asian parentage are included then around one million people (or close to 5 percent of the Australian population) have some Asian connection. And in some suburbs of Sydney and Melbourne the proportion of the population with Asian heritage would exceed 30 percent.

The opportunities for Australian business are not so much in servicing the specific needs of Chinese immigrants, students or visitors – although that is part of the opportunity. It is in grasping and understanding how the mainstream Australian market is being impacted, through osmosis, by increasingly Asian values. Greek and Italian migrants shifted the Australian palate from tea to coffee in the late 20th Century; perhaps Australia’s rising Chinese and Asian influences will shift the palate back to tea? Perhaps Australians will begin to configure housing design to reflect the principles of feng shui so as to broaden the market of potential buyers to include university-educated professional Chinese who arrived as students in the 2010s? Perhaps Australian manufacturers might like to consider the fact that China might not command the cheap-labour advantage in the 2020s that it did in the 2000s because of a demographic driven shift in bargaining power by labour that is set to emerge in the 2010s?
A reflection on the new tribes of China

Interestingly, much of the consumer tribalism that has defined Western culture for some time is now emerging in China. Chinese couples who both work and who do not have children are referred to by a term that is an Asianisation of the Anglo acronym DINK (double income no kids) except that Chinese dinks are known as dingke yizu. And those dingke yizu who make good and find extraordinary wealth in the New China are known, not always respectfully, as baofa hu – which roughly translates as nouveau riche. As in the West, aspiration comes at a cost.

Perhaps the emergence of these terms is an important part of the China Story: they define the new tribes of China. These are tribes that are not based on ethnicity or on religious belief but on the single unifying concept of aspiration.

It is aspiration for a better life and better lifestyles that is driving this nation into a closer working relationship with Australia and the rest of the world.

The question for China, and therefore for Australia, is whether this aspiration will eventually evolve into demands for the kind of Western-style freedoms that lie just beyond the consumerist world. And there is no reason to think that China would not eventually push in precisely this direction. However the challenge for China is how to manage this cultural transition over the next 20 years.

The challenge for Australia is to manage well its geopolitical relationship with China and with the US, and to respond to the commercial opportunities and challenges that this brave new world presents.
Figure 1:
Gross Domestic Product in US dollars for the US, China and the Former USSR 1990-2011

Source: KPMG Property & Demographic Advisory; World Bank

Figure 2:
China’s Demographic Faultline: Net Change in Population Aged 15-64 between 1950 and 2050

Source: KPMG Property & Demographic Advisory; United Nations
China’s continued emphasis on rapid urbanisation and development is providing an array of infrastructure opportunities for Australian businesses.

A number of key areas in the country’s infrastructure sector are opening to foreign investment: they include toll roads, water and waste treatment plants, airports, ports, and hydro, wind and nuclear power plants.

Increased access is also being provided to foreign investors in previously restricted areas such as hospitals and the overall healthcare system. Some restrictions still apply within more sensitive sectors (for example nuclear and airports), and it is important to investigate individual sectors in more detail on a case by case basis as the regulatory landscape can change quickly in China.

Water conservation and environmental protection will be an increasingly important area for investment in the next five-to-ten years, with announcements by ministers of more than RMB 2 trillion of investment over the next five years (double that spent in the last five year plan). Areas of investment include sewage treatment and wastewater treatment plant upgrading and building more water supply plants, expanding sewers and pipe networks, enhancing rural water supply, building more reservoirs, recycling more water, more desalination plants and tackling pollution levels.

Similarly, Chinese companies are showing interest in investing in Australian infrastructure projects. Australia’s need for capital and China’s surfeit of it, the long-established trading relationship and the complementary economic relationships between the two countries may provide China with a natural path to invest, even without capital account convertibility.

Importantly, China’s fundamental need to secure resource and energy assets abroad may be the key to unlocking the potential for its increased investment in Australian infrastructure.

For China, Asia is the focus in terms of the business growth and customer networks of its companies with overseas investments; the US and Europe are attractive as large economies and markets; and the Middle East and Africa attract Chinese companies because of lower barriers to entry. As a result, Chinese companies are yet to fully appreciate the infrastructure investment potential in Australia – a challenge that points to a critical opportunity for improved engagement.
Opportunities and challenges for Australia within China

The 12th Five Year Plan: implications for China’s infrastructure

• **Energy:** Clean energy, energy conservation and clean energy cars are key investment areas. Hydro power is likely to see strong growth. Expansion is also expected in other clean energy sources such as wind farms, solar and biomass. The outlook for nuclear energy is less clear after Japan’s nuclear crisis. Smart grid development is currently underway and construction will take place during the period of the 12th Five Year Plan.

• **Affordable housing:** The government’s target is to build 36 million units of affordable housing over the period of the Five Year Plan. Housing construction will help support steel demand.

• **Healthcare:** The government has emphasised foreign investment in the development of the healthcare sector. The Five Year Plan reinforced the objective of developing an affordable and accessible healthcare system and infrastructure, with a medical insurance system for the entire population – consistent with the nation’s emphasis on higher-quality future growth.

• **Transportation and logistics:** The transport and logistics sector is likely to be significantly affected by the themes in China’s Five Year Plan. The continued shift of business and development in western China will change transport demand; the planned infrastructure and housing improvements will impact the movement of raw materials; and the switch of focus to domestic consumption, together with the focus on the hi-tech and service sectors, is likely to boost domestic transportation demand for both goods and people. Improvements in inland waterways and rail infrastructure should help to limit the nearly exponential growth in road transport. There is a need for more modern systems, IT and management practices, and more sophisticated and integrated logistics solutions.

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1 China’s 12th Five Year Plan (2011-2015), KPMG Insight Series, March-May 2011
Planned investment and targets

Energy:

• China plans to invest RMB 11.1 trillion in the power industry in the next ten years with RMB 5.3 trillion invested from 2011 to 2015. RMB 2.75 trillion will be invested in power plant construction and RMB 2.55 trillion will be invested in power grid construction.

• Nuclear power and hydro power are prominent items. China originally planned to approve another ten nuclear power projects and increase nuclear power capacity to around 43 gigawatts by 2015. However, after Japan’s nuclear crisis, the pace of development is likely to be less ambitious than before.

• The Five Year Plan also calls for the construction of large scale hydropower plants in southwest China. By 2015, hydropower capacity will grow to 284 gigawatts and pumped storage hydropower capacity will hit 41 gigawatts.

Healthcare:

• RMB 850 billion was earmarked in 2009 for the first phase of a three year health service upgrade.

• Government participation is likely to deepen with an increase in subsidies for the New Rural Cooperative program (covering the rural population).

• Key goals for the sector include the strengthening of the hospital service network including the development of healthcare infrastructure (such as hospitals and clinics), encouraging and introducing private capital into medical institutions, the expansion of basic healthcare service offerings and the creation of an e-healthcare database with coverage for 70 percent of urban residents.

• Government support for the development of hospital and clinics in rural areas has been emphasised, as well as the development of a rural emergency healthcare network.

• There is an objective to increase the proportion of chain retail pharmacies from the current one-third to two-thirds to enhance the connection between national and regional services. The building and consolidation of pharmaceutical distribution channels should lead to higher efficiency and improvements in the quality and level of service based on new distribution systems.

Transportation and logistics:

• **Shipping:** The government will continue to focus on improving inner river transportation infrastructure. China’s 110,000 km of inland waterways is already a key feature of the country’s transport industry, representing an estimated 67 percent of marine freight volumes in 2010. The continued need for raw materials imports to support ongoing infrastructure investments in the country, and the targets for the construction and redevelopment of low-cost housing should continue to support steel and iron ore imports, indicating that the bulk and container shipping markets will remain important.

