Is CNOOC's Bid for Unocal a Threat to America?

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Fu Chengyu is a smart businessman doing what many chief executives would do if they were in his shoes: trying to grow his company through an acquisition to increase revenues, profits and shareholder value. The difference, however, is that most of the shares of Fu's corporation are owned by the Communist government of China and the acquisition he has his eye on is an oil company in America, where lawmakers are jittery about allowing an important natural resource to fall into the hands of a rising military power.

The startling acquisition attempt by Fu's company, CNOOC, came on June 23, when it made an unsolicited, all-cash bid of $18.5 billion for Unocal, of El Segundo, Calif. The bid by CNOOC (pronounced see'-nook) was especially dramatic because Unocal had already agreed, on April 4, to be acquired by Chevron, of San Ramon, Calif., for $16.5 billion in cash and stock. CNOOC is a subsidiary of China National Offshore Oil Corporation, China's third-largest oil company. CNOOC's shares are traded on the Hong Kong Stock Exchange.

China experts at Wharton and elsewhere say that CNOOC's sweetened bid has understandably caused concern in the U.S. Congress because CNOOC is a government-owned company. But ultimately, some say, there appears to be no sound reason why the U.S. government should move to block the deal, if Unocal shareholders decide it is in their best interests. Observers point out that China already has a large financial interest in America as a creditor holding billions of dollars in U.S. Treasury securities -- an investment that helps finance the operations of the U.S. government and makes up for the paltry rate of savings in the United States.

This is not to suggest that the proposed CNOOC-Unocal deal is run-of-the mill. In fundamental ways, CNOOC's bid underscores a tense and unresolved ambivalence that exists in the minds of both ordinary Americans and government officials responsible for U.S. foreign policy. Should China be viewed, as it was during the height of the Cold War, as a foe of American interests? Or should it be seen as a trading partner that is embracing free-market principles and whose relationship with the United States will grow warmer and less threatening as business ties between the two nations bind them closer together?

"I do not understand why there is a strong reaction from the U.S. against CNOOC's bid," says Wharton finance professor Yihong Xia. "It is a perfectly legitimate business transaction, and I do not see any serious threat to the national interest of the U.S. It is not like a Chinese company taking over the production of F-16 fighters. A free and open capital market is a two-way, not a one-way, street. There will be capital inflows and outflows, and there will be foreign direct investment to developing countries such as China and vice versa."

CNOOC's bid has raised eyebrows in Washington not only on its own merits but because the bid is just the latest in a series of developments that have heightened Sino-American tensions. Trade relations with China have been contentious for years, with some U.S. politicians criticizing China for stealing jobs from the United States and keeping the Chinese currency, the yuan, at an artificially low exchange rate against the dollar in order to boost Chinese exports to America. In addition, the CNOOC move comes on the heels of a bid by another up-and-coming Chinese multinational, Haier, to acquire Maytag, an Iowa-based appliance maker and American corporate icon. The proposals by Haier and CNOOC remind Americans of the 1980s, when Japanese firms purchased high-profile U.S. assets such as Rockefeller Center in New

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York and Columbia Pictures in Hollywood, and pushed aggressively to win market share from stumbling U.S. automakers.

Still, CNOOC's ambitious move is primarily controversial because oil is a commodity vital to economic health and national security, according to Wharton management professor Marshall Meyer.

"One argument says let the market operate, but there is another argument," says Meyer. "In this case, the purchaser, CNOOC, is a company in a pillar industry in China. CNOOC is ultimately government-owned and in some respects can choose to use government powers if it wants to. It's not clear it is an arm's-length transaction when an entity that is wearing two hats -- the hat of a business enterprise and the hat of the government, and has access to unlimited credit -- proposes to purchase a large company with potentially strategic significance to the United States. That's the issue: Who is party to the transaction? It's different from Haier trying to buy Maytag. There is a degree of separation between Haier and the government in Beijing that does not exist between CNOOC and the government. These issues need to be thought through."

The fact that CNOOC has offered to pay a premium for Unocal is also noteworthy because it reveals an important characteristic of Chinese companies. "China prefers captive supply sources," Meyer explains. "That preference is going to lead them to pay more than Western firms would pay for the same resources."

It is possible that an attempt by U.S. politicians to thwart the CNOOC bid could backfire. "CNOOC has seemed to be caught by surprise that a better and economically sensible offer [for Unocal] would be met by such an uproar in Washington," says Xia. "For a lot of Chinese executives keen on learning Western capitalist ways of doing business, such a mixing of business with politics in the U.S. is a bit difficult to swallow. It may even give the Chinese government a good excuse to meddle with future U.S. business transactions in China."

"A Political Bombshell"

To succeed, CNOOC's bid for Unocal would have to clear several hurdles. For one thing, Unocal shareholders must decide whether they prefer CNOOC's offer to Chevron's, notes Christopher T. Mark Sr., chairman of The Signal Group, a consultancy with offices in Princeton, N.J., and Shanghai that provides economic assessments for clients operating in China and other emerging markets. In addition, even if Unocal shareholders vote to accept CNOOC's bid, an inter-agency, federal panel called the Committee on Foreign Investments in the United States (CFIUS) may review the proposed transaction to determine if it endangers U.S. interests. Indeed, CNOOC on July 1 filed notice with CFIUS, calling on the panel to review the proposed acquisition. But it is not clear if and when CFIUS will begin a review, partly because Unocal has so far given no indication that it will shun Chevron's bid in favor of CNOOC's. On June 30, the U.S. House of Representatives approved a resolution declaring that CNOOC's proposed acquisition could threaten America's national security and warrants a thorough review by the Bush administration.

