

China's Outward FDI and Resource-Seeking Strategy: A Case Study on Chinalco and Rio Tinto

Shujie Yao^{a*}, Dylan Sutherland^a and Jian Chen^a

^a*University of Nottingham*

Abstract

The scale and frequency of foreign direct investment (FDI) in foreign mining companies by China's large state-owned enterprises (SOEs) is still not well explained by existing investment or international business theories. This paper advances and verifies two important theoretical propositions. First, the efforts of China's big businesses to "go global" can be thought of as being part of a national power-building globalisation strategy. Second, facilitated by extended protection from the state, reaching beyond China's national boundaries, China's large SOEs raise investment capital and take risks that their foreign competitors do not. This paper uses Chinalco as a case study to illustrate these propositions.

JEL Classifications: F21, D21, L53

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1. Background

Chinalco's failed strategic investment in Rio Tinto attracted worldwide attention and provoked sharp criticism of Rio Tinto back in China for its role in unilaterally scrapping the deal, initially struck at a time when Rio Tinto was on the verge of collapse. This was because Rio Tinto had accumulated huge debts immediately prior to the outbreak of the financial crisis. Its share price reflected its dire situation. It had dropped to less than £10/share in early 2009, from a peak of over £70/share only several months earlier in 2008. After investing \$14 billion in February 2008, approximately 9% of Rio Tinto's equity, Chinalco had incurred more than \$10 billion in paper losses. However, in February

* Corresponding author: Shujie Yao, School of Contemporary Chinese Studies, the University of Nottingham, Jubilee Campus, the University of Nottingham, Nottingham, NG8 1BB, UK. Tel: 0044-115 84 66179. Fax: 0044-115 84 66324. Email: shujie.yao@nottingham.ac.uk. We thank the anonymous reviewers for the valuable comments.

2009 Chinalco went on to agree with a further \$19.5 billion injection in Rio Tinto. This investment would have substantially reduced Rio Tinto’s large debts. For Rio Tinto, it secured a life line for its survival. For Chinalco, it would have helped secure China’s steel industry a secure, stable and cost-effective supply of iron ore, as well as allowing it to become a more truly global company. At the time when the deal was struck, therefore, it was an attractive proposition to both parties. (Table 1)

Table 1: Reasons for and against strategic partnership

| | Rio-Tinto | Chinalco |
|---------------------------------------|---|---|
| Benefits and Reasons for Partnership | Mounting debts of \$34 billion from buying Alcan makes it a target for takeover. Partnership with Chinalco prevents this from happening. | Securing stable supply of raw materials at reasonable prices. Helping China to own strategic resources overseas. |
| Costs and Reasons against Partnership | China exerts influence on board and price setting. Partial loss of ownership of some mines. Resentment by politicians and shareholders to sell strategic assets to Chinese companies. | First investment of \$14 billion lost 70% of value. Total debt costs of \$33.5 billion cannot be justified on commercial basis given profits dropping by 99% in 2008. |

Four months after the initial agreement the proposed deal had cleared most of the legal and administrative hurdles. It still, however, needed the final approval of the Australian Foreign Investment Review Board (FIRB) and Rio Tinto’s shareholders. But only one week before the FIRB meeting, on June 5, 2009, Rio Tinto withdrew from the deal and announced an alternative plan. This involved a \$15.2 billion right issues as well as a joint venture with its arch rival BHP Billiton in its crucial iron ore mines in Western Australia. This came as an unexpected blow to both Chinalco and China’s self-esteem (Yao, 2009).

Despite the failure of Chinalco in this deal, China’s relentless effort to acquire foreign assets is unlikely to diminish. Instead, its future forays may in fact become more tactical and forceful. Indeed, the Chinalco story highlights how the on-going global financial crisis and subsequent downturn presents new opportunities for China’s big business groups to actively seek substantial stakes in large foreign resource companies, often backed by China’s state-owned banks. It is most striking, in particular, that the terms of credit offered to Chinese companies making these foreign acquisitions are often very generous. This arguably raises important challenges for existing theories of international business.

To address this puzzle, we use the Chinalco-Rio Tinto case as a study to investigate certain theoretical propositions. The rest of this paper is organised as follows. Section 2 provides an introduction and background to the Chinalco-Rio Tinto case study, including consideration of world mining industry consolidation. Section 3 explains in more detail the national strategies of Chinese policy-makers and businesses and their aspirations to become global giants. Section 4 investigates two theoretical propositions regarding resource seeking strategies in the Chinese context. Section 5 concludes.