• **Rail:** High priority has been given to the railway network and the government plans to invest RMB 600 billion annually in rail projects. Rail freight transportation is an attractive low carbon option and it is likely that the key theme of sustainability in the 12th Five Year Plan will provide a further boost to rail freight.

• **Road transportation and logistics:** The government’s freeway development plan calls for the construction of seven new freeways originating from Beijing, nine new expressways running north to south, and 18 ‘thruways’ running east to west. For more rural areas, the stated objective is to ensure that by 2015, all townships and 90 percent of villages are accessible by vehicles. As at the end of 2010, 1200 townships and 120,000 villages had no paved roads. The highway building program is especially needed to support the efficient transportation of goods and people further west in the country and bolster the objective of increased domestic consumption. In the Five Year Plan, the length of the highway network is slated to reach 83,000 km from the current 74,000 km (as a comparison, the US has 100,000 km).

• **Aviation:** Increased domestic consumption and general prosperity should help boost demand for air travel, domestically and internationally. Also, demand for higher-end cargo is likely to rise and this is more likely to be transported by air. The government plans to build a second airport in Beijing and invest more than RMB 1.5 trillion in developing the aviation industry. Specific development measures include increasing the number of airports from 175 to 220, and the number of airplanes in the aircraft fleet to over 4,500 from 2,600.

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Opportunities for Australian investors

Australia’s expertise in infrastructure, services, technology, innovation and management know-how are among the key skills and capabilities China is focused on acquiring.

Energy:

- Significant CAPEX is needed for clean energy, providing foreign players with opportunities for investment. Recent updates by the Chinese Government to its guidelines for foreign investors show that more environmental and energy-saving technologies appear in the ‘encouraged’ category for foreign investment, such as the construction and operation of water treatment plants. Newly permitted foreign investment activities – that were formerly restricted or prohibited – include the construction and operation of oil refineries with an annual output of 8 million tons or less.

- Increased procurement opportunities are likely from Chinese companies, especially in areas where home-grown technologies are still being developed (ie. nuclear and smart grid). Smart grid construction will require equipment and smart meter supplies. Nuclear technology is under development, so cooperation with foreign companies beyond simple equipment supply could be important.

Healthcare:

- Private capital investment will be a key driver in the healthcare sector. The opening up of the sector could provide opportunities ranging from the low-end to the high-end, from specialty to general hospitals.

- Medical institutions (limited to equity joint ventures and contractual joint ventures) are among the newly permitted activities for foreign investors in the government’s draft of proposed revisions to its foreign investment guidelines. Further opportunities for foreign investment may emerge as the industry continues to open and the government permits new operators to enter.

- An increase in M&A activities is expected across healthcare broadly, especially in pharmaceutical distribution, an area where companies are looking to further strengthen their distribution channels as well as research and development (R&D) capabilities.

- There are potential benefits for foreign hospital operators who are looking to enter the China market. Smaller domestic operators may benefit from collaboration with more experienced foreign operators; future M&A may be a potential route of entry.

Transport and logistics:

- China’s goal to upgrade its logistics industry is likely to provide opportunities to international operators, and logistics is listed as a special services sector where ‘steady steps’ will be taken to open it up to foreign investors.

- Expertise in infrastructure, services and technology will be needed in aviation, toll roads and freight rail. There are opportunities for partnerships (eg. a majority stake) or a complete buy-out, especially in toll roads. Freight rail for the transportation of cargo (and the associated immediate economic benefits) is likely to present more of an opportunity than passenger rail projects which are more politically sensitive.

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Challenges and risks:

- **Energy**: New environmental taxes, which may be imposed, could raise overheads for foreign and domestic companies operating in China. New regulations are likely to increase compliance costs for companies. Also, with regards to M&A activity, Chinese companies might not attach a sufficiently high priority to integration issues, raising the risk of failed deals and potentially affecting their appetite for further M&A activity.

- **Healthcare**: Bottlenecks from provincial governments may cause potential delays to the roll-out of central government plans for more affordable and accessible healthcare services for the entire population. New regulations are likely to increase companies’ compliance costs and may impact small manufacturers that may not have adequate resources to meet compliance requirements.

- **Logistics**: Outsourcing to third-party logistics providers is currently limited compared to developed countries. The level of transport outsourcing needs to increase over the next five years in order to improve efficiency. Congestion and poor road speeds are a significant factor in the inefficiency of China’s domestic transport and logistics industry, with logistics costs accounting for around 18 percent of GDP (compared to around 8 percent in the European Union and 9.5 percent in the US).

Issues to consider in the short-term:

- If you are a foreign entity, you must consider whether you have the right partners to succeed in a large market where regulation will also continue to drive the market.

- The impact of planned environmental taxes on emissions on existing or potential future operations.

- Logistics requirements in light of rising domestic consumption.

- The selection of external advisers with relevant experience is critical. Advisors that bring specific experience and superior capabilities can effectively negotiate language and cultural issues, working styles and regulatory approvals. Working closely with an advisory team will improve efficiency and achieve the best results.
Recent survey data\(^8\) indicates that, similar to companies in advanced economies, Chinese companies prefer to invest in well-developed countries with a large market size and a favourable institutional environment. From Australia’s perspective, there are numerous encouraging signals from the survey findings. They include the fact that Chinese companies value highly developed economies and well-functioning institutional environments, skilled labour resources and natural resources, advanced technology and research and development – attributes that Australia offers in abundance. Chinese construction companies seem particularly eager to seek opportunities to participate or invest in overseas ventures. There is clearly scope for enhanced cooperation between Australia and China.
Australia’s infrastructure prospects

- Australia offers a particularly attractive and sophisticated environment for Chinese and other overseas investors looking to gain from the long-term potential of its infrastructure sector. China’s ongoing demand for Australia’s resource commodities will drive increasing demand for infrastructure within Australia. Australia is renowned worldwide for setting high standards for public private partnership (PPP) models and pipeline strength in terms of its clear commitment and record of effective execution. Significant infrastructure and construction-focused expertise exists, with a number of well-recognised, highly successful companies operating from the country – these include Leighton Holdings and WorleyParsons, both of which demonstrated a strong resilience to the global economic downturn of 2008-2009.

- China has long seen Australia as an attractive destination for direct investment, especially in the mining industry. Granted, less developed countries have also become attractive targets for Chinese investment and may have lower entry barriers compared to Australia. But Australia offers significant advantages on the basis of its greater political stability and stronger legal protections, once the investment is approved. Political stability points to a certain degree of policy continuity, which then provides stability for the operating environment of an asset.

- The level of public sector support for infrastructure in Australia is a key long-term driver of growth in the sector. Private sector investment is also expected to remain strong. Major infrastructure plans, both local and federal, and targeting both the energy and transport sectors, should ensure continued investment in infrastructure, according to Business Monitor International’s (BMI) report on Australian infrastructure. Growth in infrastructure is estimated to be 8 percent on average between 2012 and 2014, BMI’s forecasts show.

- The transport infrastructure industry’s value is anticipated to grow considerably, averaging 2.6 percent per year between 2010 and 2014. Two key factors are fuelling this scenario – China’s demand for resource exports and demand for passenger transport services. Roads and bridges infrastructure and railways infrastructure are likely to be the key driver behind an increase in the transport infrastructure industry’s value.

