Why Can China Go Big Globally?
And Its Implications for Foreign Companies

Arthur Jiantao YAN
The Worldwide Energy Group

For
The International Association
for Energy Economics (IAEE)

January 11, 2007
Houston, Texas

What Do You Think of China?

http://movies.yahoo.com/mv/mf/frame?theme=minfo&lid=wmv-56-p.1394721-160120,wmv-100-p.1394722-160120,wmv-300-p.1394723-160120,wmv-700-p.1394724-160120,wmv-28-p.1394721-160120&id=1808631296&f=1808631296&mspid=1809234959&type=c&a=0,15

China! *How Bad This Word Sound!*

Source: Syriana (2005), Warner Bros. Pictures; movies.yahoo.com

The Outline of China’s Going Global

The Major Forces and Drivers Behind China's "Go Global" Campaign

Changes inside China and Chinese National Characteristics

↓

Influence and drive

Chinese objectives, strategies and actions In global activities

Issues/Weaknesses the Chinese face

Hurdles/Challenges to overcome

Competitive edges/Opportunities

↓

Progress (results, setbacks/success) and Concerns

↓

Implications for foreign companies

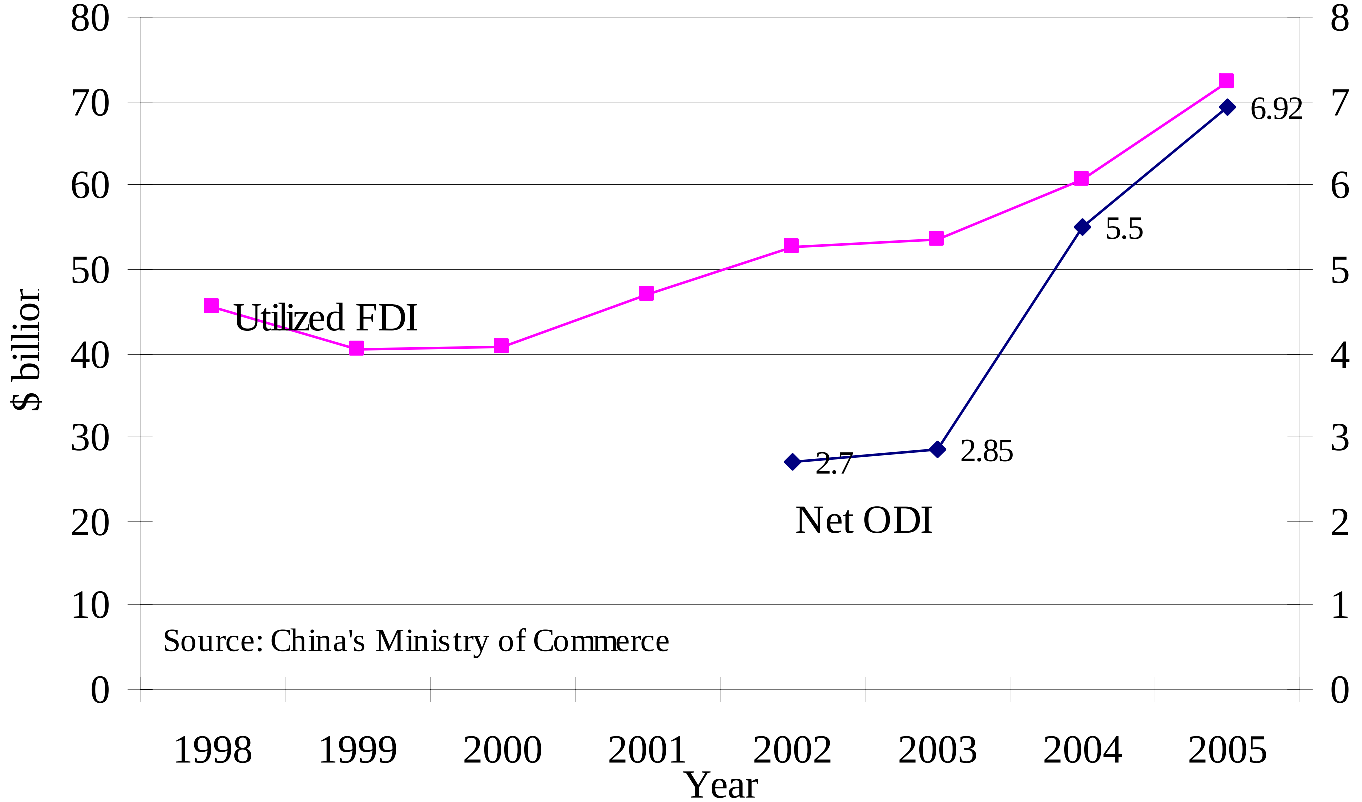
↓

Foreign current reactions to Chinese objectives, strategies, actions

↓

Recommendations: how to react, work, compete, leverage

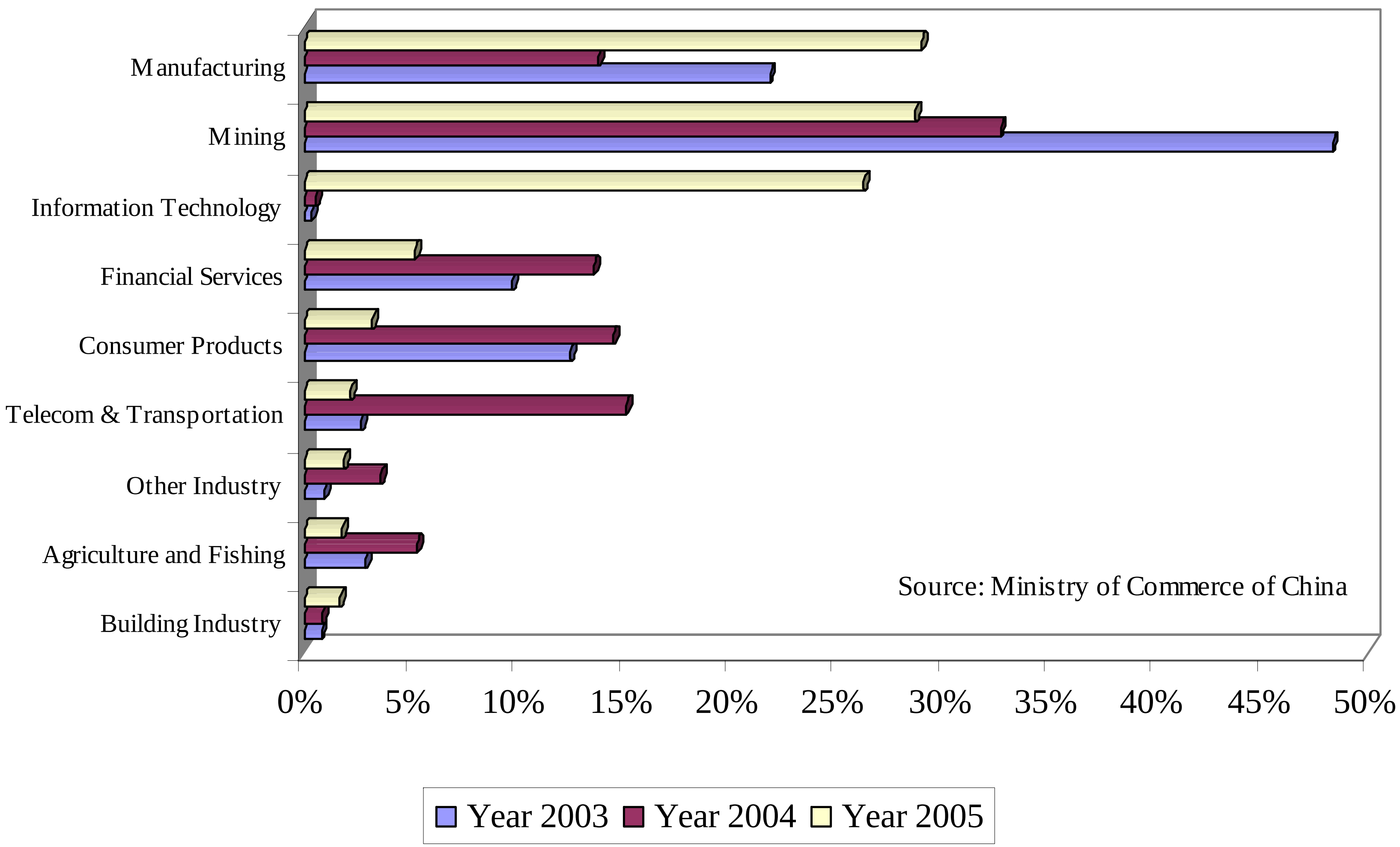
The Status of China's Overseas Investments