2. Consolidation of the world mining industry and Chinese OFDI

China's OFDI has now risen from only several billion dollars to around \$50 billion by 2008. Chinalco's proposed investment in Rio Tinto, if successful, would have been the largest outward investment of a Chinese company to date. Table 2 summarises some of the most important aspects of their engagement.

Table 2: Chinalco, Rio Tinto and BHP Billiton's struggle for control

| <i>Important dates</i> | <i>Events</i> |
|------------------------|---|
| Oct 2007 | Rio Tinto bought Alcan for \$38.6bn, but did so incurring \$34bn of debts towards the very peak of the long commodity boom. |
| Nov 2007 | BHP attempted to buy Rio on a 3:1 all-share swap |
| Feb 2008 | Chinalco, along with the US's Alcoa as a strategic partner, invested \$14bn to buy 9% of Rio's shares. |
| Aug 2008 | Chinalco raised its stake in Rio to 11 per cent |
| Nov 2008 | BHP abandoned its plans to buy Rio due to Chinalco's intervention, which was therefore hailed as a success at the time. |
| Feb 2009 | Chinalco agreed to invest another \$19.5bn in Rio: \$12.3bn for minority stakes in iron ore, copper and aluminium assets and \$7.2bn for convertible bonds to take its equity stake in Rio to 18 per cent and two non-executive seats in Rio's board. |
| 5 Jun 2009 | Rio unilaterally abandoned its deal with Chinalco and proposed an alternative, to raise \$15.2bn through right issues and \$5.8bn from BHP Billiton by forming a joint venture with the latter in western Australia |

Source: Yao and Sutherland (2009).

Chinalco's huge bid, and subsequent failure, is in the first instance representative of the fact that in general a large share of all global FDI has been carried out by a relatively small number of the very largest TNCs (UNCTAD, 2007). China's OFDI is also concentrated in hands of a small number of large business groups (Morck, Yeung and Zhao, 2008; Sutherland, 2009). In this regard, the considerable concentration of China's OFDI in a comparatively small number of big business groups mirrors international patterns. Despite its rapid growth, however, China's total OFDI still accounted for only a small share of the global total. This was partly because prior to the onset of the global financial crisis the world had experienced an unprecedented wave of transnational consolidation (Nolan, 2001). In 2007, for example, global FDI (mostly M&A activity) exceeded the two trillion dollar mark (World Bank, 2009).¹

This merger wave was caused by numerous factors and has been referred to as a "global big business revolution" (Nolan, 2001). The metals and mining industries was no exception to this general trend. It too experienced rapid global consolidation. Between 1995 and 2006, 17 "mega-mergers" (deals exceeding one billion US\$) took

¹ The real U.S. dollar price of commodities has increased by some 109% since 2003, or 130% since the earlier cyclical low in 1999. By contrast, the increase in earlier major booms never exceeded 60% (ibid.).

place in the metals and mining industries (UNCTAD 2007: 241). As a result the degree of concentration also increased significantly. Interestingly, the degree of concentration rose fastest in areas such as iron ore (from 44% to 52%) and copper (from 51% to 58%) – some of the very areas important to China.² Large TNCs from the UK, the USA, Australia and Canada, however, dominated most of these deals. This consolidation wave, moreover, was also strongly driven by the very largest TNCs, including Rio Tinto, BHP Billiton, Alcan (subsequently taken over by Rio Tinto) and Vale (also known as CVRD). In theory this increased the gap that China's large groups faced in order to "catch up" with their global competitors.

By late 2007, as the global credit crisis was beginning to unfold, the merger wave (and accumulation of debt) was reaching its zenith.³ The value of announced mining takeovers more than tripled to \$199 billion in the first five months of 2008, when compared with 2007 (Choudhury and Foley, 2008). Some firms from emerging economies also tried to take part in this merger frenzy. The largest, such as CVRD, for example, failed in a takeover bid for Xstrata Plc. Chinalco and Sinosteel, among China's largest groups, also bought significant stakes in mining assets worldwide to diversify their sources of raw materials.

