LAC Investment in China:

A New Chapter in Latin America and the Caribbean-China Relations

Integration and Trade Sector
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Introduction

In a 2012 report, *Pathways to China: The Story of Latin American Firms in the Chinese Market*, the IDB took a first step towards better understanding the dimensions and drivers of investment from Latin America and the Caribbean (LAC) in China. That work analyzed a group of firms with operations in China and found that establishing a direct presence in the Chinese market can yield major dividends for firms.

This current study updates and expands on those findings by considering a larger sample of LAC firms and analyzing in more detail how their strategies follow distinct patterns in different sectors. In doing so, we shed new light on how firms in the region have come to establish themselves in China and draw policy recommendations for supporting private sector initiatives to penetrate the Chinese market.

Why study the presence of LAC firms in China?

While the growth of trade between China and Latin America and the Caribbean over the past decade has been nothing short of remarkable, its distinct commodities-for-manufactures pattern has occasioned concerns in the region over specialization, over-reliance on low value-added commodity exports, and deindustrialization in the face of Chinese competition.

As a result, a major preoccupation of policymakers and academics in LAC has been how to diversify the region's commercial ties with China. One channel to accomplish this objective is foreign direct investment (FDI). Most of the discussion of FDI between LAC and China has focused on the potential for Chinese investment in the region in areas such as energy, transportation infrastructure, and manufacturing, although the actual results to date have fallen short of many LAC countries' expectations.

Less attention has been given to LAC investments in China. However, firms and policymakers in the region would be remiss to overlook this facet of LAC-China economic relations for at least two reasons. First, China has over the past decade established itself as a manufacturing powerhouse at the center of the global value chains that increasingly determine the pattern of production and trade in many industries. For firms in the region, setting up operations in China can be a potent strategy to overcome the disadvantages inherent in the region's distance from China and integrate into global value chains.

A second reason to consider LAC FDI in China is that country's vast and growing importance as a consumer market. Due to a combination of demographic and economic shifts, China is expected to witness a boom in consumption in the coming decades, which translates into a major market opportunity for LAC firms in sectors such as food and beverages, consumer electronics, and household goods, among others. A direct presence in China can help LAC firms expand their reach in the market, establish a brand identity, and meet the demands of Chinese consumers.

This report therefore takes one step further in trying to fill a gap in our understanding of a potentially important avenue for achieving a more balanced LAC-China economic relationship. It proceeds as follows. Part I gives a brief macro overview of LAC-China trade and investment. The following section analyzes the presence of Latin American firms in China using an original dataset of 98 firms from the region and presents a typology of internationalization strategies employed. To conclude, Part III offers policy recommendations for supporting the private sector's efforts to enter the Chinese market, an area of increasing interest among LAC governments.

The Context: LAC's Trade and Investment with China

Part 1

Trade between LAC and China took off decisively in 2003 and continues to grow dynamically, experiencing only a minor dip during the 2009 global crisis. Total trade reached US$ 292 billion in 2013, increasing nearly ten-fold from its level in 2003. As Figure 1 shows, however, beginning in 2011 this growth has been driven by LAC imports from China, whereas the region's exports have grown at a slower rate than in any other three-year period since 2000. The result has been a widening trade deficit for LAC, due mainly to subdued Chinese demand for the commodities that make up the bulk of the region's exports to China.

Notwithstanding this recent deceleration, LAC exports to China have still outpaced the region's exports to the rest of the world since 2009, as Figure 2 shows, despite slower growth in China and a significant softening of global commodity prices.

Of course, the rise of LAC-China trade has meant different things for different countries, given the distribution of factor endowments in the region. While natural resource-rich economies in South America have reaped the benefits of strong demand for their main export products, Mexico and Central America have largely borne the brunt of competition from Chinese

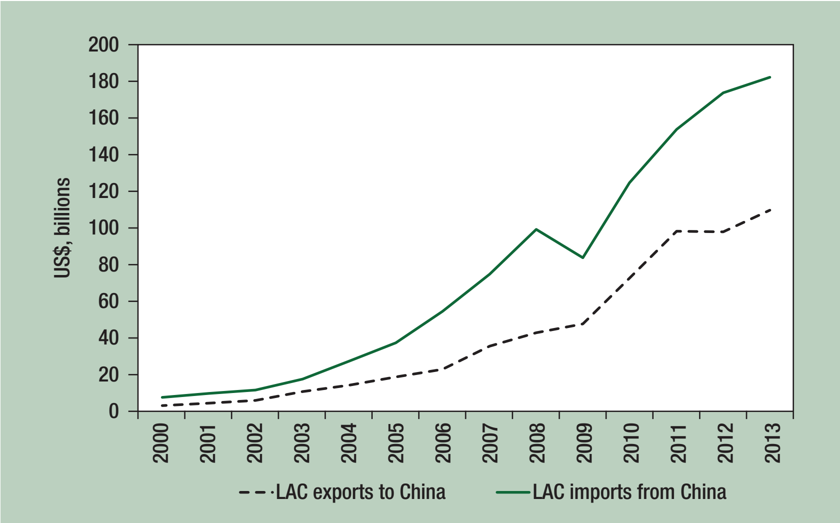
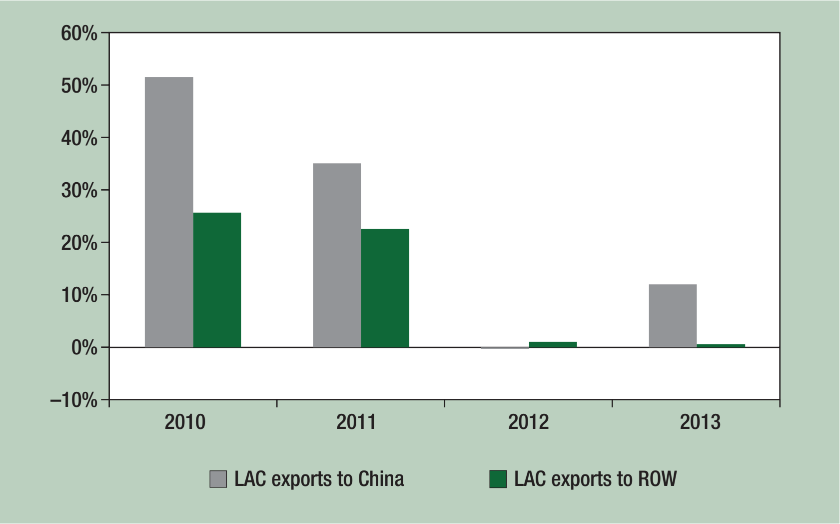


FIGURE 1/
LAC trade with China, 2000–2013

Source: IMF Direction of Trade Statistics.

FIGURE 2/
LAC export growth to China and rest of world

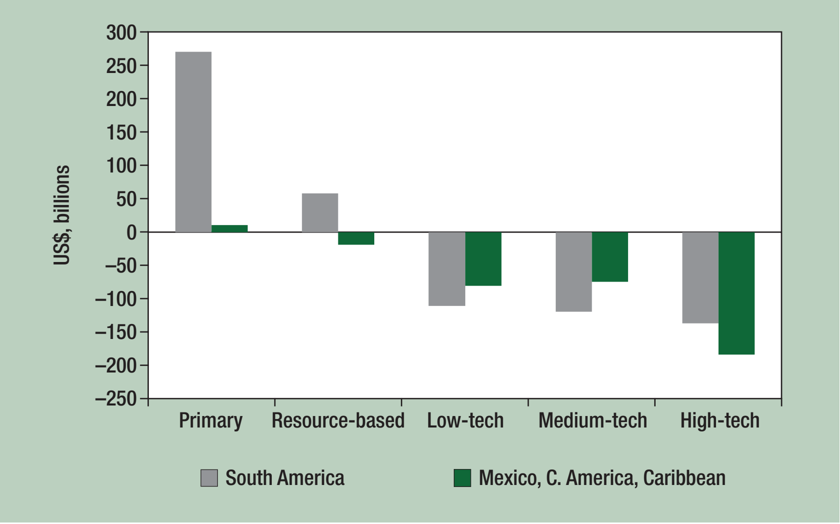


Source: IMF Direction of Trade Statistics.

manufacturing without the commodity-boom dividend. Figure 3 highlights the sub-regional and product composition dynamics of LAC's trade flows with China.

