

**Lowy Institute for International Policy
10th Anniversary 'China Changing' Lecture – Beijing
What drives Chinese investment in Australia?**

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Abstract: Mr Michelmore, based on his extensive professional experience, will share his views on the Australia-China investment relationship and the role played by Chinese state-owned enterprises (SOEs) in Australian resource and energy investments

***Check against final delivery**

Introduction

Her Excellency, Frances Adamson, Australian Ambassador to China, distinguished guests, ladies and gentleman.

大家好 (Da jia hao) [hello everyone] and welcome.

Thank you for the warm introduction and it is an honour to be invited to deliver this year's China Changing Lecture on behalf of the Lowy Institute.

It is significant not only as the tenth anniversary lecture, but the first to be delivered in the capital of the People's Republic of China here in Beijing.

My talk today, in many ways, builds on last year's China Changing Lecture delivered in Sydney by Professor David Li from Tsinghua University.

He spoke about China's readiness to take up global economic leadership.

Professor Li's thesis was twofold, first that China is arguably not prepared for this role and second, that China will play the role of a global economic leader – but in its own unique way.

To me, this is China.

A country that dances to its own tune.

A people that may not benchmark themselves explicitly against international standards, but look to their own rich history, beliefs and philosophies as a source of experience and knowledge to find new ways.

China will become recognised as a global economic leader because of the scale of its commerce and its investment.

Chinese leadership will not be simply an extension of the current ideological framework, but will be defined by its actions and impacts on the world stage.

However today, the topic of my address is very specific.

The question of what drives Chinese investment in Australia?

And I am here today speaking from a number of perspectives - as an Australian citizen, as Chair of the Minerals Council of Australia, as Deputy Chair of The International Council on Mining and Metals and as CEO of a Hong

Kong listed, international mining company, MMG Limited, which is majority owned by one of China's largest state-owned enterprises, China Minmetals Corporation.

I will attempt to bring all of those perspectives to bear on today's topic.

I'll describe the environment for Chinese investment in Australia, look at the drivers of investment, explore some of the investment models in action and finally, describe what I see as a potential new era of cooperation between our two countries.

The central theme of my address is that effective relationships, based on mutual trust, are the building blocks of success.

The environment for Chinese–Australian investment

First to the landscape of Chinese–Australian investment.

In just over 40 years, China has become Australia's largest trading partner, largest source of migrants and international students, third largest tourism market, with Mandarin the second most spoken language in Australia.

The relationship is nuanced, deep and diverse. It is much more than just a northerly trade in commodities in return for a steady flow of manufactured goods to the south. Trade in services is also increasing rapidly, with China now Australia's largest market for services exports.

And while Australia's culture has been fundamentally shaped by the last 225 years of European settlement, our recent immigration, cultural and family ties, technology and research partnerships are increasingly Asian.

There is one area where this big story of growing cooperation between Australia and China is not yet represented in Australia's economic profile.

At the end of 2011, the US and UK combined held around 50% of Australia's total stock of investment.

While Chinese direct investment into Australia increased 21% in 2012 to US\$11 billion, China still represents less than 3% of total Australian stock of investment.

And over 90% of the investment in 2012 went into the mining sector, with 56% invested into the resource-rich but sparsely populated state of Western Australia.

Despite popular Australian mythology, less than 2.6% of Chinese investment in 2012 went into agriculture and land.

While Australia maintained its ranking as the most important ultimate destination for Chinese outbound investment since 2006, the total accumulated stock of investment still remains small.

And it is not for a lack of appetite in both countries for greater Chinese foreign investment.

China has a huge reserve of investment funds that cannot all be absorbed internally.

Total foreign investment financial outflows are over US\$70 trillion. China holds significant reserves of currency and financial instruments, but these have been impacted by an appreciating RMB and an expansionary financial environment through the recent rounds of quantitative easing.