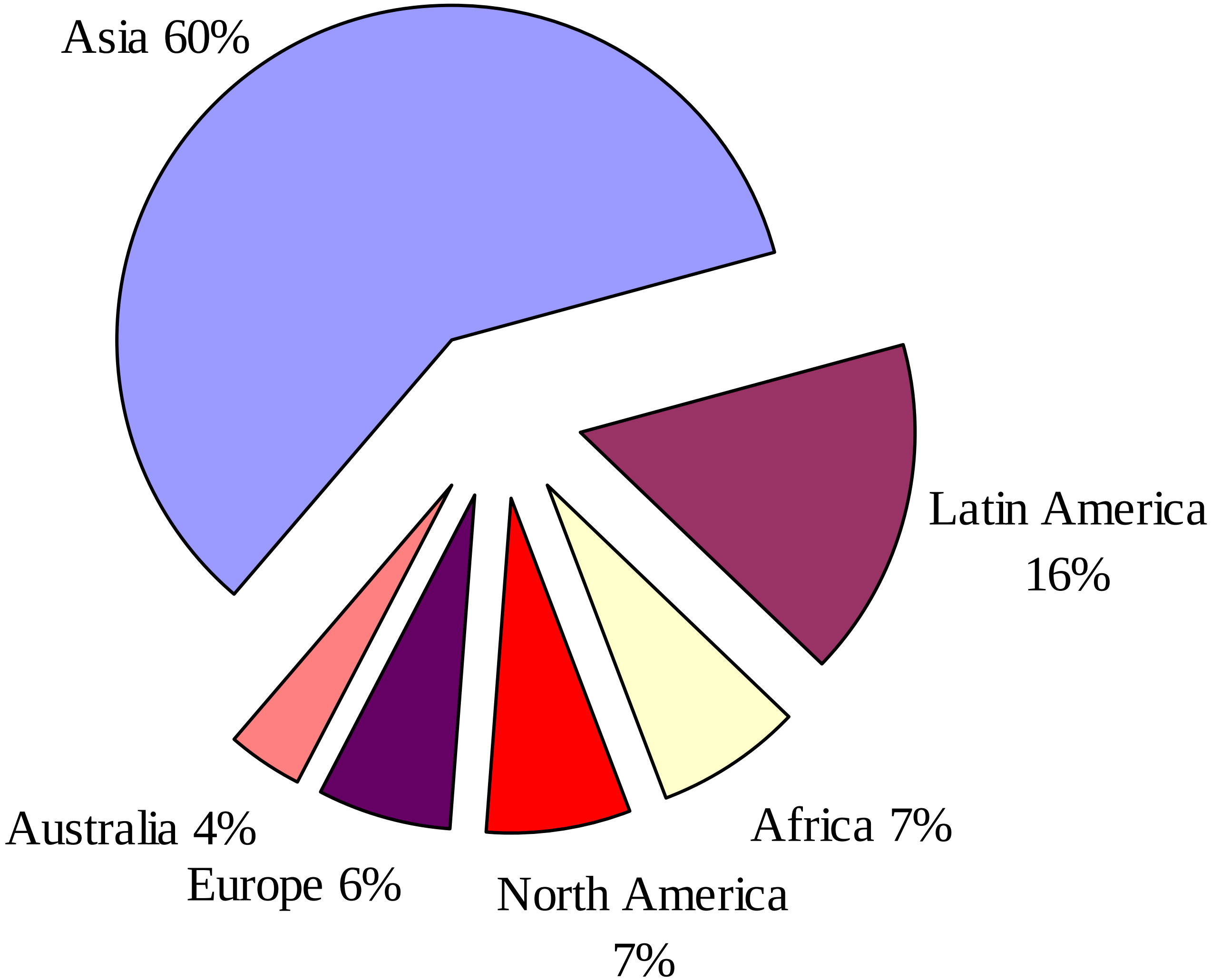
- **Total value of overseas M&A deals USD6.9 billion in 2005; 28.4% yoy growth**
- **To date, more than 10,000 Chinese companies have invested overseas**
- **China's overseas M&A to exceed USD60 billion over the next 5 years**
- **Over 90% in natural resources (50%), manufacturing, information and telecom**

The Chinese Outbound Investment (Industry Distribution)

(By percentage of the total ODI)



China's Outbound Investment (by Region: Percentage) in 2005



China's Oil Majors in Fortune Global 500

Industry	Company's Fortune Global 500 Rank in 2006	Revenue ($ millions)
Banking	Industrial & Commercial Bank of China (199)	29167.1
Banking	Bank Of China (255)	23860.1
Banking	China Construction Bank (277)	22770.6
Banking	Agricultural Bank of China (377)	17165.6
Construction	China State Construction (486)	14122.4
Electricity	State Grid (32)	86984.3
Electricity	China Southern Power Grid (266)	23105
Insurance	China Life Insurance (217)	27389.2
Metals	Baosteel Group (296)	21501.4
Oil & Gas	Sinopec (23)	98784.9
Oil & Gas	China National Petroleum (39)	83556.5
Oil & Gas	Sinochem (304)	21089
Retail	COFCO (463)	14653.8
Retail	Hutchison Whampoa (259)	23474.8
Telecom	China Mobile Communications (202)	28777.8
Telecom	China Telecommunications (279)	22735.8
Transportation	China Railway Engineering (441)	15293.7
Transportation	China First Automotive Works (470)	14510.8
Transportation	Shanghai Automotive (475)	14365.2
Transportation	China Railway Construction (485)	14138.9