As the foregoing discussion suggests, the region's exports to China continue to be highly concentrated in the primary sector, while China's exports to the region are mostly manufacturing goods, especially ones

FIGURE 3/
Accumulated trade balances with China, 2000–2012



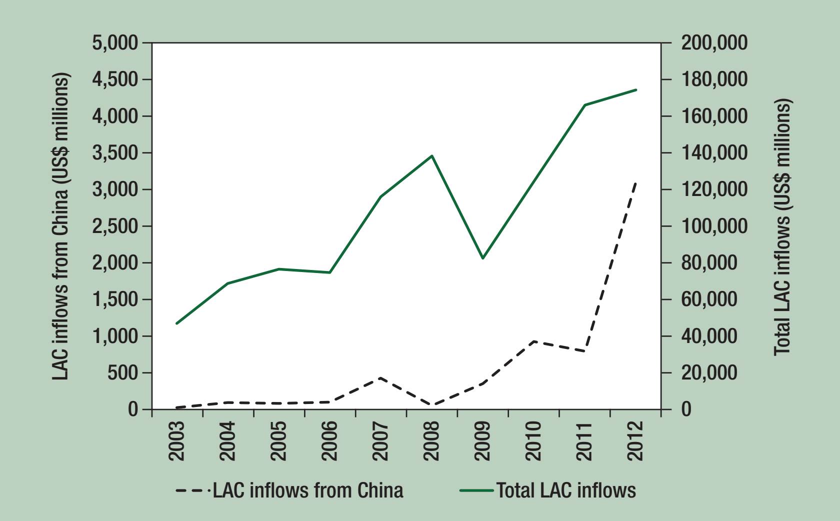
Source: UN Comtrade.

with high technological content. Foreign direct investment has, to date, done little to change the overall picture of LAC-China economic relations. Despite hopes that Chinese capital would boost infrastructure, energy, and manufacturing sectors in the region, official statistics show that FDI from China has yet to materialize in significant quantities. Instead, the bulk of Chinese financial flows to the region seems to have taken the form of "loans-for-oil" deals.[1] As Figure 4 shows, even with a jump in 2012, Chinese FDI inflows to LAC remain quite small and as yet do not constitute a major source of investment for the region. Likewise, the available evidence suggests that Chinese investments are overwhelmingly directed to the agriculture, mining, and energy sectors in LAC (see Figure 5).

The fact that meaningful trade diversification has not occurred (and FDI from China has only served to reinforce the overarching pattern of trade) reflects underlying fundamentals—LAC's abundance in natural resources and China's enormous and (relatively) low-cost labor force. Given these features of the two economies, the overall commodities-for-manufacturing exchange is unlikely to be reversed any time soon. However, China's economy should experience several structural changes, some of which are already underway, which could add new dimensions to its commercial relations with Latin America and the Caribbean going forward.

One important shift, which has been the subject of much speculation in the region, is to structurally slower growth. Recent projections suggest that

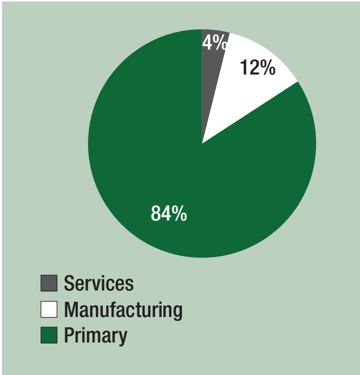
FIGURE 4/
LAC FDI inflows from China and the world



Sources: MOFCOM and UNCTAD.

[1] Gallagher, et al. "The New Banks in Town: Chinese Finance in Latin America" 2012.

FIGURE 5/
Share of Chinese FDI in LAC FDI by sector, 2005–2014*



Source: Heritage Foundation China Investment Tracker.
*Through June, 2014; these figures are based on announced investments only, but they should give an accurate reflection of the sector composition of Chinese investments in LAC.

the Chinese economy will see growth rates of around 6–7 percent per year in the medium term under a positive scenario, or as low as 4–5 percent in a less optimistic scenario.[2] The expectation of slower growth has spawned concerns that demand and prices for the region's main export products will experience a prolonged downturn. Secondly, as China competes less on low wages and more on productivity, its manufacturers are moving up the value chain, producing and exporting increasingly more technologically advanced goods that presumably compete with a new set of sectors in LAC.

A final change, and the one most relevant to diversifying LAC's exports, is the economy's anticipated rebalancing towards consumption instead of investment as the engine of growth. The combination of higher wages and an anticipated liberalization of foreign exchange and interest rates would increase the purchasing power of Chinese consumers, especially over imported goods. This shift, combined with demographic trends described in more detail in Section III, should generate strong growth in demand for products such as packaged foods and meat products, among others, that LAC firms could be well-positioned to meet. This trend thus offers an opportunity for the region's economies to add value to their export portfolios to China, selling hamburger patties instead of unprocessed beef and baked goods instead of grains, for example.

Of course, seizing this opportunity presents major challenges, not least because of intense competition in the Chinese market and the region's inherent disadvantages due to distance and cultural differences. One strategy to overcome these barriers is for firms in the region to establish a direct presence in China—either through foreign direct investment, which is traditionally conceived as the ownership and control over productive plants in a foreign country, or through commercial offices and distribution and marketing networks, which can help firms increase the visibility and reach of their products in the Chinese market. While LAC investment in China has been relatively small to date, a number of firms from the region have

[2] "China 2030: Building a Modern, Harmonious, and Creative Society," World Bank and the Development Research Center of the State Council of the P.R. China, 2013.

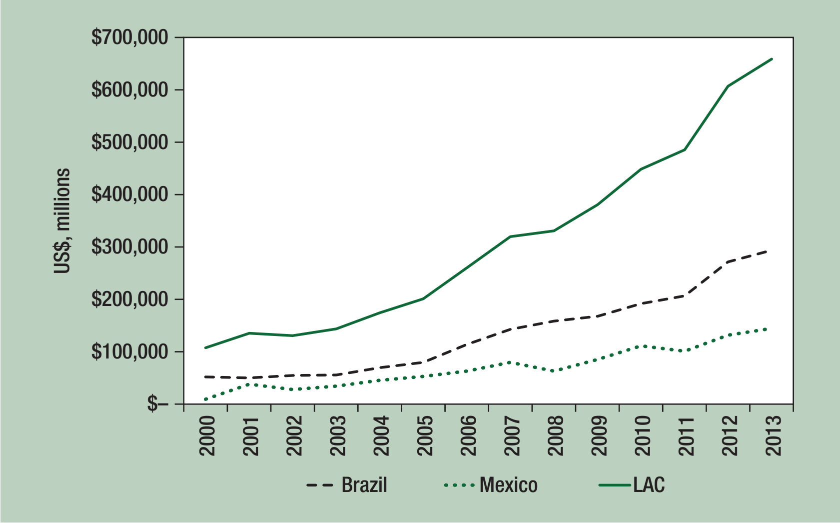
established a considerable presence in the Chinese market thanks to their operations in the country.

LAC investment in China—What's happened so far?

On the whole, outward foreign direct investment from Latin America and the Caribbean has grown strongly over the past decade. Healthy domestic economies, relatively easy access to finance, and policies in several countries to facilitate mergers and acquisitions combined to encourage foreign expansion by LAC firms.[3] In some cases, especially that of Brazil, the appreciation of domestic currencies provided further impetus for foreign operations, making them relatively cheaper than production at home. Firms from Brazil and Mexico led the way, as Figure 6 shows. Those countries increased their stock of outward FDI from US$ 52 billion to 293 billion and from US$ 8 billion to 144 billion respectively between 2000 and 2013.

This increase in outward FDI has primarily been directed towards neighboring countries, taking advantage of strong regional growth and the natural tendency for companies to target more familiar markets. In recent years, firms in the region have also increased direct investments in Europe, presumably to acquire underpriced assets in the wake of the continent's debt crisis.[4] It is, however, difficult to determine precisely the geographic

FIGURE 6/
LAC outward FDI stock



Source: UNCTAD FDI Statistics.

[3] CEPAL, "Foreign Direct Investment in Latin America and the Caribbean 2012," 2013.

[4] Ibid

destination of LAC outward FDI, because several countries in the region do not publish outward FDI figures by destination country.

