Global investment strategies for China's financial institutions

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Chinese financial institutions are flush with money at an opportune moment. They should resist the urge to build empires and instead focus on advancing their skills and global experience.

Chinese financial institutions are shopping the globe. After years of attracting investment from companies abroad—and trading access to Chinese markets for the foreigners' practical expertise—China's banks and insurers are flush with cash and looking abroad for their own investment opportunities. Beyond financial returns, they hope to use these investments to hone their skills in areas such as risk management. But our experience and analysis show that gaining solid benefits will require careful preparation and a clear understanding of what the Chinese can expect in return for what they bring to the table.

Buying a minority stake in a foreign bank or insurer is the most common route for Chinese financial institutions looking to test global waters—much more so than complete acquisitions or organic growth. But acquiring a relatively small stake in a foreign company is rarely a transformational event. And while Chinese investors can garner sought-after capabilities from these deals, much as foreign banks used investments in China to gain knowledge of the market there, they must be thoughtful and strategic in their approach.

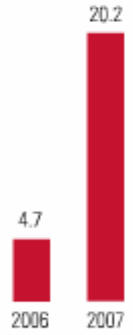
The shift from investment target to investor came suddenly and many Chinese institutions are not fully prepared for their new role. Not long ago, state-owned Chinese banks were saddled with nonperforming loans, which effectively blocked their global aspirations. But the level of bad loans has dropped rapidly—from about 30 percent of total loans in 2001 to 7 percent in 2007, according to official figures—and strategic investors such as Bank of America, HSBC, and the Royal Bank of Scotland (RBS) have helped state-owned banks to improve their operations. Following recent IPOs, three of China's four largest banks now rank among the global top ten in their industry by market capitalization. The insurance industry has undergone a similar metamorphosis: China's two largest insurers are now in the global top ten.

Those IPOs gave Chinese financial institutions the cash needed to shop the world for opportunities (Exhibit 1). Among recent deals, Ping An invested more than $6.5 billion to buy a 5 percent stake in the Belgian financial conglomerate Fortis (becoming its largest individual investor) and half of Fortis Investments, its asset-management subsidiary. This trend is likely to continue: Chinese financial institutions think the global credit crisis is opening investment opportunities that didn't exist before, and purchases of such relatively small stakes, unlike some other acquisitions, haven't raised strong political concerns abroad.

EXHIBIT 1

Shopping abroad

International acquisitions or investments by Chinese financial institutions, $ billion



Notable deals in 2006–07

Investors: Chinese financial institutions	Targets: Global financial institutions	Transaction
Industrial and Commercial Bank of China	The Standard Bank of South Africa	$5.49 billion for 20% share
China Investment (CIC)	Morgan Stanley	$5 billion for 9.9% share
Bank of China	Singapore Aircraft Leasing	$3.4 billion for 100%
Ping An	Fortis	$3.2 billion for 4.99% share, plus $3.3 billion for half of asset-management unit
China Development Bank	Barclays	$3 billion for 3.1% share
China Construction Bank	Bank of America (Asia) in Hong Kong	$1.25 billion for 100%

Source: Annual reports; McKinsey analysis

Beyond financial returns, Chinese banks and insurers hope to use such investments to gain expertise, particularly in risk management, IT, product development, and customer service. These are among the skills they sought when partnering with foreign banks that came to China. But as investors, Chinese institutions can be more proactive in selecting their partners and are better positioned to extract value, since, ultimately, it's their decision whether to invest or divest. They can also use their investments to gain exposure to foreign markets through joint ventures and other forms of collaboration. Among the world's largest institutions, Chinese banks and insurers are the only ones that have built their positions predominantly within their home markets.

Our experience working with many of the major institutions in China, however, shows that extracting maximum benefits requires a shift in mentality. Known to have deep pockets, Chinese institutions are presented with many investment possibilities and accept or reject these overtures on a case-by-case basis. This more opportunistic, deal-based approach to globalization should be replaced with a more strategic one, which would require that Chinese managers consider how many deals they want to complete in the medium term, what type, and in what markets. They should also think about how deals can add value not only in a portfolio but also independently. With a better game plan, they can weigh opportunities against their longer-term goals and become much less reactive.

Further, our work demonstrates that Chinese institutions need a clearer idea of the benefits they can gain from investments. They usually don't negotiate in detail what value beyond portfolio returns they expect for their money, although agreements in principle noting broad areas of potential cooperation are fairly common. Chinese banks should not forget that they are considered stable, long-term investors—preferable to, say, hedge funds, which are seen as more disruptive—and foreign banks are willing to work with them to retain their investment. Moreover, a minority stake will give the Chinese investor one or two seats on the board of the target, providing significant access to its inner workings.

Chinese financial institutions should be more disciplined about how to use this access, particularly with targets in more mature markets. Opportunities to extract expertise can take the following guises:

Talent. Chinese financial institutions could use their exposure to overseas markets to spot recruits to fill key positions at home, especially in technical areas such as risk management

and IT. This would require many institutions to be more open to hiring outside talent, including foreign talent, than they are today.

Capability transfers. Chinese financial institutions can use the capabilities of their foreign partners to upgrade their own, either through projects or joint ventures. As the investor, the Chinese partner may have greater leverage to tap into capabilities in new and sophisticated business areas such as consumer finance and structured finance. In addition, investments abroad open the possibility that Chinese managers could work temporarily at foreign companies or that foreigners could rotate into the Chinese company. Both would foster the transfer of skills.

International management. By working together with foreign partners in overseas markets on business opportunities such as trade finance and by serving Chinese corporations overseas, Chinese financial institutions could build institutional experience in international management. These baby steps, if managed effectively, will help Chinese companies realize their ambition to become global institutions.

Chinese financial institutions with global aspirations are taking the first steps of a very long journey. Their valuation advantage, combined with turmoil in the global financial markets, offers a great window of opportunity to invest outside China. To maintain the stamina to complete the passage, they must resist the urge to build empires from a random series of investments. Instead, they should wisely use the opportunity presented by their own financial resources and a global buyers' market to make themselves stronger and more likely to succeed away from home.

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