It is therefore not surprising, that China is attracted to investment in real assets, resources and businesses to generate returns as an international business owner — foreign direct investment or FDI.

As a sparsely populated but resource-rich economy, Australia's story is a very different but complementary one.

Australia's economy has been built on net inflows of foreign capital and this has sustained an economy and standard of living amongst the highest in the developed world.

Originally from the UK and Europe, followed by the US and then Japan, Australia has been successful in attracting foreign investment. It has pursued trade liberalisation, progressive economic reforms and the reform and opening of its financial markets.

This investment cycle has sustained Australia through economic cycles over the long term.

What drives Chinese direct investment in Australia?

On the face of it, Chinese foreign direct investment in Australia makes a lot of sense.

But when you stand in Chinese shoes, what does Australia look like as an investment destination?

When China announced its "Going Out" policy in 2000, it relaxed previously restrictive controls on outward investment.

What China lacked in recent experience it made up for in access to capital and aggressive valuations and project investment.

In developed economies such as the US, Canada and Australia, China saw stable economies with open and transparent markets, established rule of law, good infrastructure, skills and attractive, well managed businesses.

Chinese investors also saw high costs, restrictive labour practices and conflicting and unclear messages on foreign investment.

In developing countries, most particularly Africa and South America, China saw less stability, higher political and legal risk and infrastructure challenges.

They also saw great opportunity, policy and project flexibility and a demonstrable thirst for investment.

Australia was an early and willing recipient of investment.

Australia was situated in the same region and time zone.

The country had experienced 14 years of uninterrupted growth and was already a major resource provider to China. By investing in the development of new supplies in the resource sector, China hoped to hedge against future increases in commodity prices.

Australia also offered a depth of management experience making it an attractive destination to develop knowledge and understanding of operating abroad.

The China–Australia partnership looked set to be a reciprocal bonanza.

Yet, in 2013, the reality of Chinese investment in Australia is still to meet all the expectations set by that compelling rationale.

And I believe the reasons rest on both sides of this important relationship.

From an Australian perspective, we have embarked on a long cultural and national journey from our European, western origins to a destination embracing our new role in Asia and the Pacific.

Some would argue, for example, that Australia still sits in a geopolitical half-way house. On the one hand, seeking to be an Asian nation but on the other, strengthening security ties and relationship with the United States and its Pacific focus.

Last year's seminal White Paper on Australia in the Asian Century was a timely examination of what Australia could achieve.

An Australia that embraced the Asian Century, would build on its existing strengths and capabilities and would work to deepen our relationships with China at every level.

This is the path on which we embarked, but it is a path along which the whole Australian community has to be encouraged to travel.

And in 2013, the Australian community remains cautious about welcoming further Chinese investment – particularly in agricultural land.

In a 2013 Lowy Institute Poll, 57% of Australian respondents agreed with the statement that the "Australian Government is allowing too much investment from China".

This is no different to the early phases of US and Japanese investment in Australia, where community caution transformed to general acceptance over time.

The difference in China's case, is the challenge of a larger role for SOEs and the foreign investment review process.

However, I firmly believe attitudes to Chinese investment will travel a similar path.

But Australia must be cautious to send clear messages and retain its competitive position for attracting Chinese FDI.

Most recently, Australia has sent mixed messages and 'tarnished' its reputation for policy stability because of mismanagement and miscommunication around the introduction of the Minerals Resource Rent Tax and the Carbon Pricing Mechanism.

Following the recent Australian Federal Election, both these schemes are now again up for review. While the changes should bring certainty and a more rational outcome from the mining sector's perspective, the policy mismanagement has no doubt hurt Australia's comparative investment advantage in resources.

Australia is also seen as increasingly 'expensive'. A high dollar and high cost Australian operating environment, coupled with lengthy approval and permit regimes, is impacting project returns.

Our productivity has been dropping at the time that many developed and developing economies are playing swift catch-up.

China also perceives a foreign review process that is unclear and onerous.