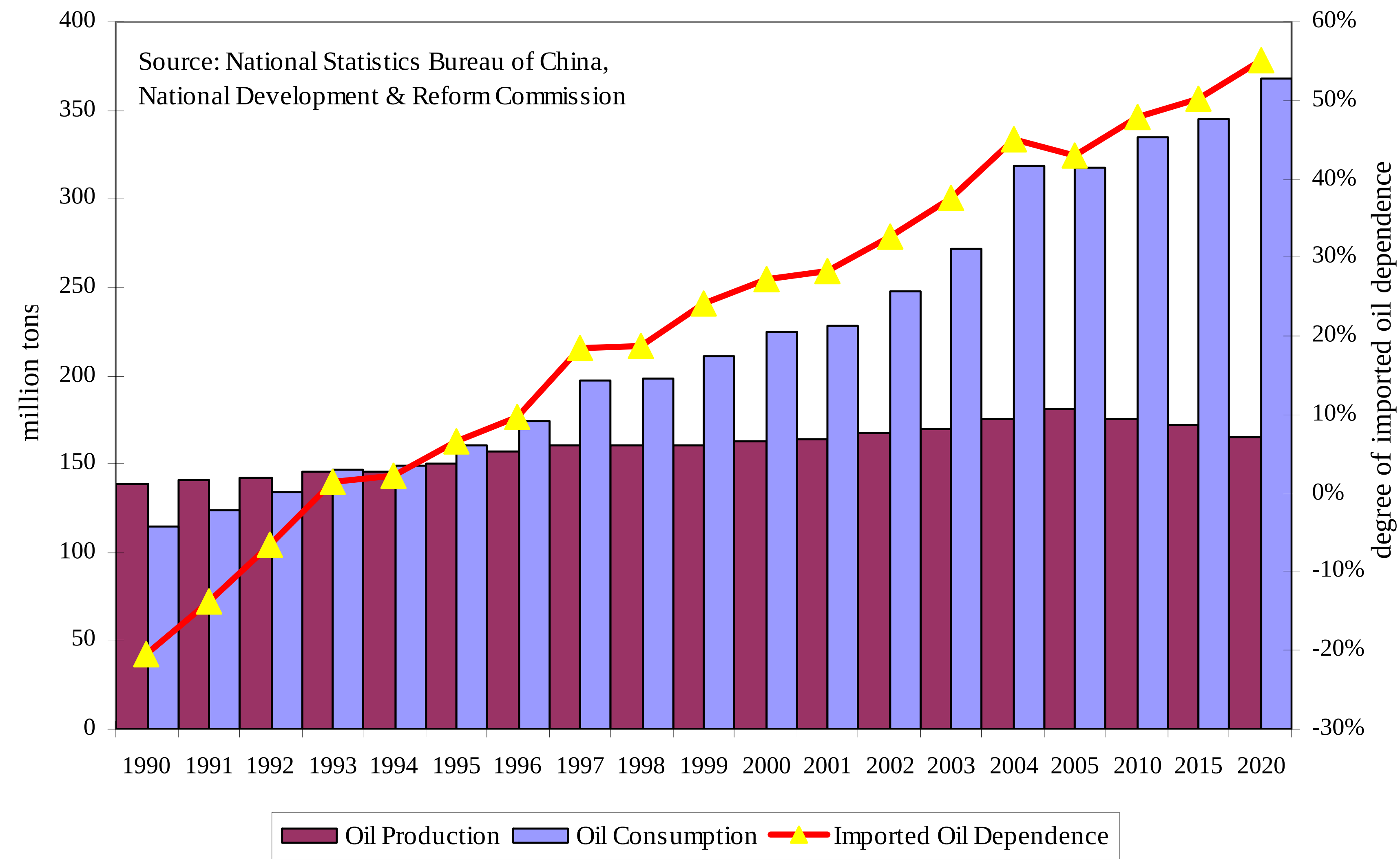
Source: Fortune Global 500 in 2006

Drivers and Forces Behind:
Changes in China - Forces outside a company

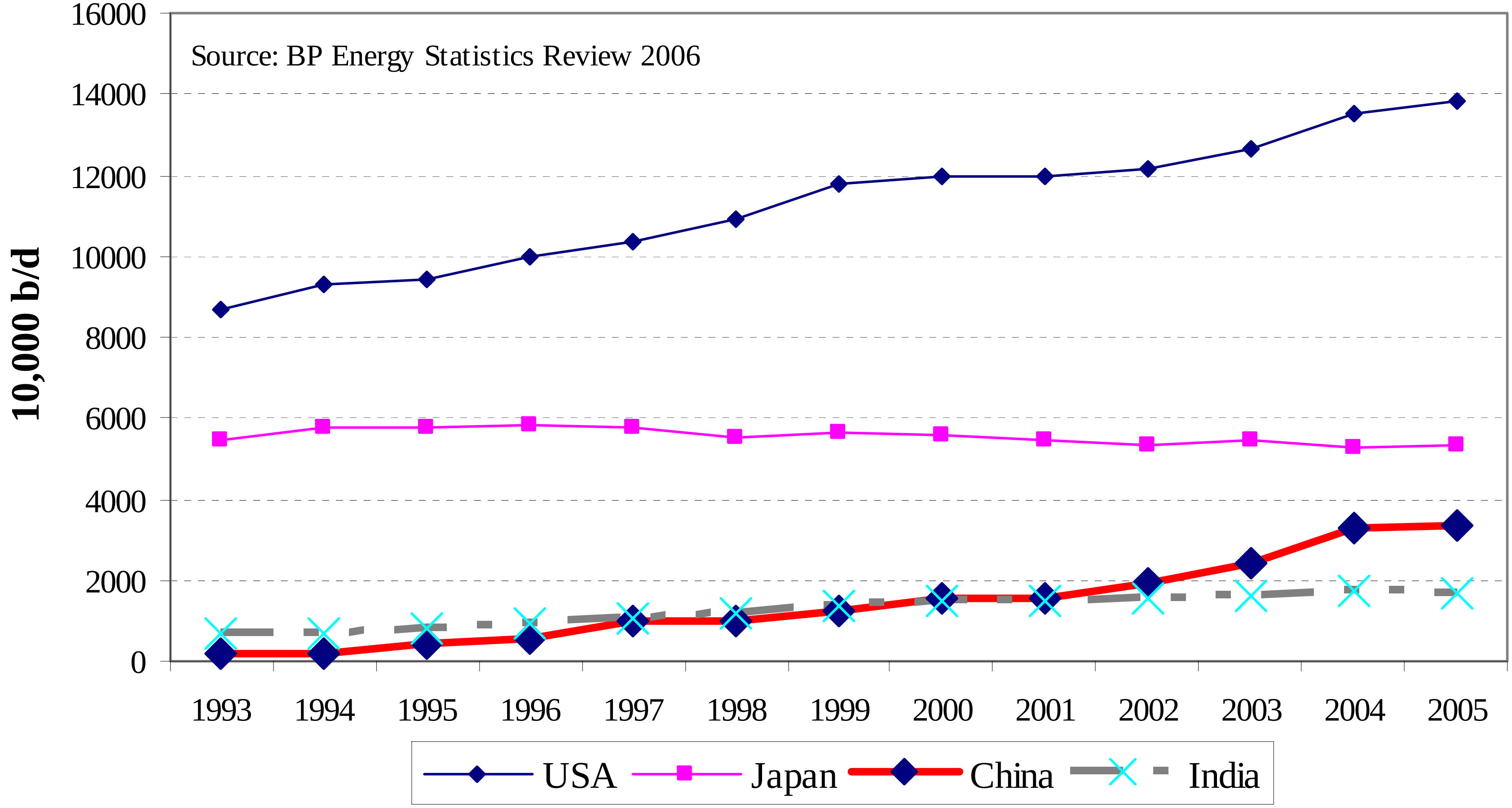
- **Economy:**
  - Realization of its domestic growth through overseas investment rather than FDI and export.
  - Cash-rich economy (GDP, No. 4) and low financing cost.
  - Effect of globalization (WTO) and internationalization.
  - Economic growth demand for energy and resources.
- **Energy security:**
  - National security vs. economic reliance on foreign oil.
- **Political policy:**
  - Coordinated government efforts to protect national industries.
  - Financial support and incentives.
  - Energy policy and ODI policy, energy diplomacy.

Natural Resources…Abundant?

China's Imported Oil Dependence



Top Four Oil Import Countries



Drivers and Forces Behind:
Changes in China - Drivers inside a company

- **Market needs:**
  - Learn technology, equipment, management skills, corporate practices.
  - Access to brand name, new markets, sales and distribution networks.
  - Domestic over-capacity and employment; extra business opportunity.
  - Trade: avoid export barriers.
- **Corporate growth:**
  - Natural evolvement of corporate growth from domestic, manufacturing image to global corporate player.
  - Access to global capital markets.
  - Commercialization and globalization of companies.
  - Fierce competition and competitiveness.
  - Mergers of global majors.
- **Corporate obligation to energy supply**

Drivers and Forces Behind: Changes in China

- The mix of political, economic, security, market, and corporate needs leads to the alignment of political and commercial interests as well as state and corporate goals.

Drivers and Forces Behind: the Chinese National Characteristics

Geopolitics:

- Money cannot buy; the Chinese wariness of foreigners has been learned the hard way.
- Rising nationalism, political and economic aspiration.
- Relations: parenting role of Chinese governments; "Big brother" of the developing world (aids, alliance).

Business self-consciousness:

- Learner's mentality (willing to pay tuition).
- Win-Win and trade-off strategy (timing, price, stable resources).
- Short-cut to brand, technology, market, management.