As a result, a better (albeit still incomplete) indication of the regional orientation of LAC's outward FDI can be gleaned from the foreign presence of major *multi-Latinas.* Data on Brazil, for example, show that among 76 major overseas investments by Brazilian multinationals, 46 were destined for the Americas, while none went to China.[5] The official Central Bank data confirm the meager participation of outward FDI to China, which made up less than 0.1% of the total from 2007 to 2012.[6]

In Mexico, firm-level research shows that a full 70% of the foreign affiliates of Mexico's 20 largest multinationals were located in the Americas (including the United States). Meanwhile, fewer than 5% correspond to East Asia. Many of the country's major MNEs (around half) can more accurately be thought of as "regional players" with no presence to date outside of the Americas, in contrast to "global players" with a clear presence in several continents.[7]

In the Chilean case, a review of major investments by the country's 20 largest MNEs between 2007 and 2009 reveals that only two out of a total of 53 deals, both by shipping company Empresas Naveiras S.A. involved FDI in China.[8] Among the top Argentine multinationals, 7% of firms' foreign affiliates are in the Asia-Pacific region, but even among this small share, Southeast Asia is represented as strongly as China.[9] Finally, Colombia, despite experiencing a 20-fold increase in outward FDI in the decade starting in 2000, counted no foreign affiliates in Asia among its largest MNEs in 2010.[10] Colombia's Central Bank reports that total outward investment in China totaled only 1.2 million since 2000.

The focus on nearby markets is not surprising. Firms undertaking FDI usually look first to neighboring countries where they can expect to enjoy the advantages of better market knowledge, geographic proximity, and cultural affinity. Only after acquiring a baseline of experience operating abroad do most firms look to extra-regional or culturally disparate markets. In line with these general trends, LAC firms investing directly in China remain the exception rather than the rule. Table 1 presents official Chinese data on inward FDI from LAC collected by the Ministry of Commerce (MOFCOM).

These figures show FDI flows from LAC countries into China follow no clear trend over the past decade, represent modest sums, and account for a very small portion of the region's total outward FDI (0.25% for the period 2002–2012). They are also mainly driven by Brazil, which accounts for 46%

[5] Campanario, Stal, and da Silva, "Outward FDI from Brazil and its policy context, 2012" Vale Columbia Center on Sustainable International Investment, 2012.

[6] Based on data from the Central Bank of Brazil.

[7] Basave and Gutiérrez-Haces, "Survey of Mexican multinationals, 2012" Vale Columbia Center on Sustainable International Investment, 2012.

[8] Razo and Calderón, "Chile's outward FDI and its policy context," Vale Columbia Center on Sustainable International Investment, 2010.

[9] Nofal, Beatriz, "Argentine multinationals remain industrially diversified and regionally focused," Vale Columbia Center on Sustainable International Investment, 2011.

[10] Ana-María Poveda, "Outward FDI from Colombia and its policy context," Vale Columbia Center on Sustainable International Investment, 2011.

TABLE 1/
LAC's outward FDI flows in China, selected countries 2002–2012, US$ millions

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002–2012
Argentina	10	19	31	11	7	11	13	12	1	7	8	131
Bolivia	6	3	1	2	3	1	1	3	5	2	0	27
Brazil	15	17	31	25	56	32	39	52	57	43	58	424
Chile	12	8	3	6	6	7	5	3	1	17	21	89
Colombia	0	0	0	0	0	0	0	0	0	0	0	1
Costa Rica	6	0	0	1	0	0	0	0	0	0	0	7
Dominican Rep.	7	3	1	2	2	2	0	0	1	0	0	18
Ecuador	0	1	0	1	0	1	0	0	2	0	0	6
Honduras	1	1	5	3	1	2	2	0	3	3	0	21
Jamaica	0	0	4	1	1	0	0	1	0	0	0	7
Mexico	7	6	21	7	12	6	4	1	15	5	15	99
Paraguay	1	1	8	1	2	1	2	3	2	0	20	41
Peru	1	1	4	3	1	5	3	0	0	1	0	20
Uruguay	0	0	0	1	0	0	0	2	1	1	1	6
Venezuela	2	1	0	3	1	2	2	2	4	2	1	20
LAC*	**70**	**60**	**111**	**67**	**91**	**70**	**71**	**82**	**93**	**80**	**124**	**917**

Sources: MOFCOM.
*Not including tax havens.

of the region's FDI to China since 2002. Even in the Brazilian case, outward FDI to China has followed an uneven trajectory since 2006.

Given the limitations of official data, research on LAC investment in China has increasingly focused on firm-level analysis. At the same time, the low aggregate numbers mean that a small number of firms are the prime actors—making a focus on their strategies and experiences natural. In fact, a number of individual firms have had considerable success in penetrating the Chinese market. One subset of such firms consists of dominant players in regional markets with recognizable global brands. These firms, which include Grupo Bimbo from Mexico, Embraer from Brazil, and Tenaris from Argentina have leveraged their considerable brand equity to expand into the Chinese market.

In the case of firms in the consumer goods sectors, it has often been necessary for LAC firms to modify their products to suit the particular tastes of Chinese consumers. This class of firms corresponds to market-seeking investments in Dunning's classic typology of FDI.[11] By contrast, a

[11] See Pathways to China, Inter-American Development Bank 2012, for a discussion of Dunning and other major theoretical works on FDI.

second group of firms has pursued a strategy driven by efficiency concerns, investing in China in order to participate in global value chains led by blue-chip multinationals. In a similar vein, a large share of Brazilian firms use their presence in China for procurement and sourcing purposes—that is, to facilitate and exercise control over *imports* from China, rather than sell to Chinese consumers or firms.[12]

Despite the region's comparative advantage in primary sectors (especially in the realm of trade with China), the natural resource sector accounts for the minority of LAC investors in China. Service sector firms make up the largest contingent of the 57 Brazilian firms with a presence in China identified by the China-Brazil Business Council,[13] while the IDB's 2012 study of 85 LAC firms with a presence in China found more than half were manufacturing firms.[14]

This brief overview of LAC's outward FDI suggests that while the presence of the region's firms in China is small, there is considerable potential for growth. One reason is that LAC investments are starting from a very low baseline. More substantively, we see that outward FDI from the region has experienced a mini-boom since around 2004, with the majority of the flows destined for neighboring countries. This outward investment should allow firms to acquire the experiences and capabilities— how to operate in distinct regulatory environments, adapt to unfamiliar business cultures, and market products to customers and clients with different preferences—that facilitate expansion into new foreign markets.

On the other hand, the Chinese market presents a distinct set of challenges, including geographic distance, cultural differences, distinct consumer tastes, and a complex business environment. These factors are often compounded by a lack of reliable information on potential counterparts and poor understanding of the policies and strategic aims of the Chinese government surrounding foreign investment.

In addition, research on LAC firms' experiences in China and the challenges they face remains sparse. A more systematic account of firm-level strategies—including motivations for investing, mode of market entry, and activities firms chose to locate in China—is necessary to better understand how the region can take full advantage of the opportunities presented by China. The next section of this report takes a step in that direction through an empirical analysis of 98 LAC firms with operations in China.

[12] Frischtak and Soares, "Brazilian Companies in China: Presence and Experience," Brazil-China Business Council, 2012.

[13] *Ibid.*

[14] "Pathways to China".

LAC Firms in China: Firm Strategies and Typologies

Part 2

A basic challenge in analyzing LAC firms with a direct presence in China is the lack of systematic data on the subject. Faced with this gap, we identified a sample of 98 LAC firms with a direct presence in China, either through wholly or jointly owned production facilities; distribution units; offices to provide services directly to clients; or representative and commercial offices for sales, marketing, or post-sale support.[15] This sample does not claim comprehensiveness; it should, however, provide a representative portrait of the activities and characteristics of LAC firms operating in China.

Summary of the sample

Out of the 98 LAC firms in our sample, manufacturing is the most-represented sector, followed by services and the primary sector. The manufacturers comprise a diverse group of firms representing industries from heavy machinery to food production, consumer goods, and chemicals (see Table 2). In terms of country of origin, Brazil and Chile are home to the largest number of firms in the sample, with 32 and 30 respectively. Twenty-one firms are Mexican, and eleven are Argentine; these four countries account for 96 percent of the sample.

Unfortunately, the available data allow only for a rough estimate of the size of LAC firms' investments in China. Still, they suggest that while manufacturing firms make up most of the population of LAC firms in China, investment dollars are in fact distributed more evenly across sectors. Based on announced Greenfield investments between 2003 and 2012, the primary sector accounted for 34.5 percent of LAC's announced investments in China, while manufacturing made up 35.5 percent and services 30 percent.[16]

Within the manufacturing category, the largest investors came from the transportation equipment, food and beverage, and steel industries. It is important to stress that these figures reflect announced investments, which often vary considerably from official FDI data. Still, they do suggest that a diverse range of business sectors are represented in LAC's FDI in China, even if the overall amounts remain small.