While in practice, the Foreign Investment Review Board process (better known as FIRB), has proved in most cases to be very workable, again, there is a perception problem.

The perception issue relates to ambiguity around review requirements, particularly in relation to what constitutes national interest.

Indeed, China Minmetals Corporation's initial bid for all of OZ Minerals assets is often cited as an example of a foreign bid being rejected on the national interest test.

FIRB blocked the initial proposal based on the grounds that one of the assets, the Prominent Hill mine, was located in close proximity to an Australia Defence facility.

In light of this requirement, China Minmetals revised its proposal to exclude the Prominent Hill mine and successfully acquired the assets that formed MMG in 2009.

It is also useful to understand the role of FIRB in the decision-making process. FIRB's role is an advisory one. It examines proposals for foreign investment into Australia and makes recommendations about whether they are suitable for approval under the Government's policy.

Like any other sovereign nation, the ultimate responsibility for making the decision rests with the executive government, specifically in the Australian case, the Federal Treasurer.

There is nothing unusual in this. While assessing hundreds of applications per year, the instances of FIRB rejecting major foreign investment applications can be counted on one hand over the many years that FIRB has operated.

Finally, project developers and managers in China have also struggled with the practices and institutions that govern doing business in Australia.

The different responsibilities for infrastructure provision, the need to pro-actively manage stakeholder expectations and the role of organised labour and engineering and construction contractors have all lengthened project timelines and impacted on costs.

Some would argue that China was ill-prepared to be a local operator - and in some cases, this was true.

Of course, there have been many successes.

What Australian policy makers must be acutely aware of is that capital is mobile and becoming more so with each passing year.

Every country must look to its competitive advantages and reduce impediments to maintain competitiveness and grow its share of the global 'pie'.

Models for Chinese FDI

While the stock of total Chinese foreign direct investment in Australia remains comparatively small, models for success are emerging.

And, in many ways, China has done it the hard way.

In preference to minority investments or small scale and incremental acquisitions, China has entered this market seeking ownership, majority or controlling stakes.

This is the dominant China investment model and it is deeply rooted in established business philosophy. Whether state-owned or private enterprise, the approach has been similar.

For a nation of 'five-year plans' that prides itself on robust strategy and successful delivery – the model fits.

However, this approach presupposes a strong capability in integration and cross-cultural management. And believe me, as a CEO of an international mining company, these are not easy capabilities to develop.

It also requires a high degree of due diligence in assessment and understanding of assets and business risks – this is challenging to achieve in contested public acquisitions.

There have been many successes. I stand here before you today as the CEO of a vibrant international mining company with significant Australian and international assets, majority owned by one of China's largest state-owned enterprises.

We represent a new and unique model of Chinese investment with the management of cultural diversity and local participation at its core.

As a chief executive who has worked with many boards and shareholder structures across cultures, I can say that at MMG, we are blessed.

We share a robust debate on strategy, an international vision for growth and the support of an investor with a long-term investment horizon.

The 'China Minmetals Model' is driving a new and more diverse investment approach.

Success in acquisitions is being redefined to mean much more than simple ownership control.

Generating value is now firmly at the heart of the 'going out' approach.

The tenets of strong due diligence, good corporate governance, appropriate risk weighting and return on invested capital are now firmly part of the China lexicon.

When MMG made its bid for listed company Equinox Minerals in 2011, it had fairly priced the asset. When Canada's Barrick Gold substantially outbid the offer, we could not see value and we walked away.

In 2012, our investment in Anvil Mining was well priced and successful. We now have an operating asset in the highly prospective Congo/Zambian copper belt.

These investment decisions were both successful, both preserved and enhanced value and both were funded, supported and made possible by Chinese government and policy bank support.

This is the emerging China model.

Rethinking the SOE

I'd now like to spend a few minutes on a question that goes to the core of that model – the role of state-owned enterprises.