3. China's national champions and the thorny path to become global champions

Against the backdrop of impressive global consolidation, China has also been trying to push its own *domestic* consolidation process, not just in non-ferrous metals, but across a wide range of different industries, so as to catch up with the leading TNCs (SASAC, 2007). Indeed, going as far back as 1991, China's State Council selected a batch of trial business groups to undergo trial reforms (Nolan and Zhang, 2002). Despite debate emerging in China concerning the significance of these large groups to her economic reforms, in the end the group strategy was accepted (Macro-economic Research Institute of the Chinese National Plan Commission, 1996; Pei, 1998). Indeed, the centrality the Chinese leadership attached to large business groups in China's opening to trade and investment was aptly summarized in a speech by the then vice-premier Wu Bangguo in 1997:

In reality, international economic confrontations show that if a country has several large companies or groups it will be assured of maintaining a certain market share and a position in the international economic order. America, for example, relies on General Motors, Boeing, Du Pont and a batch of other multinational companies. Japan relies on six large enterprise groups and Korea relies on 10 large commercial groupings. In the same way now and in the next century our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups (Yao and Sutherland, 2009).

² Iron ore and copper are the most important metal commodities globally. They account for close to around one half of the total value of all metallic minerals produced globally (UNCTAD 2007: 109).

³ The start of the credit crunch is heralded by bad news from French bank BNP Paribas, which triggered a sharp rise in the cost of credit.

Following from this strategy a wide variety of measures have been taken, and business groups (as opposed to stand alone firms, more commonly found in the Anglo-Saxon model), have rapidly emerged.⁴ In 1991, 57 large groups were selected in a number of key industries. By 1997, this batch of business groups was further increased, from 57 to 120. Chinalco is among these national champion business groups, making it interesting as a case study.

Although many of the Chinese national champions may appear large in terms of size, they cannot match their western counterparts in terms of technology, management, logistics, human resources and marketing. These deficiencies become more marked when they start to go expand beyond China’s national boundary. Beyond this point, they no longer enjoy the monopolistic positions and the market power held within their domestic market. This, in part, may explain why China has been unable so far to invest heavily in manufacturing and services industries in developed economies. Further, it also suggests that, for these champions to succeed overseas, they may also require extended state support. Chinalco is itself a large industrial corporation with many subsidiaries in China, enjoying significant monopolistic power in the aluminium industry. Due to its sheer size and market power, it has become a natural monopoly in its key product areas. This has allowed the group to rapidly increase its revenue, profits and assets (Table 3). This successful growth encouraged Chinalco to become ever more aggressive, leading to its involvement with Rio Tinto.

Table 3: Chinalco’s key financial indicators (2002-1Q 2009, billion RMB)

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 1Q2009 |
|---------------------|------|------|------|------|--------|--------|---------|--------|
| Revenue | 16.8 | 23.3 | 32.3 | 37.1 | 61.9 | 76.2 | 76.7 | 13.9 |
| Profits(gross) | 3.4 | 6.8 | 10.9 | 12.3 | 20.0 | 19.0 | 6.7 | -2.3 |
| Assets | 31.9 | 35.1 | 49.0 | 59.0 | 78.0 | 94.3 | 135.5 | 132.6 |
| Profit before tax | 1.6 | 4.6 | 8.6 | 9.7 | 16.8 | 14.4 | 0.1 | -2.3 |
| number of employees | n.a. | n.a. | n.a. | n.a. | 8,8000 | 94,269 | 10,7887 | n.a. |

Sources: <http://www.chalco.com.cn/>.

Chinalco’s first investment in Rio Tinto, in February 2008, was made near the peak of the commodity market boom. The sharp market downturn (caused by the financial crisis and the subsequent drop in metal prices in the world market), as noted, reduced the share price of Rio Tinto from over £70/share in late 2007 to less than £10/share by February 2009. As a result, Chinalco’s first investment in Rio Tinto lost more than 70% of its value on paper. The second proposed investment in February 2009 looked to recoup some of the losses incurred by the first investment. Out of £19.5 billion, \$7.2 billion was proposed to buy convertible bonds bearing 9% interest rate per annum. The bonds could be converted to shares at a price substantially lower than that of the initial investment, made in two tranches at \$45/share and \$60/share, respectively.⁵ The other

⁴ For the definition and discussion of “business groups” in China, please see Hussain and Chen (1999).

⁵ The price Chinalco paid to Rio Tinto was about \$120/share (or £60/share) in February 2008.