[15] To generate the sample, we reviewed existing data on major exporters to China, lists of the largest and most global Latin American firms, previous academic research on LAC multinationals, and the daily business press. In each case, we independently confirmed whether the firm had investments in China and gathered additional contextual information such as its year of entry, entry mode, type of presence, and core activities, where possible.

[16] FDIntelligence, accessed October, 2013.

TABLE 2/
Overview of sample

Total firms	**98**
Home Country	
Brazil	32
Chile	30
Mexico	21
Argentina	11
Peru	2
Venezuela	2
Sector	
Manufacturing firms	55
Service sector firms	28
Primary sector firms	15
Largest sub-sectors	
Metals and machinery	23
Food and beverages	15
Chemicals and pharmaceuticals	9
Entry mode	
Greenfield	56
Acquisition	19
Joint Venture	20

Activities of LAC firms in China

Depending on their strategy and the nature of their industry, firms can locate a variety of business activities in a foreign country. Among our sample of LAC firms, a large number carry out sales, marketing, or support activities in China. This type of presence, usually via a commercial or representative office and requiring minimal investment and a small workforce, can give firms a better understanding of their clients and the target market, allowing them to provide tailored products, keep abreast of market trends, and find new customers. Thirty-one percent of the investments made by firms in the sample correspond to the establishment of a sales, marketing, and support presence (see Figure 7).

Production—along with direct service provision, the equivalent for service sector firms—represents the most common activity of firms in the sample. Production in a foreign country can help firms capture market share and realize efficiency gains associated with cheaper inputs, insertion in local value chains, and vertical integration. Nearly half (48 percent) of investments by

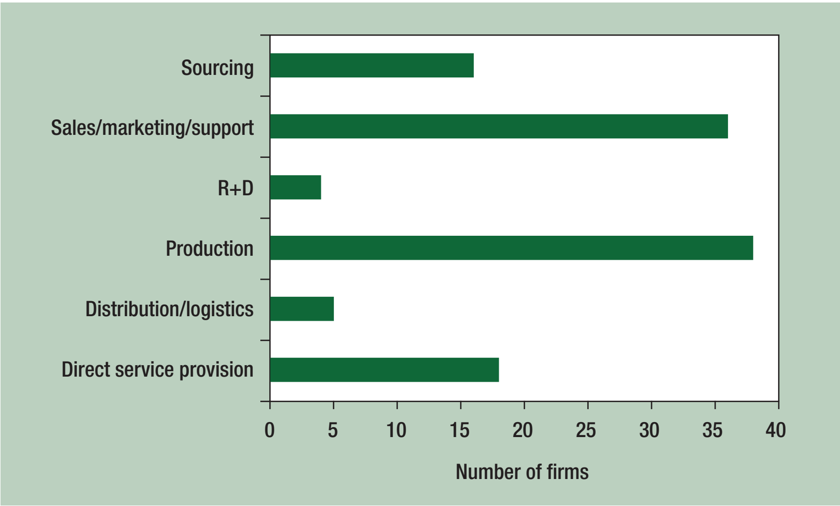


FIGURE 7/
Activities of LAC firms in China

Source: Authors' calculation based on sample of firms.

firms in the sample aim to establish a production or service-provision facility, such as a restaurant franchise, bank branch, or office for business services.

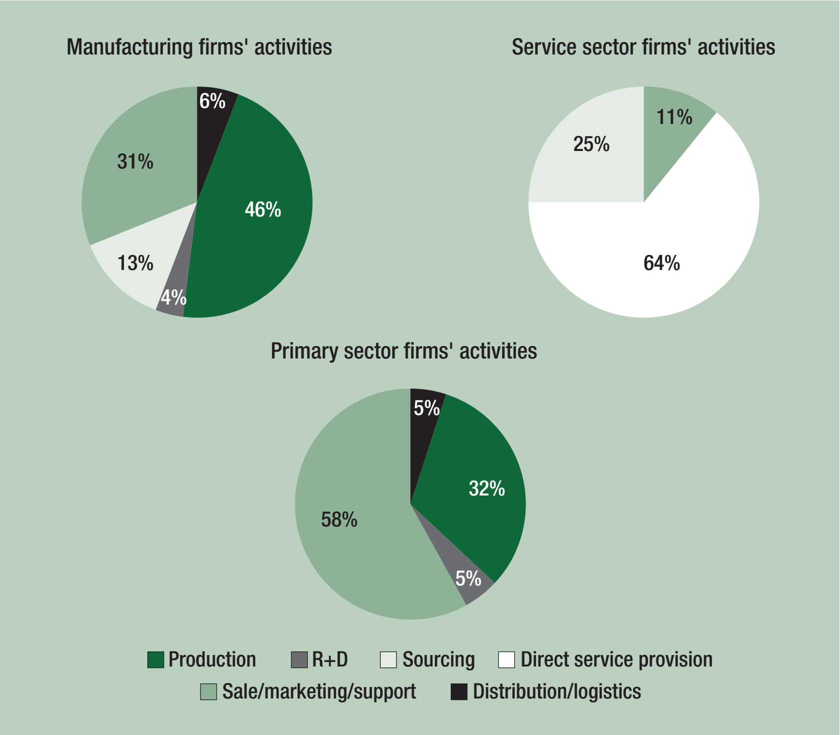
Finally, a small but not insignificant number of firms have invested in distribution capacity (such as warehouses or partnerships with domestic distributors), in research and development, or in sourcing offices. The last of these represents a strategy to exercise quality control of imports from China, which firms often use as inputs in their production processes.

However, the pattern of firms' activities is not uniform across sectors. The most clear distinction can be found in the case of service sector firms, of which nearly two-thirds are involved in direct service provision—that is, they provide their service, whether IT/software solutions, hospitality, or financial services—directly through a subsidiary in China. The flexible nature of services, which tend to require less capital investment compared to manufacturing, facilitates the establishment of this type of operation abroad.

Manufacturing firms, as Figure 8 shows, have invested mostly in production or sales/marketing/support functions, with a small portion of firms investing in distribution, sourcing, and R+D. In the primary sector, too, we see a balance of production (namely refining or processing of natural resources) and sales/marketing/support, with a larger share of the latter.

This distinction reflects different strategies among primary sector firms. One group of firms follows an export-driven model with sales and commercial representation offices abroad serving to coordinate and manage

FIGURE 8/
Firms' activities by sector



Source: Authors' calculation based on sample of firms.

export sales in the Chinese market. This has been the approach of Codelco, for example, the Chilean state-owned enterprise that holds the world's largest copper reserves, and Brazilian oil company Petrobras.

Another group of primary sector firms has invested directly in mineral assets in China, acquiring exploration rights, or establishing downstream refining operations in the country. These operations have in nearly all cases involved joint partnerships with local firms, with the LAC investor usually holding a minority stake (often in order to comply with the Chinese government's regulations on foreign investment). This strategy allows firms to respond more quickly and with greater precision to the demands of Chinese clients and develop a global footprint to take advantage of changing market conditions.

Differences among manufacturing firms

It is also instructive to look at the differences among manufacturing firms, a diverse category whose products range from auto engines to confectionary

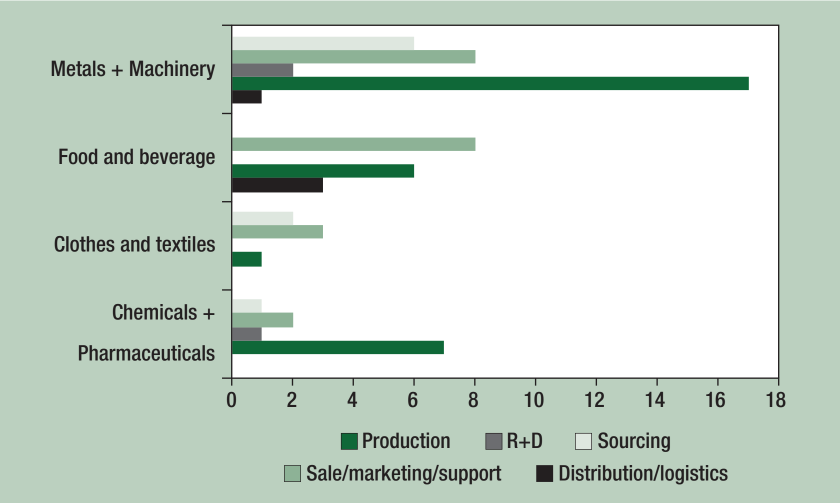


FIGURE 9/
Activities of manufacturing firms by sub-sector

Source: Authors' calculation based on sample of firms.

snacks and pharmaceuticals. In terms of strategies, firms producing auto parts and heavy machinery comprise one distinct group of manufacturing firms. These firms tend to participate in specialized production chains where their immediate clients are other firms rather than end users or consumers.