Drivers and Forces Behind: the Chinese National Characteristics

Executives:

- Enjoy dual leadership; personal agenda and personality (confidence)
- Entrepreneurial spirit, blind western admiration.

Corporations:

- Image (status conscious), vanity (make a big splash), jump on the wagon.
- Corporate driving ambition. Worth simply challenging foreign firms.
- Sense of urgency, expectation of making a move anyway.

Drivers and Forces Behind: the Chinese National Characteristics

- One should never underestimate the Chinese ambition and tenacity. However irrational, the Chinese are determined to make things happen and have the means. They can surprise or even hurt the IOCs.

The Chinese Actions: Coordinated Strategies

- **National Strategy (government guideline):**
  - Inbound: attract foreign capital, technology, develop energy systems.
  - Outbound: secure access to energy sources from abroad; obtain new supplies, invest in energy producing countries.
- **National Oil Production Strategy:**
  - Sustain the east (2/3 production), grow the west (1/6), develop offshore China (1/8), explore globally.
- **National Oil & Gas Overseas Investment Strategy:**
  - Solidify in Middle East, develop in neighboring areas, expand in Africa and explore in Americas.
  - Secure long-term, stable, diversified supply: new supply; shift away from unstable ones. Keep oil import about 50%. Consider securing oil at market.
  - Compete with oil consumer countries and directly cooperate with oil producers.

Timeline of China's Going Global Campaign

Year	Imported Oil Dependence	Events
1992	-6%	China developed "two resources, two markets" strategy
1993	1%	China became a net importer of petroleum products; CNPC made China's first overseas purchase in Thailand
1996	10%	China became a net importer of crude oil
1997	18%	CNPC invested in Sudan, Venezuela
1998	19%	China developed energy strategy blueprint
1999	24%	CNOOC aborted its initial IPO
2000	27%	PetroChina (CNPC) and Sinopec went public (IPO)
2001	28%	China opened to globalization as a WTO member; CNOOC went public (IPO)
2002	33%	China became the 2nd largest energy consumer; China launched "Going Global" campaign
2003	37%	China became the 3rd largest oil importer; China Petroleum Strategic Reserve Office opened
2004	45%	PetroChina Daqing oilfields reduced its production; Sinopec purchased in Angola
2005	43%	CNOOC aborted its acquisition of Unocal; CNOOC purchased in Canada; CNPC/Sinopec purchased in Ecuador; CNPC bought PetroKazakhstan; Oil pipeline from Kazakhstan
2006	47% (first half)	China became No 1. in foreign currency reserves (about $1 trillion); CNPC acquired in Syria; CNOOC acquired in Nigeria; CITIC acquired in Kazakhstan

Source: Company reports, China National Statistics Bureau

Oil Majors and Private Companies

中国中信集团公司
CITIC Group

中国中化集团公司
SINOCHEM CORPORATION

振华石油
ZhenHua Oil

中融集团
ZHONG RONG GROUP

Global Actions of China's Oil Majors

Name of Company	CNPC	Sinopec Group	CNOOC
Logo			
Date of Incorporation	1988	1983	1982
Asset ranking in China	2	1	3
Listed subsidiary	PetroChina Company Limited	Sinopec Corp.	CNOOC Limited
International branch	CNODC, CNPCI	SIPC	CNOOC Limited
No. of countries operated	28 countries, 58 projects	20 countries	7 countries
Global features	The first one and most experienced one going global	No. 1 oil importer, the latest & most hesitant one going global	The most Westernized but smallest one
Strategic regions	Central Asia-Russia (primary focus), Middle East-North Africa, South America, Southeast Asia	Middle East (primary focus), West Africa, Canada, Central Asia	Southeast Asia (primary focus), Australia
Regional focus	Sudan, Kazakhstan, Venezuela, Ecuador, Indonesia	Iran, Saudi Arab, Nigeria, Russia, Kazakhstan	Indonesia
Equity oil production	146.8 million barrels	6.5 million barrels	29.9 million barrels
Near-term focus	Optimize existing assets	Bid on over 20 projects	Consider more M&A

Source: company reports (as of December 31, 2005)

- Each NOC has different strategies, priorities and approaches in dealing with foreign entities.