- In order to meet the A$100 billion in investments needed in electricity generating and transmission infrastructure over the next decade, the energy and utilities infrastructure industry’s value is projected to grow by 9 percent year-on-year on average between 2010 and 2014, BMI’s report shows. Given the tremendous opportunities identified for this area of infrastructure, energy and utilities – which has historically represented the minority share of total infrastructure industry value – is expected to grow to 55.9 percent of infrastructure industry value by 2014. The sector’s value will comprise 54.3 percent from power plants and transmission grids, 40.3 percent from water infrastructure and 5.4 percent by oil and gas pipelines.
China’s interest in infrastructure projects: key insights

• China has a strong interest in being involved in Australian infrastructure construction. In line with China’s demand for energy and natural resources, Chinese companies are most concerned about infrastructure for coal and iron ore. This is obvious from the concentration of Chinese investment in Western Australia. Infrastructure not only includes transport from coal and iron ore mines to local transport hubs, but also rail and road links from hubs to ports and port facilities. These affect the efficiency and effectiveness of exports to China.

• Demand for key resources related infrastructure includes building materials, transport equipment (vehicles, ships), electricity and communication systems as well as communication and control systems for high load factor transport, strong power systems and complex transportation networks.

• Chinese construction corporations are interested in participating in overseas projects. China Railway Construction Corporation pursues projects in railways, highways, rail transportation and building construction, mainly in Africa and Central Asia. Completed projects include Tanzania-Zambia Railway, Hong Kong West Rail, the Nigerian Railway repair works, Macau Legislative Council Building and the East Wing of the Venetian Macau Casino.

• China is beginning to place more emphasis on Chinese private corporate investment in Australia, in a move away from the exclusive involvement of large state-owned corporations. With this comes an increased emphasis on market mechanisms and long-term stability. Chinese loans and equity capital are the most suitable methods to enter the Australian market because there are relatively few barriers. But in order to reduce potential risks from an unfamiliar system and environment, equity capital may be more favoured.

• There is Chinese interest in infrastructure finance. There are signs of an increasing preparedness to work with Australian partners, including in syndicated loans, and an interest in the funding and joint development of resources infrastructure. China is prepared to consider long-term and close institutional cooperation with Australia, even at multilateral level.

The opportunities for Australia-China partnerships in infrastructure

• China’s preference for entering the Australian market is to have Chinese companies funding Australian infrastructure companies or Australia-based joint ventures between Chinese resources companies and Australian partners. Other options worth considering are support for Chinese resources companies to list on the Australian Stock Exchange, lower entry barriers and the elimination of political barriers.

• There are possibilities for cooperation in airport construction. China’s airport construction industry has rapidly developed over the last decade – particularly in the past five years. Chinese construction companies have raised their standards. If Australia opened airport construction to public bidding and invited Chinese construction companies to participate, there would be strong prospects for cooperation.

• China’s financial resources and Australia’s mineral resources combined could create the world’s most important mining capital market. This would be conducive not only to Sino-Australian cooperation in resources, but also to the internationalisation of the Renminbi. Australia has a mature mining capital market while China’s mining capital market is just taking off. Fully developed trade relations inevitably lead to investment relations.

• Refinancing needs in the next 12 to 14 months for Australian infrastructure assets may offer the potential for Chinese capital to play a larger than usual role in a sector that has increasingly stirred its interest. For China, involvement in aspects of projects beyond just financing – such as the supply of equipment and technological innovations, and customer off-take – would enhance the attractiveness of Australian infrastructure assets. China’s large state backed banks are the likeliest sources of financial support for Australian infrastructure projects. Chinese banks are interested in syndicated loans for funding infrastructure.
Challenges

• The most important reason why China’s investment in Australian infrastructure is still relatively low is that the investment philosophy of Chinese industrial groups has not changed. They still tend to buy resources rather than participate in joint development. Their interest in investing in resources infrastructure will grow once they recognise the long-term return on investment in resources and the potential that the development of resources infrastructure offers.

• In order to help Chinese enterprises understand opportunities in Australia’s infrastructure sector, Australia could lower its policy barriers and obstacles, provide better information for Chinese enterprises, establish contacts to help them understand the opportunities and to subsequently move on to negotiating their participation in concrete projects.

• There is a degree of Chinese scepticism towards Australia’s institutional stability as far as investment regulations and general political support for Chinese investment in Australia is concerned. In recent years, China and Australia committed to signing a free trade agreement. Such an agreement would provide confidence to Chinese companies investing and operating in Australia. They retain concerns that Australian politicians and public opinion have not been welcoming to Chinese investment flowing into Australia and hence, from a Chinese perspective, political risk is relatively high.

• Chinese enterprises have the preconceived idea that governments of other countries are as cautious as China’s central government with regards to investment in infrastructure. Foreign investment in infrastructure is politically sensitive in China as well. For example, in railway infrastructure construction only domestic state-owned enterprises and private enterprises can participate.

Risks to Australian infrastructure investment prospects

• The possibility of a slowdown in resource commodities exports due to an anticipated cooling in Chinese economic growth over the next few years is the key risk to infrastructure industry prospects. Nevertheless, a number of forecasters believe there are considerable prospects for China’s economy to deliver upside growth surprises – despite its government’s aims to slow the pace of expansion to a more sustainable, long-term rate.

• Chinese investment abroad may be limited by the allure of opportunities in the domestic market, especially if economic growth remains consistently strong.

• Exchange rate prospects: many Chinese believe that the Renminbi will strengthen against other major currencies, which would diminish returns on non-Chinese investments.
Taking action – steps to consider:

There are a number of pragmatic approaches that companies and government could take in order to advance China’s interest in Australia’s infrastructure industry:

• Australia’s resource companies could negotiate the funding of mining infrastructure in conjunction with customer off take agreements.

• Australia should seek to involve Chinese parties which have developed relatively advanced technology and possess other advantages such as low-cost inputs.

• Companies should consider approaching Chinese debt/equity investors for funding infrastructure projects generally.

• The Australian Government should generally support foreign investment by creating more transparent, longer-term, deal flow/pipelines and manage issues which may create a negative sovereign risk perception, for example cancelled projects and a poorly understood FIRB assessment process.
Conclusion

The decade ahead presents a challenge for both Australia and China: each country must put in place the infrastructure improvements required to support long-term sustainable economic growth.

The need to address Australia’s aging and inadequate network of roads, ports, railways, airports, power grids, dams and other public works to maintain its global economic competitiveness has become critical. There is an especially urgent need to ensure that existing and new infrastructure for Australia’s resource industry – notably, mining operations and ports – is sufficient to meet persistently strong demand from China and other Asian economies for key resource exports in the coming years and decades. A failure to act soon means the inadequate state of Australia’s infrastructure could become a serious blockage for future growth.

To help overcome its funding constraints, Australia must reconsider its approach to the construction and financing of infrastructure. Its strong economic links with China create an excellent opportunity to draw on China’s investment capabilities and persistent interest in participating in infrastructure projects outside China, in order to secure additional financing. Infrastructure development in Australia’s resources industry should be a magnet for Chinese interest given China’s global drive to secure sources of energy and natural resources.

Conversely, despite the challenges, China’s infrastructure growth in coming years is an attractive opportunity for Australian businesses and investors. An increasing number of infrastructure projects will be open to foreign investment – the range of opportunities in these projects can be captured by offering a spectrum of services and expertise, besides lending and financing. To tap into these opportunities, Australian businesses and investors must select the right partners and advisers, the appropriate participation model and be prepared to dedicate significant resources to building up expertise in Chinese infrastructure markets.

There is a compelling opportunity to improve the quality of the engagement between Australia and China on infrastructure development in both countries.
China’s banking industry has gained impressive momentum in recent years: the big four commercial banks – Bank of China, China Construction Bank, Industrial & Commercial Bank of China and Agricultural Bank of China – now rank among the world’s ten largest banks by market capitalisation. Their size alone gives them the clout to influence the world’s largest markets. The four banks clocked average earnings growth of 29 percent last year\(^1\), driven by strong credit growth. It was the fourth consecutive year of record profits. Second tier and local banks are also growing rapidly and moving into the underbanked small and medium-sized enterprise (SME) and private enterprise sectors.