\$12.3 billion would have been used for buying up to 49% of the shares in a number of important copper, aluminum, and iron ore mines in Australia.

One critical advantage of the proposed deal to Rio Tinto was that it could pay off its immediate debts incurred after the purchase of Alcan and stop its share price from falling precipitously during late 2008 and early 2009, a difficult time for markets. The disadvantages, however, were also serious. In particular, the high interest rates attached to the convertible bonds and the eventual conversion of these bonds to share equity at a less favorable rate would lead to diluted ownership rights of many important mines, and the influence of the two Chinese Communist Party members as its board directors.

For Chinalco, the failed deal was a serious blow, not only for itself as a commercial company but also for China's national image and self-esteem. For Rio Tinto, on the other hand, the decision to reject Chinalco's offer appeared to be primarily the result of shareholders drive for better returns. It was thus driven by private interests, rather than national interests. The failure of Chinalco to press home its advantage when Rio Tinto was most vulnerable also reflects the naivety and lack of familiarity of its senior management in making foreign acquisitions.

4. Theories of OFDI in the Chinese context

Academic literature suggests that FDI should generate mutual benefits for both the investing and host economies. For host economies, their incentives to attract FDI may include the transfer of new technologies, managerial skills and access to international markets. For investing economies, the key incentives may include resource-seeking, market penetration, exploitation of scale economies at the global level and lower costs.

In most cases, FDI involves a significant component of technological transfer and spill-overs, as inferred from the new theory of endogenous growth (Romer, 1986; Sala-I-Martin, 1996). Export-orientation forces producers to respond to international competition. In the Asian newly industrialised economies (NIEs), Taiwan, Korea, Hong Kong, and Singapore, the outward looking strategy has been associated with relatively free labour and capital markets (Balassa, 1988).

Empirically, many recent econometric analyses have focused on understanding the causality between the dependent and independent variables. For example, does FDI cause GDP to grow, or *vice versa*? Most empirical results support the argument that FDI can promote output growth. Yao and Wei (2007) demonstrate that FDI into China explains up to one-third of economic growth and technological progress during the 1978-2004 period. Chuang and Hsu (2004) show that FDI has the biggest impact on the productivity of those industries that import appropriate technologies rather than the most advanced technologies. Among the OECD countries, Choi (2004) shows that *per capita* income disparity tends to decline as a result of rising bilateral FDI flows. Wang, Siler and Liu (2002) show that foreign firms are more productive than domestic firms in the UK.

Many recent studies also suggest that market size, labor cost, location and timing are important determinants of FDI (Chakraborty and Basu, 2002; Filippaios, Papanastassiou and Pearce, 2003; Deichmann, Karidis and Sayek, 2003). Park (2003) and Love (2003)

try to explain the motives of Japanese and US firms to invest abroad. Japanese firms experienced three stages of their investment strategies, natural resource-seeking (1950s and 1960s), market penetration (1970s and 1980s), and the combination of cost-saving and market expansion from the 1990s (Park, 2003).

Although existing literature may provide some insights as to why China has geared up its OFDI in recent years, the special characteristics of its OFDI in the form of resource-seeking have not been well considered. Based on existing theories of international business, firms making OFDI must possess some kind of advantages over their host-country competitors. These advantages can be technology, brand, or management skills. The key objective of any TNC is to maximize profits and increase their international competitiveness. However, if we compare Chinalco with Rio Tinto, the former does not appear to have any such advantages. It is actually smaller and less profitable. If, however, Chinese policy makers are seen as using Chinalco as a vehicle for national security and development, the high degree of asset specificity – China’s total dependence on iron ore to develop – may explain its desire to vertically integrate with Rio Tinto.

Chinalco was selected as one of a few Chinese national champions to seek natural resources overseas through investments and acquisitions of large foreign TNCs. In this way it could guarantee that foreign resource supplies would be available to China’s large and growing metals industries. This was why Chinalco was allowed to become a large and monopolistic industrial group in China and to make such large investments abroad, which could not have been justified based on its own financial strength alone. As illustrated in Table 3, the company’s performance deteriorated sharply after its listing on the Shanghai Stock Exchange in 2007. Indeed, if Chinalco were a western TNC, it would have been close to bankruptcy and not launching a massive investment plan to acquire foreign assets. Banks would have called in their loans rather than putting them forward. Even despite its poor performance, however, four of the biggest Chinese state-owned banks agreed to lend Chinalco US\$21 billion. These banks, moreover, charged very low interest rates, only 94.5 basis points above the six-month London inter-bank offered rate (LIBOR). Further, they did not set a time for Chinalco to pay back the loans. By comparison, BHP Billiton at the same time issued ten-year bonds which had to bear interest at 390 basis points above the six-month LIBOR.⁶