This sub-sector is more likely to set up production facilities in China. Overall, among 32 investments by firms in the metals and machinery subsector, 17 (53%) have established production facilities, meaning the firm is directly producing in China (see Figure 9). However, looking at the firm level rather than the individual investment level, we find that a full 16 out of the 19 firms in this sub-sector are producing in China.[17] This trend suggests that in sectors like automobiles and capital goods, participating in production chains in China requires an in-country production presence in order to respond efficiently to the pace and demands of these industries.[18]

In contrast, sectors with *consumers* as their target have followed a different path. This group includes producers of foods and beverages, textiles and clothing, and other goods such as consumer electronics and durables. For these firms, distribution and marketing are important concerns, as firms must position their products at the right sales points and make a compelling pitch to consumers in order to compete in a crowded marketplace. The largest LAC food companies in China—firms such as JBS, Brasil Foods, Bimbo, and Marfrig—have all made investments in distribution infrastructure in the country or are evaluating such investments as part of their strategies.

[17] Because several firms have invested in both production and another activity, such as marketing or distribution, the number of investments is greater than the number of firms.

[18] In many cases, it is worth noting, LAC firms that establish a production base in China go on to develop a commercial infrastructure to expand sales to the broader Asian region through sales representatives in countries such as Malaysia, Thailand, India, and Singapore.

Many other firms in the food and beverage sectors have established commercial offices to manage export sales and work more closely with distributors to make sure their products are well-positioned in the market. Firms often work with several distributors, each having its own regional purview within China. A presence on the ground helps firms manage these all-important relationships. Commercial offices also support firms' marketing efforts, helping design targeted campaigns to fit the preferences of Chinese consumers.

Production in China is a less common strategy in this sector, although companies such as Grupo Bimbo and Gruma, both Mexican producers of bakery products, have set up extensive production facilities to make breads, tortillas, snacks, and other food products in China. Given the comparative advantages of LAC firms in modern food production, opportunities could arise for direct investments that bring LAC expertise in large-scale production and technology to help modernize domestic production in China.

One example is pork production, where the Chinese domestic industry, despite being the world's largest, consists of many small, relatively inefficient producers. There have been signs of interest among Chinese authorities in investments from LAC in this sector.

Meanwhile, manufacturing firms in the metals, machinery, and capital goods sectors have not invested in distribution. The spatial organization of these industries, in which production often takes place within industrial parks that contain suppliers and their primary clients, might explain this pattern. In other cases, these firms sell to clients who are concentrated in a relatively small geographical area. For such firms the distribution of final products to end users plays a minor role in their strategy.

A final, smaller sub-set of manufacturing firms consist of pharmaceutical and chemical firms. These firms share some of the characteristics of the capital goods producers in that some chemicals firms are closely tied to the industrial production networks that have proliferated in China. Their products provide key inputs at different stages of these value chains, and a number of these firms have established production facilities in China.

Another strategy of firms in the chemicals and pharmaceuticals businesses has been to make investments to enhance research and development capabilities. These investments often take the form of joint ventures or mergers with local firms and aim to acquire assets such as patents, technology, or know-how.

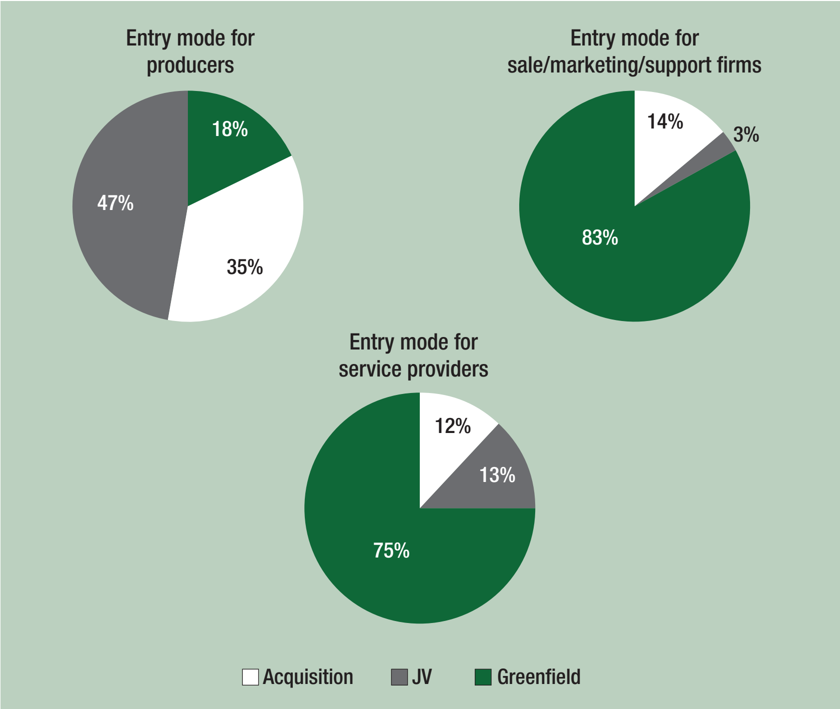
Entry mode by activity

Entry mode can offer additional insight into firm-level strategies. An initial observation is that the choice among a Greenfield (new) investment, a joint venture, and a merger or acquisition (M+A) tracks closely with the type of activity a firm locates in China.

Firms that establish a support and sales function or an office for direct service provision usually do so through a Greenfield investment. These activities generally require smaller investments and fewer bureaucratic hurdles, making the Greenfield option a good choice. Partly because of the preponderance of direct service and sales/support offices, Greenfields make up the largest single entry mode in our sample. For service sector firms, a full 75 percent have entered China via a Greenfield investment (see Figure 10).

Firms that engage in production, by contrast, are much more likely to enter China through a JV or acquisition. There are several possible reasons for this. For one, production, especially in capital-intensive industries such as steel, chemicals, or auto parts, entails significantly higher start-up costs,

FIGURE 10/
Firms' entry mode by activity



Source: Authors' calculation based on sample of firms.

which give firms an incentive to share costs through a JV, or acquire up-and-running operations from an incumbent looking to sell its assets. Similarly, in light of the sunk costs incurred in setting up production facilities, firms have an incentive to team up with a local partner that knows the market and can help navigate a foreign business climate.

Finally, there are policy issues at play. Every several years the Chinese government publishes guidelines that classify foreign investments as encouraged, restricted, or prohibited depending on their sector (see Part III for a more detailed discussion). In certain industries, including a number of mining and manufacturing sub-sectors, foreign firms face restrictions on their ownership share or are limited to joint ventures with Chinese companies. Service sector firms by contrast generally find fewer policy barriers to operating in China. In fact, firms in frontier sectors such as new information technology and software often enjoy tax breaks and other incentives to invest in China.

Towards a typology of strategies in China

What general conclusions can we draw from this survey of LAC firms? This section builds on the preceding analysis of LAC firms in China and incorporates insights from executives from the region to construct a typology of LAC firms in China.

An initial distinction can be drawn between firms targeting the consumer market and firms that participate in value chains. Firms in the second category often act according to a "follow the client logic." For example, when leading multinationals such as General Motors go to China, their suppliers in the auto sector, including LAC firms such as Mexico's Nemak or Brazil's Randon, have a strong motivation to set up operations there as well. Our interviews with companies suggest that this is a powerful motivation for a certain type of firm to establish itself in China. On the other hand, firms in the food and beverage business are attracted by the presence of a huge and growing consumer class rather than leading manufacturers.

The two types of firms also behave differently in the market. Consumer-oriented firms start with exports and might move on to establish a commercial office in China, explore investments or partnerships with distributors, and in some cases set up production facilities. Their aim is to be progressively closer and well-attuned to the consumer.

By contrast, firms in production chains also begin by exporting, and often open commercial offices to better respond to clients, but they are more likely to establish production facilities, given the demands for flexibility and just-in-time delivery in industrial value chains. An interesting feature of this trajectory, which emerged from interviews with LAC firms, is that importing provides a first step towards a direct presence in China for some firms. A number of LAC companies that imported inputs and intermediate goods from China have decided to open offices in China to facilitate sourcing and perform quality control on-site. This presence brings firms closer to Chinese counterparts and can lead to opportunities for partnerships aimed at the Chinese market itself.