The banks’ escalating market values and robust, profitable growth have spurred greater global ambitions and provided them with the capital and currency to take action. In recent years, Chinese banks have expanded into markets in Asia, South Africa and the US.

Efforts to establish a greater presence in Australia have been focused on three key areas: corporate lending – primarily syndicated lending, trade finance and migrant banking. For example, Bank of China’s activity in Australia, where the bank holds A$9 billion in assets, is comprised of roughly 50 percent loans (half of which are syndicated loans and the other half, bilateral loans) with the remaining 50 percent in trade finance facilities\(^2\).

Importantly for Australia, China’s banks have a clear interest in channelling funding to areas that support China’s long-term strategic interests, such as the resources and agribusiness sectors, and potentially resources infrastructure. Under the nation’s ‘go global’ strategy, Chinese banks are focusing on the financing of resource sector acquisitions. However, they are also expanding support for mergers and acquisitions with small to medium-sized foreign enterprises that will support China’s drive to move up the value chain, in particular those with technology content\(^3\).

Australia’s extensive experience in syndicated lending, transaction banking, fixed-income, currency and commodity products, trade financing, treasury and capital markets operations and wealth management offers a critical pathway towards creating new revenue streams for both Australian and Chinese financial institutions through partnerships in both countries. Additionally, Australia is in a solid position to satisfy Chinese financial institutions’ long-running interest in developing management skills in corporate governance, risk management, internal controls, technology, the adoption of best practices, product development to help diversify income streams and expertise in the operation of treasury divisions. There are numerous complementary advantages for both Australian and Chinese banks, including providing each other with first-hand insights into their home market’s competitive and regulatory issues.

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1. Bloomberg, March 2011
2. Merrill Lynch Australia – Equity research
3. University of Sydney China Studies Centre
China’s 12th Five Year Plan: an ongoing agenda for financial sector reform

- Over the next five years, China’s government intends to move toward more market-based interest rates and capital account convertibility.

- The 12th Five Year Plan highlighted core areas including interest rate reform, improving the framework and transmission of monetary policy, strengthening regulation and supervision, developing alternatives to bank finance, reforming the exchange rate regime, and liberalising the capital account.

- Corporate finance, in particular SME finance in China, is part of structural reforms and further marketisation under the 12th Five Year Plan.
Achievements in financial sector reform: a decade of progress

Bank commercialisation: Banks’ internal risk management and accounting practices have been strengthened, with foreign strategic partners helping to implement international best practices. The main banks have been listed on the Shanghai and Hong Kong stock markets, helping to strengthen investor oversight and control and ensure compliance with international accounting standards. A large volume of bad loans – over 15 percent of GDP in 1999 – was carved out and placed in asset management companies while the banks were recapitalised with government support.

Regularisation of enterprise finance: The private enterprise and SME sector is currently not fully serviced by the state banking system and partly relies on informal finance (pawnbrokers, credit associations, money houses etc). Local and regional banks are increasingly filling this gap. These banks need to develop expertise and procedures for dealing with the new enterprise sector, including developing their own corporate governance.

Regulation and supervision: The regulatory infrastructure has been significantly improved with the establishment of individual regulators for insurance, banking and securities markets. Laws on new companies, trusts, securities and investment funds have also been enacted, providing a modern framework for capital market development.

Fixed income: Interest rates on a range of fixed income instruments have been allowed to be determined more by market forces. China’s corporate sector still remains heavily dependent on bank financing but a structural shift is underway. Corporate bonds are a small but rapidly growing part of the debt securities market. We expect this growth to continue, particularly if there is further tightening of the bank and regulatory environment.

Financial centres: Shanghai has become a critical part of the global financial infrastructure. Best practices and state of the art trading platforms have been adopted in key markets and equity market liquidity increased by making a larger proportion of shares tradable. Shanghai’s market capitalisation now stands at around US$3 trillion, the sixth largest equity platform in the world. Shenzhen has launched the Growth Enterprise Board, giving small and medium-size companies access to equity financing with streamlined listing procedures.

Capital market reforms have seen the continued roll out of Qualified Domestic Institutional Investor (QDII) and Qualified Foreign Institutional Investor (QFII) schemes with the latter playing an important part in terms of enhancing fundamental research and market sophistication. The proposed launch of the Shanghai International Board, development of offshore Renminbi business in Hong Kong and the emergence of financial products through, for example, stock index futures are further examples of reform.

Informal finance and private equity: Informal finance remains strong, but is starting to become more leveraged and professionalised. SMEs rely more on informal finance than on bank finance. Private equity firms are increasingly funding companies with the potential to IPO, in particular the Shenzhen Growth Enterprise Board.

4 Extracts from the International Monetary Fund’s Article IV report, People’s Republic of China, July 2011 and KPMG China analysis

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Opportunities for Australia

Several aspects of financial sector reform in China suggest significant long-term consequences and opportunities for Australian banks planning to form alliances with their Chinese counterparts. These include the evolution of the bond market and the Renminbi’s internationalisation.

Wealth management and insurance are areas of opportunity beyond wholesale banking for Australian financial institutions that can offer the product manufacturing capabilities and knowledge to complement the service offerings of Chinese partners.

How do Australian banks compare with long-established foreign players in the China market, such as HSBC and others? Australian banks’ major advantage is their expertise in resources-related financial management and operations, and internationally renowned professionalism. Disadvantages relate mainly to a relative lack of familiarity with the customer base in China, particularly the retail market, challenges securing local deposits and limited distribution capability. For new entrants a relative lack of familiarity with the regulatory system and the corresponding network of relationships can prove challenging⁵.

⁵ University of Sydney China Studies Centre
The bond market: The prioritising of bond market development will enable large SOEs to tap a broader range of investors and better match their lending horizons.

Bond market development will ease the reliance of the corporate sector and local governments on bank loans and ease the pressure on banks to take up the quasi-fiscal responsibilities of local governments. These developments point to a healthier Chinese banking system and an enhanced need to acquire new capabilities in fixed-income products and markets. The latter may prove particularly challenging for the country’s smaller to mid-sized banks.

Australian banks are well-positioned for strategic investments or alliances that would effectively combine strengths from both sides: Australia’s origination capabilities in debt capital markets and Chinese banks’ local knowledge, relationships and distribution capabilities.

Renminbi internationalisation: This promises to be an accelerating trend over the years ahead, mostly in the form of capital account liberalisation. The pace at which the capital account is likely to be opened up will still be relatively cautious given China’s preference for closely managing its currency. An active Renminbi product market-based in Hong Kong is highly likely as currency market development proceeds.

Over the past year, the offshore use of the Renminbi has grown tremendously. With the expansion of Renminbi trade settlement, monthly settlement volumes reached RMB 134 billion in April (or around 7 percent of total trade). At the same time, the volume of Renminbi deposits in Hong Kong stood at RMB 511 billion at end-April (representing 8 percent of the Hong Kong deposit base). Finally, the development of Renminbi financial products offshore has moved quickly with a range of instruments, spot markets, and derivatives now available. This has included the issuance of around RMB 155 billion in Renminbi bonds in Hong Kong.

Liberalisation of China’s capital account, deeper capital markets, the easing of restrictions on market-making institutions and a subsequent boost to Renminbi trading volumes would allow the development of a variety of currency hedging instruments. These would, in turn, facilitate better access to Chinese savings pools via a larger spectrum of deposit and wealth management products.

Australian banks must, in the face of increasing competition from other banks outside China, prepare for the inevitable rise in the Renminbi’s presence in trading and market transactions – or risk losing valuable opportunities.

Wealth management and insurance: There are moves to lower the dependence of China’s corporate and local government financing on banks in the years ahead. As a result, banks’ loan growth is expected to decline further this year and in coming years with mid-sized banks – the key beneficiaries of strong loan growth in past years – likely to be more affected than the large banks. Growth in bank credit rose 19.9 percent year-on-year in 2010, down from 2009’s 31 percent pace.