This type and scale of lending activity is possible only in China, where state-owned banks and businesses are treated as the left and right arms of the state in order to achieve its national long-term development objectives (Yao, 2009). As a result, the OFDI of China’s national champions, such as Chinalco, cannot be well explained by existing theories. Instead an understanding of aspects of the political economy of OFDI is also required (Yao and Sutherland, 2009).

To further understand the motivation and behavior of Chinese big businesses making OFDI, we propose two theoretical propositions.

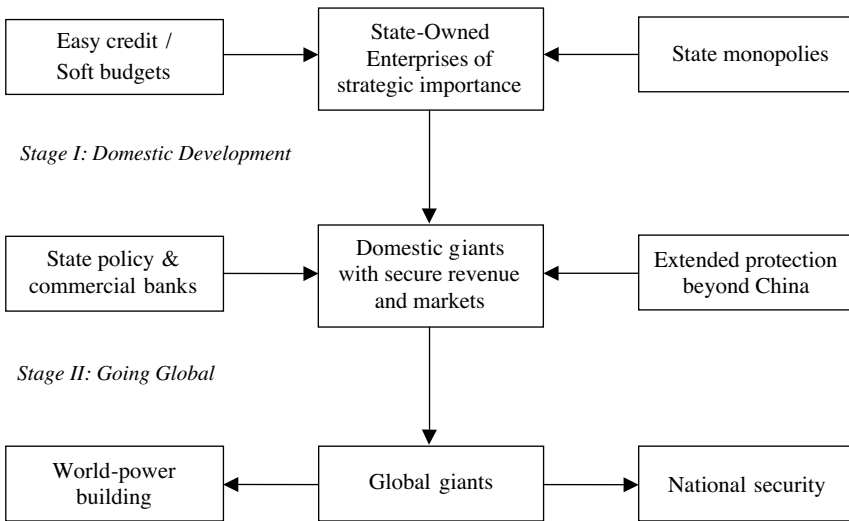
Proposition 1: The efforts of China’s big businesses to “go global” and undertake OFDI are part of the country’s power-building and globalisation strategy.

⁶ Zhen Yang, “Easier loans lead to more M&As,” *China Daily*, 20th April 2009, p.4.

Proposition 2: Soft budget constraints and extended protection by the government beyond the nation’s boundary are the key policy instruments compensating for the technological and managerial deficiencies of China’s national champion groups undertaking OFDI. This policy support enables these companies to outstrip their foreign competitors in taking risks and raising investment capital.

These propositions can be illustrated in Figure 1 below. They have generally not been considered in the existing literature on management and international business. This may be because they are especially applicable to emerging economies such as China.

Figure 1: Evolution of China’s business champions going global



Notes: (1) The top 3 squares show how state-owned enterprises are supported by soft budgets and monopolistic power to become domestic giants. (2) The middle 3 squares show how these domestic giants are further supported by state banks and government protection to go global. (3) The bottom 3 squares show two key national objectives (power building and security) that these business giants are expected to achieve.

Figure 1 implies that Chinese business champions undertaking OFDI cannot be regarded as isolated commercial entities. Their development has also been supported by the state and they are also tasked to achieve two important national objectives: world-power building and national security. However, the extent to which the government is prepared to support these champions and the extent to which these champions will respond to the country’s development ambitions through maximizing and balancing private (company interests) and social (national interests) benefits are two important questions that need to be addressed.

These questions can be answered through a simple model, explained below. It is assumed there exist two utility functions, one for the state, denoted by U_s , the other for a particular company, say Chinalco, denoted by U_p .