In a 2013 OECD paper on state-owned enterprises, China stood out as the nation with the highest presence of SOEs.

China was home to 117 of the Forbes 2000 largest companies of which 60% were SOEs.

When you look at the BRIICS economies of Brazil, Russia, India, Indonesia and South Africa, that same proportion of state-owned enterprises in those economies is estimated at 47%.

Indeed, when I was growing up in Australia, SOEs were a large and distinctive part of the Australian landscape – in sectors such as airlines, banking, telecommunications, energy and infrastructure.

What is clearly evident is that SOEs play a critical role in nation building.

And, while the proportion of the Chinese economy represented by SOEs is high, the scope and speed of nation building occurring in China is unprecedented. Additionally, the contribution of SOEs to the Chinese economy is in long-term decline as private business expands.

As an international community, it is time to stop judging and start understanding the challenges and opportunities presented by SOEs – and more broadly, Sovereign Wealth Funds – participation in international investment, trade and commerce.

That is why MMG is partnering with the Australian National University, the Department of Treasury and Resources, Energy and Tourism in Australia; Peking University and CASS here in China; to look at the transforming role of Chinese enterprise, SOEs and private corporations in global business.

A new era of cooperation

Our two nations have everything to gain from adapting and developing this investment relationship. It is already the largest investment relationship China has with any single country — bigger than that with the United States, all the European countries or countries in the developing world.

So Australia is clearly open for business with Chinese investors – despite the challenges of managing Chinese investment in Australia properly.

I'd like to conclude with some observations on what I believe could, and should, define the China–Australia investment relationship over the next ten years.

First, both nations must take an active and partnership role in ensuring that the case for Chinese–Australian investment is made. Both nations must do better to build 'cultural capability' and realise we share a joint obligation to win and build public support for the economic benefits which flow.

Second, we must create the policy environment to facilitate growth. A far-sighted free trade agreement between Australia and China would present a critical foundation for continuing partnership. There is much to be gained and it is time for protracted talks to lead to real action.

Third, we must lower the barriers to investment. Current approval processes on both sides are cumbersome and fragmented, involving multiple agencies, at low levels of investment and with unclear expectations.

While we must acknowledge there will be a legitimate level of community concern about foreign investment in any country and in Australia too, there is growing recognition of foreign investment's role in supporting Australia's growth.

The Business Council of Australia, of which I am a member, has called for a rethink about our foreign investment review policies, while balancing the need to provide the public with confidence that foreign investments are in the national interest.

In an economy-wide action plan released in late July, the BCA called for a higher review threshold for all private foreign investment into Australia, and also recommended revisiting the policy for foreign investments by SOEs.

It is clear we need more discussion about the role of foreign investment in Australia, and how we treat foreign government investment.

Fourth, we must remember that Government-owned business enterprises are by no means unique to China.

China and Chinese companies must clearly explain the evolving role of state-owned enterprises in international investment and acquisition. Misinformation abounds.

Indeed, in this area I feel a deep personal responsibility to better communicate the competitive and commercial reality of China SOEs.

The search for stereotypes – and China is saddled with more than its fair share – hides the emerging and complex commercial reality of Australia and China.

In both countries, we are in a period of tectonic change. We are facing huge economic and business challenges.

I believe that every participant in this important exchange should maintain an open mind to business models – learn how to stand in the shoes of their counterparts and see the world through different eyes.

Through my regular interactions with China Minmetals Corporation, I am constantly reminded that we face the same business challenges, but we often find solutions in different places.

There is no 'one China' as there is no 'one Australia'.

We are diverse, exciting economies full of different attitudes, people and business models.

And on that basis, we have every chance of building shared wealth and prosperity.

And I'll share with you my own business mantra – as it is as relevant to the bilateral relationship as it is to the corporate boardroom.

Relationships are built on trust. Trust builds transparency. Transparency builds solutions. And solutions lead to outcomes.

Thank you.