PNC Shanghai Representative Office (SRO) QUARTERLY UPDATE

2ND QUARTER 2018 EDITION

CHINA GDP GROWTH				
FY2014	FY2015	FY2016	FY2017	1Q2018
7.3%	6.9%	6.7%	6.9%	6.8%
RMB EXCHANGE RATE (USD/CNY)[1]				
End of 2014	End of 2015	End of 2016	End of 2017	1Q2018
6.2066	6.4952	6.9447	6.5342	6.2881

FOREIGN EXCHANGE RESERVES (BILLIONS USD)				
2014	2015	2016	2017	1Q2018
$3,843.02	$3,303.62	$3,010.52	$3,139.95	$3,142.82
PBOC REFERENCE LENDING RATE		**PBOC REFERENCE DEPOSIT RATE**		
4.35% (6/27/2015)		1.50%		

HOT TOPICS

U.S. AND CHINA DIRECT INVESTMENTS: LATEST TRENDS AND WHAT TO EXPECT

U.S. companies have historically invested a significant amount in China in the form of Foreign Direct Investment (FDI) in various industries, such as entertainment, manufacturing, financial and business services, and recently into consumer and service segments.

The dynamic and the industries U.S. investors prefer shift over time.

Since 2009, the outbound investment from China into the United States has grown noticeably and surpassed the amount of investment from the United States to China for the first time in 2015.[2] However, as fast as the rise of Chinese investment in the U.S. has been, the fall was abrupt in 2017, as evident from 2017 data and analysis.

U.S.-China FDI Statistics[3]

Year	US FDI in All Chinese Industries from 2008-2017 (billions)	Chinese FDI in all U.S. Industries from 2008-2017 (billions)	Total Two-Ways FDI (billions)
2008	20.94	0.772	21.712
2009	9.93	0.703	10.633
2010	12.69	4.57	17.26
2011	13.49	4.86	18.35
2012	15.41	7.41	22.82
2013	14.65	14.23	28.88
2014	14.59	12.69	27.28
2015	13.73	15.32	29.05
2016	13.81	46.49	60.3
2017	13.94	29.72	43.66
Total	**143.18**	**136.765**	**279.945**

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1 China Foreign Exchange Trade System (CFETS); central parity exchange rate set by the PBOC
2 Rhodium Group: "Two-Way Street: 2018 Update US-China Direct Investment Trends"
3 U.S.-China FDI Project (http://www.us-china-fdi.com)

CURRENT STATE OF U.S. – CHINA INVESTMENTS

While it is relatively common knowledge that U.S. companies have invested steadily in China over the years, Chinese companies have also been investing in the U.S., picking up the pace and reaching $14 billion per year in 2010.[4] The dramatic increase of Chinese-to-U.S. FDI deals starting in 2015 caught many by surprise, reaching a record of $46.49 billion in 2016.

Some of the recent high-profile deals include HNA's purchase of a 25% stake in Hilton and investment in 245 Park Avenue in New York in 2017, Anbang Insurance's purchase of the New York Waldorf Astoria in 2014 and Strategic Hotels and Properties Group in 2016, Wanda Group's purchase of AMC Theaters in 2015, Haier's purchase of GE Appliances in 2014, and more.

Capital outflow from China has coincided with the timing of increased Chinese-to-U.S. FDI. The RMB's central reference rate policy was changed by the People's Bank of China on August 2015, leading to an RMB depreciation period. This prompted many companies in China to look for financial returns overseas, for example, in the United States, with the prospect of RMB losing value relative to overseas assets. Many Chinese companies also looked for technologies that they could acquire through purchase of companies that held key patents or technologies that complement the companies' core business.

DIFFERING INVESTMENT CHARACTERISTICS

Unlike U.S. investments into China, which are primarily "greenfield" investments (investments in its own company operations from the ground up) rather than through M&A, Chinese investments in the U.S. are predominantly through M&A, and greenfield investments are less frequent. Cumulatively since 1990, 93% of all investments from China to the United States were through acquisitions, compared to 29% through acquisitions of U.S. investment entry to China.[5] With many companies in China looking to strengthen their business and competitiveness, acquiring U.S. companies with technology capabilities and patents is an attractive option.

CURRENT REGULATORY TREND

While the increase after 2015 and the dramatic ramp up of deals and financial flows in 2016 was quite dramatic, the decrease was also quite noticeable in 2017 (though nominally much higher than 2016). This is the result of a couple of trends.

1 Restriction by Chinese Government

While the Chinese government encourages companies to invest overseas, the pace at which capital was leaving the country and the industries that many companies were investing in caused alarm. It was evident that many companies were investing overseas in real estate, entertainment, sports clubs, etc., simply for financial return. This trend was not lost to the government.

To address what the government viewed as irrational overseas investments, the "Notice on Further Guiding and Regulating the Directions of Outbound Investment" was issued in August 2017, categorizing the types of investments as Encouraged, Restricted, and Prohibited. This was followed by another issuance of "Measures for the Administration of Outbound Investment by Enterprises" in December 2017, which created additional rules and reporting requirements for all foreign investment deals.[6]

2 CFIUS & FIRRMA

The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee formed in 1975 and led by the Treasury Department. It is tasked with reviewing mergers that could result in control of American business by foreign individuals or companies, and whether or not that would pose a threat to national interest and security.

While CFIUS may be familiar to those in the U.S.-China business community, it recently gained greater visibility due to the fact that it blocked certain transactions due to national security concerns. These included MoneyGram's attempted $1.2 billion sale to China's Ant Financial in January 2018; Chinese private equity firm Canyon Bridge Capital's attempted purchase of Lattice Semiconductor Corp for $1.3 billion; and, in March of this year, the Broadcom-Qualcomm $117 billion deal. Although Broadcom isn't a Chinese company, by blocking the transaction, CFIUS raised awareness of its mission.