Global Energy Presence in 2005

Source: Company statistics

Crude Oil Sources in 2005 (barrels per year)

Crude Oil Source	Import (barrels)	yoy Change
Saudi Arabia	162,645,743	28.6%
Angola	128,034,025	7.7%
Iran	104,641,783	7.8%
Russia	93,715,627	18.6%
Oman	79,489,624	-33.7%
Yemen	50,157,659	39.2%
Sudan	48,544,401	14.7%
Congo	40,551,441	16.0%
Indonesia	29,991,934	19.2%
Equatorial Guinea	27,132,067	6.4%
Total (Top 10)	764,904,305	3.3%
Others	164,992,300	-15.5%
Total	929,969,935	3.3%

Source: National Development & Reform Commission of China

Major Issues the Chinese Face and Hurdles to Overcome

- **Internal issues**
  – Inexperience in global markets, talent cap, man power, expertise, corporate governance and risk management.
  – China's domestic market reform, regulatory approval and competition, competing with its own domestic attention.
- **Geopolitics**
  – Weak local knowledge and sensitivity, prevalent "China Threat" image.
- **External issues**
  – Uneven level of bilateral relations, local preference of non-Chinese partners, underestimated roles of global market players.
- **Negative reactions of the IOCs**

The Build-up of the Chinese Competitive Edges

- **Capabilities**: Building a risk profile by avoiding weaknesses, staying away from competing directly with the IOCs, and playing to their strengths.
- **Costs (dual nature of the SOEs)**: They are also financially responsible and take care of their shareholders.
- **Assets**: The Chinese are as much money-minded, they also want to have their investments secured with a solid chance at an appropriate return.
- **Package deals**: In dealing with these countries, the Chinese employ a conscious, shrewd mix of tactics: diplomacy, economic aid, and social investing, as they understand local uncertain environment and address local social needs.
- **Experience**: Most of new growth areas around the world are in countries in transition. The Chinese have a closer understanding and experience of the issues and challenges in developing countries.

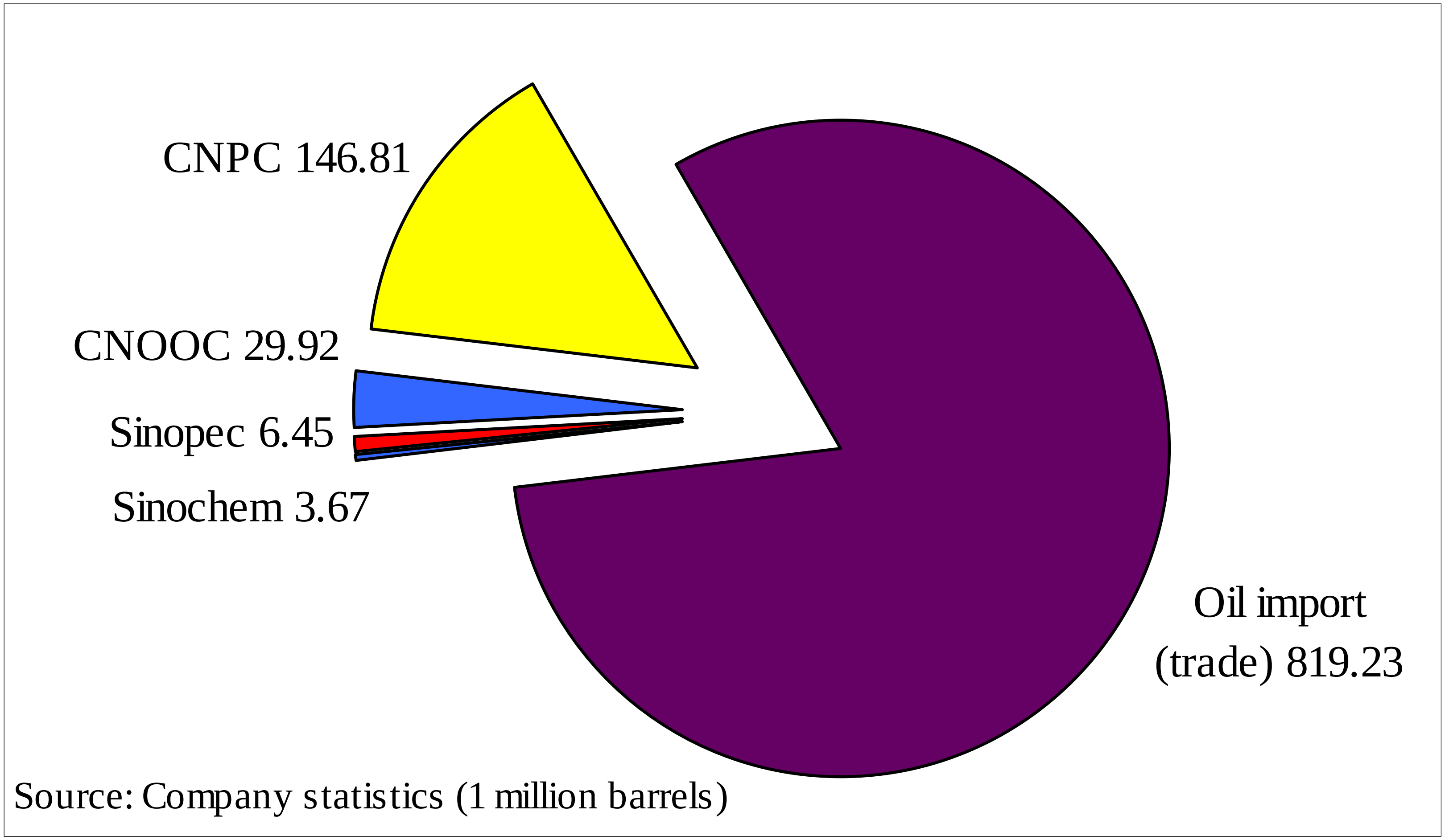
Progress: How Well China Fare So Far?