In U_s , the level of utility is determined by the state's ability to gain power in the world economy, denoted by WP , and to raise the level of national security, denoted by NS , as a result of any OFDI made by the company but supported by the state, as shown in equation 1.

$$U_s = f(WP, NS) \tag{1}$$

In U_p , the level of utility is determined by the company's ability to increase profit (π) and world market share (MS) as a result of outward investment, as shown in equation 2. For simplicity, market risk and price volatility are not considered in the following model and discussion, although the model could potentially be elaborated to include the effects of price changes and market uncertainty.

$$U_p = f(\pi, MS) \tag{2}$$

WP , NS , π and MS are themselves non-declining functions of OFDI. However, whether the state needs to support or subsidize the outward investments made by the company depends on the returns to investments. Assuming the marginal return per unit of investment (e.g. \$1 billion) in the domestic market is fixed as μ and the return to the same amount of investment made overseas is denoted by $\frac{\partial U_p}{\partial OFDI}$, then, there are two possible outcomes.

First, if the return to overseas investment is equal to or greater than the fixed return in the domestic market, there is no need for state support. This is shown in equation 3. Second, if the return to foreign investment is than that from the domestic market, the company will need state support, as shown in equation 4.⁷ The first scenario is a possibility but it is not the focus of our interest. Instead, we focus on the case where state support is required.

$$\frac{\partial U_p}{\partial OFDI} \geq \mu, \text{ no need for state support} \tag{3}$$

$$\frac{\partial U_p}{\partial OFDI} < \mu, \text{ need for state support} \tag{4}$$

The next question is how to determine the optimum level of support for a given amount of OFDI. In theory, the amount of support to the company should be equal to the difference between μ and $\frac{\partial U_p}{\partial OFDI}$, or denoted by $d\pi^*$. This level of support leaves the company indifferent as to whether it makes the same investment at home or abroad. The

⁷ Equation 4 may also suggest that if the government can effectively reduce the return in the domestic market, the company will have incentives to invest abroad. We preclude this as a realistic possibility however, as all the evidence we find points to the alternative: namely that increased domestic returns have been consistently promoted by the state in its efforts to promote larger business groups that can compete internationally. We therefore assume that the state is constrained to act only in a positive manner towards the profitability of the companies it wishes to support.

state, however, may or may not provide this support, depending on the additional utility that the state can derive from supporting this investment. As a result, the equilibrium condition triggering state support is dictated by the condition in equation (5), namely the amount of support should be equal or smaller than the additional utility accrued to the state as a result of the company making that investment.

$$d\pi^* = \left(\frac{\partial U_p}{\partial OFDI} - \mu \right) \leq dU_s = df(WP, NS) \tag{5}$$

The additional state utility can be decomposed into two parts: the marginal utility of increased world market share (or increased world power), and the marginal utility of the increased national security as a result of OFDI. This decomposition can be shown in equation (6).

$$dU_s = df(WP, NS) = \frac{\partial U_s}{\partial WP} \frac{\partial WP}{\partial OFDI} dNS + \frac{\partial U_s}{\partial NS} \frac{\partial NS}{\partial OFDI} dWP \tag{6}$$

With (6), the equilibrium condition for state support can be re-arranged in (7).

$$d\pi^* \leq \frac{\partial U_s}{\partial WP} \frac{\partial WP}{\partial OFDI} dNS + \frac{\partial U_s}{\partial NS} \frac{\partial NS}{\partial OFDI} dWP \tag{7}$$

It implies that the amount of state support to satisfy the condition that additional investment should achieve equal returns in both domestic and foreign markets to an individual company. This support should be equal to or smaller than the total derivative of the state utility function with respect to world power and national security. The total derivative of the state utility function can be decomposed into two parts: (1) the state’s marginal utility of world power resulting from making OFDI multiplied by the additional national security, and (2) the state’s marginal utility of national security resulting from making OFDI multiplied by the additional world power. These two components are shown on the right hand side of equation (7).

This model can be applied to analyse Chinalco’s proposed second investment in Rio Tinto (of \$19.5 billion). The state support can be quantified by the amount of possible interest subsidies for its proposed bank loans, which at about 3 percentage points amounts to an implicit subsidy of \$585 million annually. State support can also be implied by the fact that, in the event that Chinalco made an absolute loss, the state would also act as its guarantor. Such soft budget constraints are seldom available to western private companies.

The benefits to the state may not be easily quantified, but the fact that the state-owned banks were happy to provide the loans implies that the total benefits should be greater than the amount of implied subsidies. These benefits include the ability of China to increase the secure supply of iron ore, a key strategic resource, and the ability to negotiate for a lower price of seaborne iron ore with the large oligopolistic suppliers. In 2008, China imported about \$60 billion of iron ore. Reducing the import price of iron ore by one percentage point would save \$600 million annually for its steel industry.