The Foreign Investment Risk Review Modernization Act (FIRRMA), a CFIUS reform bill introduced in November 2017, if passed, would give CFIUS greater authority over new categories of transactions, including instances of transfers of "intellectual property and associated support," as well as closing loopholes that allow for evasion of CFIUS review.[7] With the trade tension growing between the United States and China, CFIUS may be taking a more active role in reviewing investments from China in U.S. companies.

4 U.S.-China FDI Project (http://www.us-china-fdi.com)
5 U.S.-China FDI Project (http://www.us-china-fdi.com)
6 SCMP: "China sets new rules on overseas investment for its biggest deal makers"
7 Steptoe & Johnson: "CFIUS Reform: A Primer on the Key Changes Under Consideration"

OUTLOOK AHEAD

While RMB depreciation grabbed attention in 2015 and 2016, the RMB exchange rate relative to the USD has stabilized as of late, nearly returning to pre-August 2015 level. This should reduce some of the Chinese government's concerns about the rate of capital outflow and rapid decrease of foreign exchange reserves apparent in 2016 and parts of 2017.

However, an increase in U.S.-China trade tensions could cause some roadblocks to transactions being completed. Already this year, we've seen some deals blocked by CFIUS. FIRRMA may create additional scrutiny for cross-border deals into the U.S. At the same time, while the RMB has largely stabilized, rising interest rates in the U.S. may put pressure on the RMB to depreciate. If so, Chinese regulators may react if the capital outflow is above acceptable level.

With that said, U.S. companies have steadily invested in China over the last few years, and U.S. investors' interest in the China market should continue.

While investment from China to U.S. was lower in 2017 than in 2016, regulatory restrictions were a significant contributor rather than decreased interest in investment from China to the United States. Chinese investments in the U.S. should continue at a healthy pace and be more strategic, especially in sectors encouraged by the Chinese government. How these various factors would impact the investment flows between U.S. and China remains to be seen.

RECENT CHANGES TO KEY GOVERNMENT AGENCIES: WHAT BUSINESSES SHOULD KNOW

China's government will be going through a restructuring that is unprecedented in recent times. Announced on March 13 on the 13th National People's Congress, the changes are part of China's President Xi Jinping's focus on cracking down on corruption, firming the economy, and protecting the environment. Chinese officials say that the changes will make the government "better-structured, more efficient, and service oriented."

The changes are comprehensive, covering the financial sector, market supervision and taxation, which will affect American businesses operating in China. Other areas such as forestry, agriculture, culture and travel, which are not as relevant to American businesses, are also covered.

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From the perspective of foreign businesses operating in China, these are the changes that businesses should closely observe:

Merged banking and insurance regulators: The long-rumored merger of financial regulators in China officially took place in March as part of the overall government restructuring. The new structure merges banking regulators and insurance regulators to form the China Banking & Insurance Regulatory Commission (CBIRC).

Interestingly, the securities regulator, China Securities Regulatory Commission, previously rumored to be part of the super financial regulatory body, remains independent. The combined oversight of banking and insurance industries will help the regulators better manage cross-industry risks while mitigating risks as a result of "regulatory arbitrage," a term coined to describe the behaviors of firms that classify financial products as either a bank or insurance product to take advantage of regulatory gaps. At the same time, this would provide consistency in regulatory oversight and action given how intertwined banking and insurance industries are in China, addressing the critique that the banking and insurance regulators' actions were not coordinated, creating inconsistency or duplicative oversight.

As part of this change, oversight of financial institutions and insurance companies will continue to grow. From a banking perspective, banks in China will likely be conservative in risk-taking and in creation of new financial products in the foreseeable future. This may affect the offerings that banks can provide to companies, including lending and high-yield deposit services such as wealth management where the yield has been more tempered and with fewer choices available than in the past.

National Market Supervision Administration:
The newly created National Market Supervision Administration will assume the functions of the State Administration of Industry and Commerce (SAIC), the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), and the China Food and Drug Administration (CFDA). It will also take on pricing supervision and antimonopoly law enforcement responsibility from the National Development & Reform Commission, Ministry of Commerce and State Council.

With this change, SAIC, AQSIQ and CFDA will no longer exist. While the effects will continue to unfold, the consolidation of market supervisory bodies means that companies will be interacting with different agencies, potentially affecting the dynamic of such interactions and their government relations programs.

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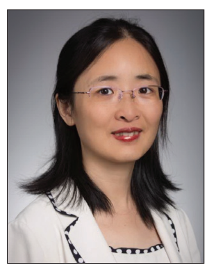
Local tax consolidation:
Currently, there are tax offices at the provincial, city, county and township level. At each level, there are local tax bureaus that collect taxes for the local government in addition to the state tax bureau that collects taxes for the central government.

The local tax bureau reporting to and collecting taxes for the local government creates uneven tax practices as each local tax bureau may implement its own tax policies. This, therefore, creates tax policies that are inconsistent across the country, a common challenge that resonates with companies in China.

A proposal from the 13th National Party People's Congress will merge the bureaus that oversee tax collections below the provincial level and the State Administration of Taxation will regulate the tax system administration with inputs from the local governments.[8] This should allow for better management of tax policies at the state level and more transparency for companies.

8 International Tax Review: Tax and Regulatory Reforms Outlined as National People's Congress Meet

SROs' CONTACT INFORMATION



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