Benchmark deposit rates have also risen in response to public discontent with an extended period of negative real interest rates – as well as outsized banking sector profits. Still, a long period of negative real returns from bank deposits suggests the market is ripe for greater innovation and offerings in higher-yielding wealth management products. Insurance products also may offer the Chinese retail market a higher return than bank deposits – a vital factor for the growth of retirement savings for an aging population.

Chinese banks’ offerings in the areas of wealth and asset management remain relatively undeveloped given their focus in past years on deposit and lending businesses for retail and commercial customers. However, fee income from the sale of wealth management products has been rising strongly.

Wealth management and insurance are areas of opportunity beyond wholesale banking for Australian financial institutions that can offer the product-manufacturing capabilities and knowledge to complement the service offerings of Chinese joint venture partners.

Australian institutions can offer experience and expertise in critical areas such as fee income generation, credit risk assessment, the cross-selling of products and asset management.

Chinese banks have been very focused recently on developing bancassurance, with a number of recent investments in insurance businesses. Regulators have attempted to put the brakes on this channel – such as banning insurance sales people from bank branches, but this represents a significant area of focus for the banks going forward.

Australian wealth management specialists should target Chinese partners in municipalities with a high concentration of wealth. Chinese banks, trust companies, fund managers and securities companies may offer attractive sales channels, existing client bases and good customer service coverage of major domestic regions.

The market can be entered through a strategic investment in an existing wealth management provider, such as a bank, fund manager, trust company or securities company. Alternatively, a distribution agreement with a local partner, such as a bank, can be established to pursue a bancassurance strategy. Or organisations could pursue an organic strategy. However, there are only a limited number of remaining opportunities with high-quality partners.

The key to the success of Australian banks in China is to strengthen cooperation rather than to compete. China’s overseas acquisition of resources is only in its early stages and is most likely to accelerate over the next decade and beyond. This phase will be a golden opportunity for resources-related Australian banking.

In the immediate-term, there is an area that is not a strength of Chinese banks and represents significant growth potential: loans to Chinese SMEs. This is one major area of expansion in the Chinese domestic market that can be pursued with Chinese partners or alone. Additionally, as Chinese enterprises increasingly seek overseas merger and acquisition targets in the resources and other sectors, Australian banks could fund Chinese SMEs that are intent on overseas mergers and acquisitions, especially in Australia.

6 Extract from International Monetary Fund: Article IV report, People’s Republic of China, July 2011

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Opportunities may abound in China’s banking industry but in the effort to forge alliances with a Chinese bank, Australia’s banks must note that the risks need to be carefully managed.

- Benefits acquired through a partnership or joint venture may be countered by a sacrifice of control, and significant differences in operational processes, cultures and organisational structures. As a result, operational risks including potential fraud are relatively high. Australian banks that may acquire some management control as a result of a minority stake in a Chinese city-level bank may find that effecting change is tremendously challenging. Acquisition strategies in China, like all forms of cross-border merger and acquisition transactions, can be beset with strategic, transactional and integration challenges. Communication and change-management challenges also exist. Any sound strategy requires cooperation with local partners, including participation in their learning processes.

- Along with a significant Chinese Government presence, central bank and regulatory oversight of the banking sector is high – all of which may have an impact on management decisions. A lack of ability to drive changes may affect performance and the ability to develop differentiated product offerings. Political risks also exist and include future changes in China’s leadership. While abrupt radical changes in central policies are unlikely, changes in local leadership changes may impact local bank operations and partnerships.

- The key risks to Chinese banks’ credit quality remain concentrated in loans to local government financing vehicles, off-balance sheet lending, and, to a lesser extent, credit to the property sector. To counter these credit risks, the bank regulatory agency has indicated it is in the process of requiring that banks assess their credit portfolio in a downside scenario and ensure that lending to local government vehicles meets certain minimum collateral requirements. Banks had been asked to raise the capital requirements and provisioning for such loans. In addition, banks are now being required to bring much of their trust-related lending back on balance sheet by year-end.8 According to recently published data, local governments owe RMB 8.5 trillion to Chinese banks. This represents a potential risk to the banking system of about 5 percent of GDP from non-performing local government loans.9 However, local government debt figures are chronically unreliable and do not include local government off balance sheet assets.

**Strategic approaches**

Australian banks seeking to enter China’s financial services industry or form alliances with Chinese partners can consider the following strategic options:

- Strategic investment with a capability transfer program. There is a regulatory cap of 25 percent foreign investment and 20 percent per individual institution, but in practice, foreign investors may be restricted to a much smaller stake due to commercial realities. There is unlikely to be much appetite amongst China’s big four banks but there may be opportunities with the joint stock commercial banks.

- Strategic investment with a capability transfer program in local banks or joint stock commercial banks with a focus on SME markets where foreign banks have found it easier to reach the 20 percent maximum sharehold for individual foreign investors.

- Organic growth through local branch set up and ultimately, local incorporation. This strategy can be complemented by selective acquisitions in micro financing (which has experienced significant growth), non-bank lending organisations or rural cooperatives (although these have potential non-performing loan issues). For example, a banking strategy that focused on the SME market – with a focus on market segment rather than market share – can still be very profitable. The choice of approach depends on the respective strategies of each Australian bank, their market and product alignment, their risk appetite and the amount of capital they intend to deploy. The strategic rationale and choice of partner or target essentially depends on cost and risk assessments, the potential delivery of value to shareholders and willingness to engage with local partners.

The number of potential Asian or Chinese partners may be diminishing as foreign investment and competition for stakes in Asia’s fast-developing wholesale banking industry rises. It may be difficult for newer Australian entrants to Asia to compete with the well-established brands of HSBC, Citigroup and Standard Chartered – and even ANZ Bank – that already have global or regional technology platforms and capabilities such as the provision of end-to-end multi-currency products to high net-worth and corporate clients.

Acquiring minority stakes in Chinese commercial city-level banks may set the stage for further expansion for Australian banks. However, the degree of management control is restricted – Chinese banks remain wary of ceding management control, but are keen to acquire capabilities and corporate governance know-how. Australian banks can offer important contributions in building skills that are relatively undeveloped in China, such as credit evaluation and spreadsheet analysis.

The Commonwealth Bank (CBA) and ANZ Bank currently have investments in two city commercial banks, which is the maximum allowed. Qilu Bank (CBAs investment) recently experienced a very large fraud, highlighting the risks associated with a minority stake and a limited ability to influence local management. The effective implementation of a capability transfer program is extremely challenging – and CBA actually has a track record of success in this area – often due to issues related to differences in approach, communications and cultural differences.
Delivering a successful capability transfer program in China

The ability to deliver a successful capability transfer program is often a key factor in the choice of an international partner. Accordingly, an important part of the transaction evaluation process is assessing areas where your organisation can truly add value and demonstrating that value to the domestic partner.

Once a deal has been agreed, implementing a successful capability transfer program which meets the needs of both parties can be a real challenge, due to the institutional differences that exist between Chinese and foreign companies. There are numerous recent examples where the results have been disappointing. There are two fundamental questions that need to be addressed up front to help determine how you will approach this type of exercise:

- Are you comfortable for the local partner to have control of the process?
- How willing are you to share your intellectual property with the domestic partner?

To be successful, it is very important to build a long-term partnership with the local management team. The experience and composition of the team appointed to deliver the program is of critical importance. Cases where the overseas party has parachuted in a large team of technical experts from their domestic business have typically proven to be unsuccessful. Similarly the content of the program must be tailored to local conditions. This can only be done through working closely and on a long-term basis with local management. Similarly it is critical to work closely with an adviser who can assist with designing and planning an effective program, deal with the practical issues that arise in relation to establishing an appropriate structure, manage resource constraints, overcome language barriers and leverage technical expertise to help implement specific initiatives.