A third group consists of firms in the natural resource sector, whose strategies and activities are influenced by a different set of concerns—namely, the location of resources. In some cases, these firms have been content to pursue an arms-length strategy focused on exporting; such firms may establish a commercial office to manage supply and contracts with local buyers and monitor local market conditions more closely. Other firms, however, have sought to participate directly in the mining or oil value chains in China, pursuing joint ventures in exploration, resource extraction, or downstream activities such as refining, distribution, and marketing. For these firms, a commercial office serves as a basis to form partnerships necessary to carry out these activities directly in China.

The strategy of natural resource firms in China is thus not restricted to the acquisition of resource rights alone. It encompasses partnerships aimed at refining, distribution and other links in the extractive industries value chain. In this sense, the approach of natural resource firms can perhaps better be thought of as project-based, where the permanent presence serves to explore and pursue a variety of opportunities at different stages in the value chain. Unlike capital or consumer goods producers, the strategy is not contingent on continuous sales to the market.

A final contingent of companies seeks to acquire specific strategic assets, whether they be technology, human resources, or other firm-level assets. This strategy has not been common among LAC multinationals in China—one reason is that large *multi-Latinas* often already possess superior capital and know-how in many sectors. However, this rationale for investment can be seen in the partnerships formed in the pharmaceutical and biotech sectors between a few LAC firms and Chinese counterparts.

How do service sector firms fit into this framework? We noted in the preceding section that these firms often follow different market strategies in China. Still, they can be classified according to the same type of market objectives outlined above, even if the way they go about establishing themselves differs.

One group of service sector firms is distinctly consumer-oriented: restaurants, movie theaters, and other entertainment services. The nature of these services makes exporting impossible, so entering a foreign market requires a direct presence or franchising arrangement. In this category, LAC food chains such Peru's Pollo a la Brasa and Mexico's El Fogoncito have made inroads in China. It is worth noting that other LAC firms in the entertainment sector—such as Cinepolis, the cinema operator, and Kidzania, which runs amusement centers for children, have a strong presence elsewhere in Asia such as India and Indonesia.

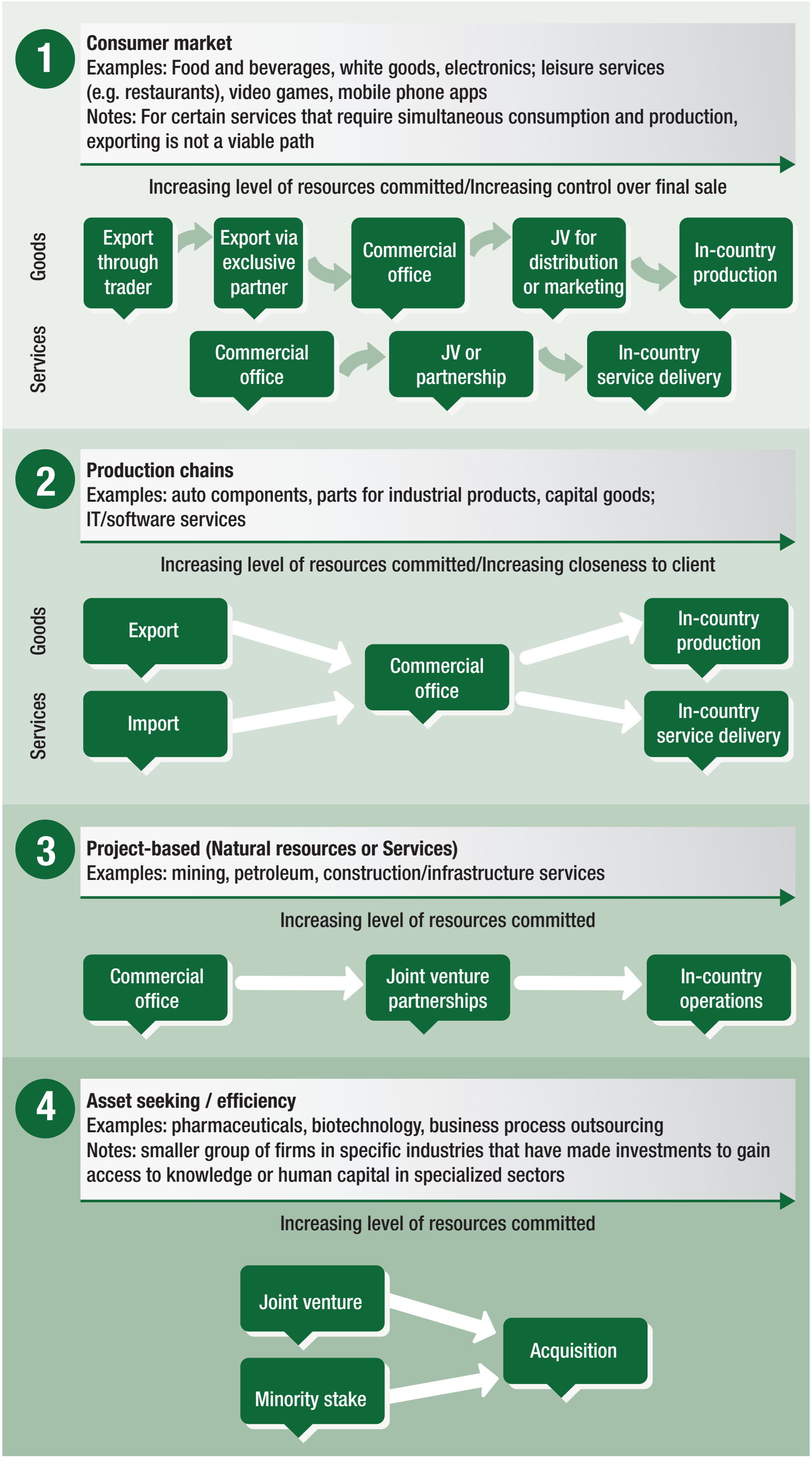
A second set of firms provide services to other businesses in China. These companies include software or IT solutions providers, business consultancies, and financial firms. While this class of services is technically exportable (consulting services for China-based companies can be performed from Brazil or Mexico), the ability to compete in foreign markets usually demands a direct presence, which allows firms to provide services in the native language. Conceptually, these firms can be thought of as participating in value chains—often contributing high-value added services—and thus represent the service sector corollary to the manufacturers of auto parts, engines, and heavy machinery.

Similarly, natural resource projects require a range of complementary services such as construction, engineering, and oil field services. Firms in these areas have pursued similar strategies to the traditional natural resource firms, in that their entry into the Chinese market generally follows the trajectory of establishing a commercial or representative office and then looking for partners and bidding on individual projects. This group had included LAC firms such as Brazilian construction companies Odebrecht and Camargo Correa, although recently these firms have emphasized sourcing of materials over project development. We can also imagine a service sector equivalent of the asset seeking group that looks abroad to acquire a strategic asset such as technology or highly skilled human capital.

We have thus defined four broad categories of strategic motivations for firms entering China, with the different entry strategies entailed in each case. Figure 11 outlines the general progression of each category from the most arms-length to the most integrated strategy, with a progressively greater commitment of resources from one stage to the next. Our goal here is to present a general typology grounded in the major theories of FDI, with modifications to reflect the empirical evidence gathered through our survey of LAC firms in China, as well as in interviews with LAC executives involved in China operations. It is not meant to suggest that every firm from the region must follow precisely one of these trajectories.

Of course, the activities of LAC firms in China do not take place in a vacuum. One factor that clearly shapes and constrains the opportunities for foreign firms in China is the policy environment, both in China and in their home countries, which means that the actions of the public sector are also relevant to this discussion. A second factor is the trajectory of the Chinese economy, which will naturally shape future opportunities in the market. The concluding section addresses both issues, outlining how changes in China's growth model might affect the prospects for firms in the region and offering policy recommendations to support firms' internationalization strategies.

FIGURE 11/
Typology of market strategies by type of investment



The Opportunity and How to Seize It

Part 3

The edifice of LAC-China trade has been built on comparative-advantage fundamentals: China faces a relative scarcity of natural resources and abundant labor, while LAC features the opposite relative factor endowments, leading to a distinct commodities-for-manufacturing trade pattern. However, this textbook case of comparative advantage need not be the end of the story. China's rapid development over the past three decades has brought about major demographic and economic shifts that carry implications for its trade patterns moving forward.