This saving would be enough to cover the interest subsidies needed for Chinalco's \$19.5 billion bank loans.

5. Conclusions

The Chinese political system is unique compared to many other emerging economies in the sense that large state-owned banks and big business groups have been treated as the left and right arms of the state, so facilitating its goal of becoming an influential world power. To achieve this national goal, China may be willing to sacrifice some short-term benefits and suffer large losses with a view to winning international respect and larger global market shares.

From one perspective, Chinalco's bid for Rio Tinto appears to have been a failure. The complex deal was always bound to be subject to a long review. As such, it opened the way for closer scrutiny and public discussion, missing the small window of opportunity that in the end turned out to be available to it. In February 2009, owing to the financial crisis and the large debts Rio Tinto had accumulated, Chinalco had what seemed at the time an all powerful bargaining position. Unfortunately, it tried to push this dominance too far. If it had made a straightforward equity deal, instead of the complex joint venture arrangements and convertible bond it did propose, it may yet have been successful in brokering a deal. Because of this failure Chinese steel makers now find themselves in an unenviable position, with mounting losses and facing even harder future negotiations. In this regard Chinalco failed to get the deal it wanted.

From other perspectives, however, there are also reasons for optimism. Firstly, Chinalco's initial investment through a special vehicle was considered a shrewd strategic move executed with some skill. It effectively blocked the much larger BHP/Rio Tinto mega-merger. Chinalco's approach showed signs of sophistication and finesse in these early stages. As well as this, the fine detail of its failed bid was also cleverly designed to give it considerable strength in the marketing and negotiation of sales contracts of the iron ore produced at Rio Tinto's Pilbara mines, vital to keeping prices low for China's steel makers. This, indeed, may have been its ultimate objective. A simpler equity deal may not have been able to achieve these ends. As such, the message for western TNCs is that not all aspects of Chinese OFDI are handled with as much incompetency as we are sometimes lead to believe (particularly by the media). Some mistakes were made, as in the earlier infamous CNOOC/Unocal debacle, but there were also signs of sophistication, particularly in the early stages.

Further positives can be taken from the fact that Chinalco's bid failed primarily on commercial terms, not political ones.⁸ In the end, shareholders saw more value in the BHP Pilbara joint venture, coupled with a non-dilutive rights issue. There is indeed a compelling economic logic, given the cost savings and also market power it creates, for this joint venture. As such, it was always going to be difficult for Chinalco to succeed in its bid for Rio Tinto. Looking at the bigger picture, the Chinalco/Rio Tinto debacle

⁸ All companies, even big foreign private companies – as China's recent rejection of Coke's \$2.4 billion takeover bid for the famous Huiyuan juice brand shows – may face similar political obstacles. The political challenges Chinese groups have faced are not exclusive to them.

also demonstrates that the real prospects for China's national champions are far brighter than they were before the financial crisis. Until recently, these were considered rather bleak. Rio Tinto, however, only became vulnerable in the first place because of the crisis. Whereas Rio Tinto could not pay off its massive debts, accumulated during the commodity boom, Chinalco was strongly supported by China's state banks in its overseas forays. The evidence suggests that these banks will continue to back more national champion groups in their overseas acquisitions, as China looks to turn its monetary reserves into hard assets. The investment strategies of these groups may not be driven by firm-level motivations but may be as much related to national political and economic considerations. Clearly, the political nature of some of these investments, and the close involvement with a state run banking sector, will create tensions with host economies in the west. It will be interesting to see how these political challenges are dealt with or whether, in the end, they prove too difficult to surmount in the majority of cases.

The main contribution of this paper is that it makes two important theoretical propositions to show how business is conducted differently when large Chinese SOEs undertake investments abroad. These large business groups have been encouraged to grow quickly via granting of domestic monopolies and easy access to capital. Once they become large and try to make foreign investments, however, they are faced with tougher competition overseas. These international investments are also strongly driven by the wish of policy-makers in China to turn it into a world business power. In the case of natural resources, such outward investment is driven strongly by the need to secure its national interests through the supply of strategic resources such as iron ore, oil and other mineral products. This means that the state and SOEs have to work together to simultaneously achieve both private and social goals. The state, playing its part, has provided SOEs with soft budget constraints, particularly via easily attained low cost bank credit, provided through its own state owned banking system.

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