Taking action – steps to consider

A vital guiding principle for Australian banks keen to forge partnerships with China’s banking industry is that a clear, long-term strategy is necessary. A China strategy requires, at minimum, a long-term investment horizon in order to succeed. Still, Australian banks must approach opportunities with a firm plan for short-term achievements – in case an alliance partner proves less accommodating than expected. These expectations for short-term achievements must be clearly communicated in advance.

In the short-to-medium-term, steps that may be considered by Australian banks include:

- Independent assessments of core areas of competitive advantage that are transferrable to Chinese markets such as particular expertise in products or organisation.
- Developing constructive relationships with regulators as well as with local Chinese Governments.
- Ensuring complete strategic alignment among all stakeholders – board members, senior management, shareholders, regulators and local governments.
- Ensuring a sound investment strategy for the long-term.

Shareholders and investors may balk at the prospect of rapid overseas expansion by Australian banks – perceiving this as a diversification strategy carrying too many risks. However, over the longer-term, with opportunities for significant domestic growth dwindling, ongoing problems in the advanced economies and strong, stable capital positions, it is critical that Australia banks capitalise on opportunities in China, allocate larger portions of their balance sheets abroad to secure their growth prospects and leverage Australia’s trade advantages.
Opportunities and challenges for China within Australia

Outward-bound Chinese banks pose more of an opportunity for growth than a threat for major Australian banks. A likely slower pace of domestic credit growth in coming years poses a significant challenge to Australian banks’ domestic expansion prospects and the reality is that fast-growing Asia may offer the greatest promise for growth.

Chinese banks in Australia: key insights

- Expanding Chinese enterprise activity in Australia indicates that Chinese banks will expand their business activities in Australia. The two trends are directly linked.
- Demand for Chinese retail banking products and services will grow as Chinese immigration to Australia rises. This is a market for Australian banks.
- Following the increasing number of Chinese resources and energy enterprises operating in Australia, Chinese banks in Australia are experiencing solid growth in activity and opportunities. In view of the opportunities, Chinese banks not yet operating in Australia are also considering entering the market.

From November 2007 to September 2010, FIRB approved over 190 Chinese applications for direct investment, amounting to a total of A$60 billion Australian dollars of funds and far exceeding the A$40.5 billion investment approved during the preceding decade.

Within a few years, Australia became one of the countries with the highest concentration of Chinese Overseas Direct Investment. With the large number of Chinese energy and resources enterprises entering Australia, the huge demand for financial services presents Chinese banks in Australia with opportunities and results.

- China’s 12th Five Year Plan proposes to continue deepening the reform of state controlled large financial institutions, improving the system of modern financial enterprises, strengthening internal governance and risk management, enhancing capability for innovation and development and international competitiveness.

- Another important part of China’s banking sector reform is to ‘go global’. In recent years Chinese banks have collectively headed abroad, increasingly with Australia as an important target country. Chinese banks use Australia as a training ground for investments in Australian resources enterprises and also, for helping Chinese banks acquire experience, skills and capabilities. For these reasons, Australia has become an important long-term strategic base for Chinese banks.

- With Chinese companies becoming increasingly active in Australia, the demand for Chinese banking services is likely to affect the Australian banking sector in three ways:
  - First, Australian banks will need to consider establishing specialised internal divisions for the China market and China business or setting up specialised banks for China business.
  - Second, Australia’s banking sector will need to be familiar with Chinese business regulations for the China market.
  - Third, there will be strong demand for people familiar with both national markets and the financial sectors of both countries.
China’s foray into Australian syndicated debt

The Australian syndicated lending market has emerged as a key opening for Chinese banks seeking to go global and diversify their businesses. Asian bank activity in domestic syndicated lending has been particularly vigorous recently and China’s presence has been notable. Falls in activity from North American and European banks, due to low appetites, and a decline in Australian major banks’ participation in syndicated transactions have opened the way for Chinese banks.

Prospects for further Chinese bank activity are strong given the ongoing problems among Europe’s banks and most importantly, China’s strategic interest in the Australian resources sector.

Among other things, Australia’s domestic syndicated market offers the attractions of relatively low barriers of entry and the smallest capital expenditure requirement for new entrants. Given these points and based on the level of recent activity, Chinese banks are expected to continue using Australia’s syndicated lending market as an efficient and lower-risk mechanism to target corporate lending. This will be achieved by leveraging a major domestic bank’s local market knowledge, relationships, credit systems and processes. The corporates typically targeted are blue-chip Australian organisations and large, multi-national corporations such as Origin Energy, Telstra and Woodside Petroleum.

The risk over time is that bilateral lending is likely to grow i.e. single-lender loans from Chinese banks directly to an Australian corporate and increased activity is likely to exert pressure on spreads in the syndicated lending market.

Challenges

In terms of inbound opportunities for Australia, perceptions that our foreign investment regime discriminates against China, if allowed to persist, may cast a shadow over China’s attempts to build a greater banking presence in Australia. This will require appropriate responses through long-term confidence building.

The way forward

Australia’s banks should capitalise on the global expansion of Chinese banks through partnerships that would unlock opportunities within China itself, assist Chinese companies that are going global and facilitate an exchange of each other’s distinct domestic market knowledge and expertise.

Explicitly, Australia should capture opportunities to provide Chinese banks with the presence and capabilities to serve an increasingly globalised client base, through true partnerships that help meet China’s appetite for acquiring new skills, enhancing its financial services offerings within and outside its borders, and leveraging its local and emerging market coverage.

Australia’s banking system stability and high credit ratings are a highly attractive platform from which to press the case for greater alliances.
ENERGY AND NATURAL RESOURCES

China’s latest economic development plans ensure the country will retain its colossal appetite for natural resources and energy for the next five years and beyond. As demand for resources escalates in response to ambitious development and urbanisation targets, issues such as environmental degradation and pollution have prompted China to move decisively towards the development of clean energy technologies and the use of renewable energy sources.

Energy and natural resources – particularly iron ore, coal, gas and copper – are, and have been, the cornerstone of the Australia-China economic relationship. The opportunities for Sino-Australian cooperation in trading, business and investment in the resources and energy sector are set to intensify, given prospects for increased consumption demand from China for Australia’s largest resource exports.

New opportunities are also emerging for Australia in the clean energy sector as China embarks on a long-term policy commitment to increase the use of clean energy, including nuclear, and reduce pollution.
An impression of a Chinese future city, Tianjin Eco City
The way ahead for Australia

Australia should seize its relationship advantage with China and leverage its intellectual capital, innovative capacity and technological know-how to assist China with its energy and natural resources policies.

Few, if any players can afford to sit still in a world where China’s economic development ambitions are moving ahead at breakneck speed.

A more comprehensive partnership

Chinese demand for Australia’s natural resources and energy exports will continue to grow strongly, providing opportunities to develop our nation’s mining, energy and associated infrastructure. Along with the prospect of further growth in the production and export of iron ore, coal, nickel, copper and LNG, there are also opportunities to build new industries such as the production of magnetite, and new resource-producing regions – for example, in the mid-west region of Western Australia and South Australia.

Any international energy deals that China secures may lead to opportunities for Australia to provide assistance to improve exploration and production, the development of unconventional resources and LNG and refinery expansions.

China’s focus on improving living conditions for its people creates strong opportunities for Australian companies in clean energy including clean coal technology.

Australia needs to focus on developing the intellectual, financial, and political infrastructure that aligns with China’s clean energy ambitions in order to be well positioned for when investment opportunities come knocking.