Breakneck growth over several decades has increased China's average per capita income from around US$ 300 in 1990 to over US$ 6,800 by 2013,[19] bringing tens of millions out of poverty and into the middle class. This shift creates a mass of consumers who find themselves for the first time with disposable income to spend on higher-quality products, including foreign goods.

China's middle class reached 157 million by 2010, a very large number that nevertheless represents only around 12 percent of the population.[20] Relative to the country's population, China's middle class thus remains small by global standards, and projections suggest this portion of the population is poised for fast growth, considering that a large share of China's population is currently clustered just below the middle class threshold.[21]

Structural features of the Chinese economy provide further support for the proposition that China's consumer market will take off in the coming years. China's growth to date has relied on fixed investment and exports; domestic consumption, meanwhile, contributes only 37 percent of national income, well below its share even in other developing Asian countries such as India (54 percent), Indonesia (61 percent) and Vietnam (66 percent). Factors such as rising wages and anticipated reforms to liberalize interest rates and allow greater appreciation of the renminbi should considerably boost Chinese consumption, which is expected to grow at a rate of between 8 and 11.5 percent annually through 2030.[22]

Rapid urbanization will likely continue to accompany economic growth in China. Recent projections estimate China to be on pace to add another 350 million people to its cities by 2030.[23] Urbanization and middle-class lifestyles entail changing consumption patterns that increase demand for products

[19] In current USD; World Development Indicators, World Bank.

[20] Based on a definition of middle class as households with daily expenditures between US$10 and US$100 per person in purchasing power parity terms.

[21] Homi Kharas "The Emerging Middle Class in Developing Countries," OECD Development Center, 2010.

[22] "China 2030: Building a Modern, Harmonious, and Creative Society," World Bank and the Development Research Center of the State Council of the P.R. China, 2013.

[23] McKinsey Global Institute. "Preparing for China's Urban Billion" 2009.

such as meats, processed foods, consumer durables, and electronics, as well as leisure activities such as trips to cinemas or shopping malls.

At the same time, China's status as a global manufacturing powerhouse will only grow in the coming decades. China is increasingly at the center of Asia's dense network of value chains, and the economy received US$ 123 billion of FDI in 2013, making it the world's second largest recipient of foreign investment for the sixth year in a row.[24]

These trends suggest that LAC companies wishing to participate in the world's most dynamic large market should look to China sooner rather than later. All the more so, considering that several of the areas where demand in China should increase the most—meat products, fruits, processed foods, and snacks—are sectors where the region enjoys competitive advantages. The challenge will be to introduce high-value products and services at low prices that are accessible to the emerging middle class. Given this scenario, what can governments do to help firms from the region?

Policy

Discussions of the policy framework surrounding foreign direct investment tend to emphasize host country domestic policies regarding FDI and, secondarily, agreements such as Bilateral Investment Treaties (BITs), Double Taxation Agreements, and Free Trade Agreements (FTAs), which increasingly include provisions for foreign investment protection. This section will give due consideration to these policy areas; however, the focus will be on policies that LAC governments themselves can undertake to support firms' initiatives to enter the Chinese market. This focus reflects acknowledgement of the complicated political economy of bilateral trade and investment negotiations, which limits what any one country can accomplish in this space.

China and LAC governments have made progress on formal investment agreements. There are currently 14 LAC countries with bilateral investment treaties with China, and the China-Peru FTA (2010) contains an additional chapter on investment. While BIT's and investment provisions in FTAs can be important for promoting an open and competitive investment climate and generating confidence between parties, most of the action in investment policy comes unilaterally.

This is certainly true in the case of China, where the government takes a very strategic and hands-on approach to foreign direct investment in the country, actively encouraging investment in certain sectors while restricting

[24] UNCTAD World Investment Report, 2014.

and prohibiting it in others. Beginning in 1995, China's National Development and Reform Commission (NRDC) and Ministry of Commerce (MOFCOM) have published a Catalogue for the Guidance of Foreign Investment Industries every several years. This document classifies investments as "prohibited," "restricted," or "encouraged" based on their sector. Any projects that do not fall into one of those categories are considered "permitted."

These categories affect the degree of regulation and level of approval required for foreign investments. In the encouraged and permitted categories, provincial authorities—the local Development and Reform Commissions (DRC)—have the authority to approve projects of up to \$300 million. Larger projects in these categories require approval by the NDRC as well as industry regulators, and any project greater than \$500 million must also be submitted to the state council. For projects in the restricted category, the thresholds are lower: \$50 million for approval by the NDRC and \$100 million for the state council.

The catalogue also specifies certain industries where foreign investments must take the form of joint ventures with Chinese firms and others in which Chinese investors must hold a controlling share. In the most recent edition of the catalogue (which entered into force January 30, 2012), areas with such restrictions include exploration and mining of types of coal, barites, and noble metals; manufacturing of active pharmaceutical ingredients and certain transportation and industrial equipment; construction and operation of urban infrastructure for gas, heat, water, and sewage; and telecommunications and passenger transportation services.

The list of encouraged industries gives an insight into the evolving priorities of the Chinese government. In the current catalogue, the government added 44 new industries to this category, with a strong emphasis on energy-efficient and environmentally friendly technologies (for example, new-energy automobiles, renewable energy sources, and marine oil pollution clean-up technology), next-generation information technology, and high-end manufacturing. Sectors downgraded from encouraged to permitted included production of complete automobiles, polycrystalline silicon, and large-scale coal chemical products. Here, the government's motivations include developing the local industry and preventing overcapacity in certain sectors.

While the FDI Catalogue provides a broad guide to the regulatory setting for investments in different sectors, it does not offer a comprehensive account of all the relevant policies and requirements for foreign firms. Just because a sector is categorized as "encouraged," for example, does not imply it is fully open to FDI without restrictions. The catalogue gives plenty of examples of encouraged sectors where foreign companies must have a Chinese partner under an equity or contractual joint-venture, including in several sectors relevant for LAC firms such as oil and gas prospecting and exploitation, biotechnology, and auto manufacturing. Similar requirements may apply to sectors not listed in the Catalogue—those considered by default to be "permitted."

As a result, firms seeking to fully understand the regulatory environment need to look to complementary sector-specific policies, as well as the regulations applied in free trade zones and special economic zones, which often have their own incentives as well as lists of encouraged and restricted sectors for foreign investment. As reports by the OECD and United States Trade Representative have shown, sector-specific requirements not described in the Catalogue are common, and the criteria applied by central and local authorities in the approval process are not always clear.[25]

The message here is that LAC firms considering investing in China must avail themselves of information from a variety of sources to fully understand the opportunities in the Chinese market as well as the universe of relevant policies, processes, and technical requirements governing FDI (see Figure 12). These tasks add to the costs implicit in undertaking foreign operations but also present an opportunity for governments on the LAC side to help firms overcome these informational and technical barriers.

The Role of LAC Governments

What policy levers are available to governments in the region to support the internationalization of domestic firms in China? Perhaps the question to begin with is whether governments should promote outward FDI in the first place. On the one hand, supporting domestic firms to invest abroad potentially replaces jobs in the local economy with foreign production, and moreover supporting the international operations of large firms that might already enjoy a dominant position in the domestic market may not be the best use of scarce public resources.

On the other hand, outward FDI can yield gains for firms' productivity, growth, technology absorption, and innovation that can have important spillover effects into the domestic economy, helping compensate for any domestic job loss. The growth of foreign subsidiaries can lead to increased

[25] OECD "China Investment Policy: An Update" OECD Working Papers on International Investment, 2013; USTR, "2013 Report to Congress On China's WTO Compliance," 2013.