- Management: local run.
- Confidence reflects closer understanding of developing economics.
- Money is not an issue: have to, well aware of over-pay.
- Different risk profile, alignment of national and corporate interests.

Going Global Concerns

- In reality such a hedged risk profile does not always work well.
- The Chinese face problems and resistance in oil producing countries and repercussions from competitions.
- They are still not competitive enough and often edged out of deals. Despite aggressive spending, they are neither spending enough nor outspending the IOCs.
- For all their efforts over the past years, they are not picking up the best assets, just largely remote, second-rated small deals.
- Securing energy supply through equity ownership proves difficult.

China's Overseas Equity Oil Production in 2005



For all the attention given to the Chinese investment in overseas oil assets, four Chinese NOCs only secured 186.8 million barrels of equity oil production in 2005.

What Wrecked CNOOC's Quest for Unocal?

- The Unocal deal is a classic example: a Chinese company was unable to close the deal, when it was forced out by a major IOC in collaboration with local political and interest groups.
- A testimony of personal influence of CNOOC's confident CEO and a test of the modern CNOOC's corporate ambition.
- The deal failed in part due to the way CNOOC set up its overseas business and it handled interest groups and foreign advisors.
- It took political and regulatory barriers for granted. In the bidding process, CNOOC failed to use the open trade and free market principle the U.S. advocates to fight back its protectionism.
- While Chevron benefited from leveraging its institutional power, CNOOC failed to use its. It is also the evidence of failure of utilizing the institutional powers of the Chinese government when a Chinese company like CNOOC faced the host country opposition.

Effect of the Unocal Deal and the Greater Implications of China Going Global

- **Inside China**. The U.S. political opposition during the deal hurts its image of free market leader. A sense of double standards rankles with the Chinese the most.
- **China's role**. A fundamental clash is about the role of China to the IOCs. China is not doing what it is supposed to do: be an energy consumer on the global markets through interdependent producer-consumer framework.
- **The established areas**. The Chinese may challenge the IOCs but still cannot compete with powerful and competitive global players.
- **New growth areas**. They may change the competitive landscape and, sometimes, dictate deal terms and set up barriers.
- **The rising NOCs**. It upsets the balance of the risk-reward framework which has largely proven successful for the IOCs in the established areas. Globalization has not displaced national identity and interests.

Effect of the Unocal Deal and the Greater Implications of China Going Global

- **The M&A outlook.** The Chinese may stay away from the U.S. and, for a while, will not do more high-profile deals. However, the need of corporate internationalization and energy security make more deals bound to happen. Despite missteps, the Chinese NOCs will come back stronger, more prepared, sophisticated, and creative.
- **The greater impact.** Volatile commodity prices, unpredictable global energy system, energy security, corporate profitability.

Foreign Reactions:
How to react, compete, work, leverage?

- Facing the Chinese challenges, the IOCs react poorly. Many are yet to accept the Chinese as legitimate global players and still treat China as a secondary priority.
- Some do not take the Chinese seriously. They focus on hard factors and are obsessed with the Chinese inability, missteps, and such natural weaknesses as paying top dollar and unsophisticated practices.
- Others take the Chinese seriously. They challenge China to play by the rules and compete on the free market. It succeeded in the Unocal case.
- Much of the talk about the Chinese new status comes down to the very nature of competition.

Is China A True Challenger?

- China vs. IOCs: acreage awards, reserves, production, delivery, capital expenditures.
- Among many challenges it faces, where will an IOC rank the China challenge?
- Does China really want to challenge the interests of IOCs? Or just acts differently.
- What would happen to the Chinese companies, when the oil price drops to the level in late 1990s?

Recommendations: Understanding, Leverage, and Strategy

- **Ultimately, the IOCs must quickly become comfortable with a world full of the Chinese challenges. The Chinese global actions pose potential threats and present opportunities.**
- **Successful partnerships will be built on pairing the specific needs of a particular Chinese NOC with unique competencies of the IOCs.**

Conclusion

- China's going global is the natural evolvement of its economic growth and corporate internationalization. The Chinese NOCs benefit from the alignment of political and economic interests as well as governmental strategic needs and corporate goals.
- As the Chinese have built a favorable risk profile, each IOC needs to agree to disagree, accept the rising China, and develop a proactive strategy.

Thank You!

The China Gateway Consulting Group

A Worldwide Energy Group

www.cgcg-consulting.com