In terms of the potential for greater Chinese participation in Australia-based projects, there will inevitably be some concerns from Australian companies competing for a role. Opportunities to engage Chinese manufacturers in Australian infrastructure development, for example, have led to a push by Australian companies to provide local content for major projects and some tension over the issue. Domestic sensitivities about the merits or otherwise of partnering with China may potentially be heightened as Chinese involvement in Australian projects grows.

Strong potential for increased Chinese direct investment

Chinese direct investment into Australia remains very low. The opportunity to boost investment cooperation is high and should be encouraged to bolster our trade relationship.

Total Chinese investment at the end of 2009 was just A$16.6 billion, or slightly less than 1 percent of the total stock of foreign investment, according to the Australian Bureau of Statistics. This compares to a stock of A$514.7 billion – or 27 percent of the total of investment from the US, Australia’s largest foreign investor. Still, recent flows indicate China’s investment is slowly on the rise. Chinese investment in 2009 increased to A$78 billion, or about 5 percent of total inflows that year.

Encouragingly, there is more to come. Investment approvals from FIRB show approvals of Chinese investment rising from A$2.6 billion in 2006-07 (less than 2 percent of approvals by value) to A$26.6 billion in 2008-09 (16 percent), putting China in second place, still well behind the US in terms of the value of total approvals. In 2009/10, China’s figure eased slightly to A$16.3 billion (about 12 percent of approvals by value), but this was still sufficient to make China the third largest investor by country of approval.

China’s Big Five energy companies (Guodian, Huadian, Huaneng, Datang, and China Power) are actively looking at overseas investments, especially in coal mining and renewables. For coal, Australia is a focus while in renewables, options are available in the US, Europe, and Australia. Uranium supplies may be sought from Canada, Africa and Australia. Overseas grid line acquisitions – for example China’s State Grid recent grid line acquisitions in Brazil – are also in focus. The acquisition of equity stakes in new rare earth producers in Australia is also of increasing interest to China as Australia possesses 6 percent of global rare earth reserves.

However, gaps in Australia’s understanding of China’s transactional culture and its approach to due diligence and negotiation still persist. At a minimum, it is critical for those involved in merger and acquisition transactions or joint ventures with China to be aware of the extent of differences in approach to negotiation, execution and integration. Differences will also exist with regards to transparency, openness and the use of external advisers. Such factors should be built into any risk assessments.

1 Lowy Institute: Mark Thrilwell – International Economy Comments, April 2011
2 KPMG China analysis of Five Year Plan – March 2011
3 KPMG Australia data
Delivering resources and energy security

Key issues and opportunities to consider:

- China’s investment in Australia’s energy and natural resources sector will grow, but in a reflection of its transformation to a more innovation-oriented economy driven by greater domestic consumption its choice of targets will become more sophisticated. It is likely that Chinese investors will increasingly secure projects earlier in their life cycle where the Chinese have greater access and the ability to secure a greater level of influence or control.

- There is evidence that Chinese companies are increasingly seeking investment opportunities in Australia’s supply chain at several levels. For example, acquiring energy assets that can supply mining operations in order to secure future energy supplies.

- Australian companies in the energy and natural resources sector have an opportunity to participate in China’s move up the value chain and plans for greater self-sufficiency. For example, entering into joint ventures in steel mills and copper/zinc/lead smelters in China. This would ensure longer-term involvement in China’s economic evolution, beyond the traditional export of bulk commodities.

- Harmonising the relationship between the downstream user and upstream supplier of resources is critical. The relationship has experienced many ups and downs over the years. In the long-term, a true partnership relationship will benefit both sides and potentially distinguish Australia from competitor countries. This could be achieved, for example, by increasing the transparency of government investment protocols and reducing barriers to Chinese investment. Currently Chinese state-owned enterprise bidders are at a competitive disadvantage to other countries that do not need to make bids conditional on government approvals.

- The Australian Government could discuss with the Chinese Government the prospect of creating a China-Australia platform for a more seamless outflow of Chinese capital to develop capital-starved Australian or Australian-sponsored resources projects. This approach could achieve a win-win outcome for Australia and China. This may involve, for example, relaxing regulatory restrictions for China capital outflows into resources projects or the creation of a China-Australia Fund.

Investment and the role of integrated reporting

A shared understanding of the challenges of global resources and energy security will be a prerequisite to greater collaboration and partnerships between Australia and China. Constructive dialogue needs to occur on multiple energy issues that will open the way to more comprehensive energy partnerships between the two countries that help solve energy policy issues. Delivering resources and energy security, energy affordability and energy acceptability carries a huge investment requirement in both labour and technology. Will the finance be available?

Integrated reporting is a key element that may enable both Australia and China to deliver on their energy investment requirements. It is now well recognised that financial reporting under International Financial Reporting Standards is not a strong tool for comparing various energy investment propositions in the search to identify the propositions most deserving of capital at a reasonable cost. Through the integrated reporting movement, now formalised through the Integrated Reporting Committee (IIRC), things are moving quickly to develop and implement an integrated reporting framework. This is a critical development for the allocation of capital to the most deserving energy investment propositions.

Australia has a leading position in the IIRC through the Australian Business Reporting Leaders Forum (BRLF). KPMG worked with the Society for Knowledge Economics to establish the BRLF. The BRLF is aiming to bring key Australian energy companies to the IIRC pilot process in 2011. The IIRC believes that China and other rapidly growing nations are critically important to the success of integrated reporting given their importance to the global economy.

Australia and China could develop a relationship in pursuing integrated reporting for energy companies as a key strategy in delivering the energy financing requirement.
“By 2050, China’s urban dwellers may account for 20 percent of global energy use”

Resources: voracious consumption

Chinese demand for iron ore and other metals commodities has been buoyed by escalating steel production, continuing demand from government infrastructure projects and continued growth in domestic private consumption. Factors such as the country’s poor natural endowment in metal and mineral resources, a lack of pillar mineral industries, mine closures and other challenges have compounded the multi-year trend of rapid consumption of resources, fulfilled mainly by imports. The gap between supply and demand is set to continue to expand.

In 2009-10, more than 85 percent of Australian merchandise exports to China comprised primary products, with iron ore and concentrates leading the way and accounting for around A$25 billion, or about 54 percent of the A$46.4 billion of total merchandise exports to China4.

In 2003, Australia was shipping around half a million tonnes of iron ore each day. Now daily shipments exceed 1 million tonnes. If projected new capacity comes on line, the figure is forecast to climb to perhaps two million tonnes a day within the next five years7.

By 2020, China’s iron ore consumption will be 1.3 billion tons with accumulated demand exceeding 16 billion tons; refined copper consumption will be 730 to 760 million tons with accumulated demand approaching 1 million tons; aluminium consumption will reach 13 to 14 million tons with accumulated demand over 160 million tons8.

If domestic exploration efforts fail to improve by 2020 and the pattern of economic development remains unchanged, 19 out of 45 major mineral resources in China will be in short supply. Of those, 11 resources supply pillar mining industries. China’s external dependence on iron ore will likely rise to 40 percent and external dependence on copper and potassium will remain at 70 percent9.

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Chinese-powered demand for Australian commodities has contributed to large increases in the prices paid for these resources, with global prices for iron ore rising at an average annual rate of 23 percent over the 2005-2010 period in Australian Dollar terms6.

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Energy: robust demand growth ahead

Earlier periods of China’s economic expansion were supported by energy supplies from its own domestic production. In recent years, however, a growing portion of its energy needs have had to be satisfied by imports. As urban expansion persists and new cities are constructed and connected, the demand for energy and water resources will continue to grow: city dwellers consume more resources than those in rural areas (approximately 3.5 times as much energy and 2.5 times as much water), placing significant stress on already scarce resources.