FIGURE 12/
Relevant policies and government agencies for FDI

	PROJECT DEFINITION	PROJECT ENTRY MODE	PROJECT APPROVAL
RELEVANT POLICIES	• Catalogue for the Guidance of Foreign Investment Industries (2011) • Additional policies on how to implement the catalogue (ex: Provisions on Guiding the Orientation of Foreign Investment, State Council, 2003) • Local policies (ex: Announcement on the issues concerning related tax policies for the in-depth implementation of the west development strategy, 2011) • Sector related policies (ex: Policy on Development of Automotive Industry, 2004)	• Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures • Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures • Law of the People's Republic of China on Wholly Foreign-Owned Enterprises;	• State Council on the release of investment projects approved by the Government directory, Guo Fa 47 [2013] • Anti-Monopoly Law of People's Republic of China (2007) Notice of the General Office of the State Council on initiating a security review system for foreign investors seeking to acquire Chinese enterprises, Guo Ban Fa (2011) No.6, 2011
RELEVANT GOVERNMENT AGENCIES	• Ministry of Commerce of China (MOFCOM) • Investment Promotion Agency of MOFCOM • Provincial and Municipal branches of MOFCOM • Provincial and Municipal Investment Promotion Agency • National Development Reform Commission (NDRC)	• Ministry of Commerce of China (MOFCOM) • Provincial and Municipal branches of MOFCOM • State Administration of Industry and Commerce (SAIC) • Provincial and Municipal branches of SAIC	• State Council (depending on the project's value) • Ministry of Commerce of China (MOFCOM) • National Development Reform Commission (NDRC) • State Administration of Industry and Commerce (SAIC) • Provincial and Municipal branches of MOFCOM, NDRC and SAIC

demand for domestically-produced inputs and intermediate products as well as technology and knowledge diffusion to the home economy.[26] In addition, the presence of globalized MNEs in the domestic economy can further stimulate inward FDI by raising the overall absorptive capacity of the economy.[27]

In any event, several countries in the region have already initiated programs to support outward FDI by domestic firms, so it makes sense to consider the most effective policies in this area, keeping in mind the particular challenges of the Chinese market.

A first question to consider is whether such support should take the form of financing for domestic firms' international operations or be limited to technical support, coordination, and information provision. The first scenario would undoubtedly involve a greater commitment of public resources but could potentially do more to encourage outward FDI. On the other hand, a policy agenda focused on technical support and information provision could still make a difference for firms while providing a better return on public investment and avoiding controversies over the allocation of resources to large private investors.

This choice also bears on which agencies would be responsible for internationalization support. If countries opt to help finance firms' foreign operations, national development banks and even finance ministries would most likely be the lead actors. Technical support and information provision, on the other hand, might fall more naturally under the remit of trade and investment promotion agencies, which already have experience implementing similar programs. In addition, policies in this realm can be carried out effectively by sector-specific industry associations, either independently or under public-private frameworks.

Countries in the region have in general opted for technical support and information provision. In Brazil, the national development bank, BNDES, has been involved in the internationalization of domestic firms, but mostly indirectly. While BNDES does not have a dedicated credit line to support Brazilian MNEs' investments abroad, the bank has extended credit lines to support the mergers and acquisitions of large Brazilian firms such as Itautec, Marfrig, and JBS in the past several years, which have in turn helped these firms make investments in foreign markets.

Observers have noted that this policy of promoting "national champions" via the encouragement of domestic M+A indirectly supports internationalization through consolidation in the local market.[28] Beyond

[26] See Håkansonand Nobel, R. "Technology characteristics and reverse technology transfer," 2000.

[27] Tavares and Young, "FDI and multinationals: patterns, impacts and policies" 2005

[28] Campanario, et al 2012

BNDES' activities, Brazil's lead trade promotion agency, APEX, has programs to support the internationalization of firms through information and technical support.

Other countries in the region have only recently initiated programs aimed at increasing outward FDI. Mexico export promotion agency ProMexico unveiled in 2010 a program supporting the internationalization of firms through advisory services, capacity building, support for business trips, and other modes of technical and informational (rather than financial) support. These programs target SMEs. Mexico has also developed sector-specific initiatives to help small and medium firms internationalize, such as a technology sector business incubator that has offices in industrial parks in the United States, Canada, and Spain.[29] Colombia, too, recently endorsed outward FDI as a policy objective in its current National Development Plan, which it intends to implement through technical support by ProExport, the official export promotion agency.

How can governments in the region make the most of such policy initiatives? Based on our primary research and analysis of firms' experiences in China, as well as the main obstacles they tend to face, we can identify several broad recommendations that are compatible with a policy framework that favors provision of technical and advisory rather than financial support.

In general, LAC firms considering entering or already operating in China report challenges surrounding geographic distance and cultural unfamiliarity; lack of information on the relevant processes and policies for entering the Chinese market as well as on reliable Chinese partners and business opportunities; uncertainty on how to deal with Chinese authorities and manage the regulatory process; and concern over the protection of intellectual property rights in China.

The information gap represents a clear area where public intervention can play an important role. As discussed above, firms wishing to gain a comprehensive understanding of the regulatory environment for FDI in China must navigate a variety of policies both at the sector and general level and emanating from local and central authorities. Government agencies (or private industry groups) in LAC could provide a crucial service by providing up-to-date, consolidated, and sector-specific information on the current rules and procedures governing investments in a particular sector.

A model for this type of intervention can be found in the EU-China Chamber of Commerce, which maintains a comprehensive and

[29] CEPAL, 2012

regularly-updated list of all relevant Chinese policies bearing on EU businesses in various sectors. The Chamber also makes formal requests to Chinese officials to amend certain rules and tracks the success of such requests.

Policies to overcome information barriers can also take the form of assisting in localization decisions, sponsoring trade missions, hosting potential Chinese partners for joint ventures in LAC countries, and building databases on potential Chinese partners based on firms' previous experiences. Many firms in the region report that lack of trust in counterparts represents an important barrier to doing business in China; governments can play a role here by working with the private sector to create lists of reliable business partners, a project that is underway in Chile. In addition, information scarcity especially affects small and medium sized firms, which lack the existing contacts, recognizable brands, and resources to devote to obtaining information—advantages enjoyed by the largest multinationals in the region. Policies to improve the availability of information on China would therefore be particularly beneficial for SMEs.

An important prerequisite for this type of information provision policy is to develop the necessary capacity and familiarity with China in public agencies in the region. Many agencies that could be taking the lead in these efforts lack offices dedicated to China and China specialists in general. Developing country-specific expertise is critical and requires a general shift in thinking from viewing China mainly as a competitor to viewing China as a market opportunity for LAC firms.

While there is little to be done about the great distance between China and the region, governments could take steps to facilitate the movement of people between the two economies. Just as high international transport costs inhibit the region's participation in global trade, the high cost of travel between the regions complicates the face-to-face interactions and mutual familiarity that are so important to fostering business relationships, especially in the case of China, where the importance of personal connections based on trust—captured in the concept of *guanxi*—is paramount.

The liberalization of maritime and air services between the regions would help improve connectivity and facilitate business relationships, even given the long distance and poor state of infrastructure on the LAC side. Of course, improvements in domestic infrastructure in Latin America and the Caribbean are also an important part of the equation—although this is a longer-term challenge that goes well beyond the scope of internationalization strategies. Policies such as open skies agreements, on the other hand, can considerably reduce the cost and increase the availability of travel routes without straining public sector budgets.

In the longer term, governments can take steps to bridge the cultural distance between China and LAC, so that issues of unfamiliarity and lack of trust dissipate over time. Initiatives in this area might include cultural and educational exchanges, which would help create cultural solidarity and develop better educated, globally-savvy youth with international networks that could lead to business connections in the future.

Finally, governments in the region might explore opportunities to cooperate, pool resources, and develop synergies in promoting firms' internationalization in China. One way to do this is to work together in China to promote mutually beneficial business opportunities; a good example can be found in the efforts of the Pacific Alliance countries (Chile, Colombia, Mexico, and Peru) to establish joint trade promotion offices abroad, including in several Asian countries. In addition, private sector actors in the region are already working across borders to create business ventures aimed at the Chinese market.

Initiatives launched to place products in China from one country in the region have the potential to quickly expand to neighboring countries, and networks of entrepreneurs in the region increasingly team up to establish new ventures, often with China as a target.[30] Governments could help catalyze such multi-country initiatives in LAC by creating regional business incubators, opportunities for networking, and other activities that bring together entrepreneurs and potential financiers.

The challenges facing LAC firms in China will certainly not be surmounted overnight. However, China's importance as a driver of economic growth and market for consumer goods is not likely to be a passing phenomenon either. Countries in the region have already benefitted considerably from China's rapid emergence as an economic power. Governments in the region would now like that economic relationship to mature and diversify. One clear way to work towards that goal is to view the vast Chinese market as an opportunity for the region. The aim of this report has been to give firms and policymakers a better sense of the scope and dimension of that opportunity—and how to take steps towards seizing it.

[30] An example of such an initiative is Foodlinks, a Chilean startup that has helped connect firms in Chile's food and beverage sector with partners in China; the company recently expanded operations to Peru.