By 2050, China’s urban dwellers may account for around 20 percent of global energy consumption. While the country has substantial coal reserves, it is hampered by insufficient mining and transport infrastructure and the negative environmental consequences flowing from the excessive use of coal under existing technologies.

Net imports of coal are widely expected to increase during the period of the current Five Year Plan, to 2015. Its oil imports are forecast to jump from 4.3 mb/d in 2009 to 12.8 mb/d in 2035, with the share of imports in demand rising from 53 percent to 84 percent, according to the International Energy Agency (IEA).

Natural gas imports are also projected to increase substantially to reach a share of 53 percent of demand in 2035, requiring a major expansion of pipeline and LNG regasification infrastructure, the IEA noted in its 2010 outlook on world energy. Exports of coal to China accounted for A$5 billion or approximately 11 percent of total merchandise exports in 2009-10. China was one of the top three export markets for Australian coking coal. Over the 2005-2010 period prices for coal rose 8 percent (A$ terms).

Massive growth in Australian LNG exports is guaranteed from projects currently under construction in which China has an offtake and/or investment participation. By the end of 2015, the proportion of coal consumption in China’s primary energy mix may drop to 63 percent, down from 70 percent in 2009. Notably, the proportion of natural gas consumption will increase to 8.3 percent from the current 3.9 percent, according to research from the University of Sydney’s China Studies Centre.

By 2020, China’s coal consumption will exceed 3.5 billion tons and accumulated demand from 2008 to 2020 will exceed 43 billion tons. Oil consumption will be 500 million tons with accumulated demand exceeding six billion tons. China’s external dependence on oil will rise to 60 percent by 2020 if current demand-supply and economic development patterns remain unchanged.

By 2015, China’s energy consumption per capita will reach 3.15 tons of standard coal; electricity consumption per capita will be 4,000 kWh – both of which will be above the world average. Dependency on external energy will exceed 15 percent by that year.

By 2015, China’s total production for primary energy will reach 3.63 billion tons of standard coal. Total consumption of primary energy will amount to 4.31 billion tons of standard coal. Total national power generating capacity will reach 5.5 trillion kwh.

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10 Elizabeth C. Economy, Foreign Affairs magazine, November/December 2010
12 With data from China’s Development and Planning Department of the National Energy Administration
13 University of Sydney China Studies Centre, with Chinese official data
14 University of Sydney China Studies Centre, with Chinese official data
Australia’s edge: a complementary economic relationship

While less developed countries than Australia have been targets for Chinese resource investment – some may have lower entry hurdles than Australia. Australia offers highly attractive factors such as stronger legal protection and political stability, on top of having a long-established position as a key supplier of commodities that are vital to China.

Australia does not compete economically with China, nor does it pose a political threat – rather, it has long been constructive about China’s economic rise and both countries have benefited from a stable and complementary economic relationship. The Sino-Australian trade relationship is firmly anchored in comparative advantage – Australia exports resources and imports Chinese manufactured products.

Opportunities abound for greater constructive engagement in the resources and energy sector.

China continues to see Australia’s mining industry as an attractive destination for direct investment. In addition, there are numerous opportunities for both countries to collaborate in projects outside their borders. In Africa-based projects, for example, Australia may provide exploration dollars and mining experience and an entrepreneurial ability to uncover large projects, while China brings to the table the political, financial and construction heft necessary to ensure multi-billion dollar mine and infrastructure projects progress to fruition.

Union power within Australia makes it difficult for Chinese construction companies to take advantage of cheaper human resources. Such restrictions are less burdensome in many other countries.
New opportunities – China’s clean energy campaign

To keep pace with the power needs of burgeoning urban populations, China established a vast number of coal burning power plants in past years. The resultant high emissions of carbon dioxide, escalating costs of deteriorating air and water quality and fears of overdependence on oil and coal imports has accelerated the nation’s move towards clean energy initiatives.

China is, at present, the world’s largest user and manufacturer of wind turbines and solar panels, and moving rapidly towards taking the lead in the use of clean coal and nuclear technology.

China is promoting seven strategic industries that it wants to account for 8 percent of GDP by 2015. They are energy saving and environmental protection; next generation information technology; biotechnology; new energy; new energy vehicles; high-end equipment manufacturing; and new materials.

The latest Five Year Plan has CO2 emissions per unit of GDP declining by a cumulative 17 percent in the next five years; while the 2015 non-fossil energy supply target is 15 percent of total energy consumption, compared with only 7.8 percent in 2009.

China’s business ambition for the decades ahead is to build a value chain covering the production, transformation, distribution, and application of clean and new energy based primarily on solar, biomass, nuclear, wind, and hydropower.

Official targets for alternative energies for 2020 include 80 million kilowatts of nuclear power, 380 million kilowatts of hydro power and a total of 170 million kilowatts of wind/solar – almost double the previous targets approved in 2007.

China is planning to build ten new nuclear power plants over the next five years to complement the 13 already in operation.

By 2015, hydropower utilisation will be 2.5 million kilowatts and nuclear power will reach 39 million kilowatts, research by the University of Sydney China Studies Centre shows. The proportion of hydropower and nuclear power in primary energy consumption will rise by 1.5 percentage points. Utilisation of wind power, solar and other renewable energy will amount to 110 million tons of standard coal. Their share in primary energy consumption will rise by 1.8 percentage points.

The championing of clean energy should attract a total investment of about RMB 5 trillion in the alternative energy sector, according to China’s National Development and Reform Commission (NDRC).

The need for new technologies, equipment and clean energy expertise

The pursuit of clean energy usage will increase demand for technologies – notably the development of clean burning technologies for coal, equipment and expertise in the climate change management and sustainability areas, as well as consulting services.

Power saving technologies such as electric converters, energy performance contracting and smart utility meters will see a rise in demand. Industrial upgrades will be required for the seven strategic industries, which should lead to greater demand for technology imports and expertise, and equipment. During the process of upgrading industrial or technical competency, the equipment sector could grow substantially.

There are likely to be increased procurement opportunities from Chinese companies, especially in areas where home-grown technologies are still being developed (i.e. nuclear and smart grid). In 2009, the biggest grid company, State Grid Corporation, announced a plan to invest around RMB 4 trillion in a smart grid technology upgrade between 2011 and 2020, under the Strengthened Smart Grid Plan. In 2010, total investment in the grid was estimated to be at about RMB 220 billion. This plan is expected to create huge business opportunities for the companies involved.

Nuclear technology in China is immature, so cooperation with foreign companies beyond simple equipment supply could be important. Australia, for example, could offer expertise in the shaping and maintenance of standards on uranium handling, use and accountability. Australia has 25 percent of the world’s supply of exploitable uranium or around 40 percent of global uranium production.

Australia is well positioned to participate in the evolution of China’s nuclear power industry and importantly, contribute to the reduction of emissions globally.

15 University of Sydney China Studies Centre, with China’s Development and Planning Department of the National Energy Administration
KPMG’s China Practice

KPMG’s Global China Practice is a network of 34 countries providing high quality, consistent services to China inbound and outbound investors globally. The Global China Practice allows KPMG to maximise the opportunities emerging from China’s rise as an economic superpower, and provides a sustainable competitive advantage for KPMG around the world.

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University of Sydney China Studies Centre

The China Studies Centre was established by the University of Sydney in 2011 as a major initiative of the University’s 2011-2015 Strategic Plan. The China Studies Centre represents a commitment by the University to cross-disciplinary research and public education including cooperation with external partners. The Centre’s open research architecture facilitates interaction between Australian researchers working on China, Chinese academics and external partners with specific expertise.

The Centre’s China Business Development team works on projects concerned with new and changing markets emerging from China’s deepening marketisation and privatisation of public services and state monopolies. These projects anticipate new trends and create new knowledge for Australia China cooperation.

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