"The CNOOC bid is a political bombshell," says Mark. "It comes at an especially problematic time in U.S.-China trade relations." But he notes that CNOOC appears to be interested more in Unocal's assets in Asia, not in extracting oil from any of Unocal's U.S. fields.

What makes Unocal attractive to CNOOC is that 70% of Unocal's current proven oil and natural gas reserves are in Asia and the Caspian region. Fu, CNOOC's chairman, has said that Unocal's low market value is due in part to the fact that its natural gas market has not been sufficiently developed. "The combination of Unocal's resources and CNOOC's market potential will create huge economic value," according to Fu. "This is the biggest reason for us to bid for Unocal."

Some analysts have pointed out that Unocal's "upstream resources" are only one of the reasons that

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enticed CNOOC to make its offer. CNOOC has long desired Unocal's distribution channels for natural gas, especially LNG. For years, CNOOC has suffered from limited oil and gas resources. Domestically, it ranks third behind PetroChina and China Petroleum & Chemical. The only way for it to grow is through acquisitions. Meanwhile, CNOOC, as a big state-owned enterprise, shoulders part of the responsibility for ensuring China's energy security. To China, the oil and gas resources in the region are vital, as its fast-growing economy requires ever-larger quantities of petroleum.

If the bid for Unocal goes through, CNOOC's oil and natural gas output would double and its reserves would rise 80% to four billion barrels of oil equivalent. Domestically, CNOOC would leap past China Petroleum & Chemical to be the No. 2 company in terms of oil and natural gas reserves. Internationally, CNOOC would become a medium-sized oil concern. "If the bid for Unocal succeeds, CNOOC's business will be expanded to 12 countries, and CNOOC will transform from a Chinese company into a global enterprise," according to CNOOC's president, Zhou Shouwei.

In addition, because Asia is the core market for both Unocal and CNOOC, the combined company would become the leader in Asia's oil market. In Fu's estimation, acquiring Unocal would save CNOOC dozens of years it otherwise would have to spend to reach that scale.

Funding Sources

CNOOC obtained most of the funding for the Unocal bid by borrowing from domestic and overseas sources. Its parent, China National Offshore Oil, provided a $7 billion loan. Of that, $2.5 billion is interest free, which CNOOC can pay back by offering new shares within two years; the remaining $4.5 billion is payable over 30 years at the relatively low rate of 3.5%. (However, critics of how China's government has helped finance a variety of state-owned enterprises in recent years note that borrowers often treat such financing more like working capital than like loans that actually have to be repaid.) In addition, CNOOC will borrow, at commercial rates, $3 billion from Goldman Sachs and J.P. Morgan, and $6 billion from the Industrial and Commercial Bank of China. CNOOC also will use $3 billion of its own cash -- $2.5 billion to be applied to the acquisition of Unocal's shares and $500 million for compensation to Chevron.

According to an analysis by the online Chinese-language version of London's *Financial Times*, as China transitions from a planned economy to a market economy, many of its big state-owned enterprises find themselves divided, in effect, in two. One part performs well, gets spun off from the state-owned enterprise, attempts to raise money in overseas capital markets, and tries to compete globally. The remaining part continues to be burdened by debt and controlled by the government. Under such an arrangement, it is common for parent companies to invest in subsidiaries. For instance, China Unicom, China Mobile and China Telecom all received generous support from their parents. In August 2000, CNOOC's rival, China Petroleum & Chemical Corp., got a $4.3 billion interest-free loan from its parent.

Xiao Zongwei, director of investor relations for CNOOC, told Knowledge@Wharton's China edition that an acquisition of Unocal would not pose any threat to America's energy security. Unocal's oil and natural gas output in the United States would continue to be sold in the U.S. market -- output that represents less than 1% of the total U.S. consumption of oil and natural gas. In addition, CNOOC has promised to spin off some of Unocal's U.S. assets immediately after the acquisition. Xiao also notes that the Chinese government has never intervened in business deals involving Chevron and CNOOC. Both companies have cooperated for some time on drilling ventures in China's South Sea and Bo Sea, and Chevron has an oil distribution channel and operates service stations in China, he says.

In the end, Mark of The Signal Group predicts that if Unocal shareholders vote to approve CNOOC's offer, the Bush administration will not stand in the way. "This does have political sensitivities written all over it. And we have seen in [recent] days some of the expected criticism of the deal in terms of scarce American resources being snapped up by a Communist-run government. That, on the face of it, creates political concern. But the far broader concern for the United States is attracting foreign investors to this country. We are far and away the world's leading debtor country. We need the confidence and the money

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of foreign investment to bridge the gap between our investment needs and our notoriously poor savings habits."

Mark notes that Haier's bid for Maytag may turn out to have greater international business repercussions than CNOOC's run at Unocal. The Haier offer "is a shoe I've been expecting to drop for some time. It's an example of how major Chinese firms that are really being squeezed domestically are looking to acquire brands internationally as a way out. There are parallels here with what Japanese and Korean firms did decades ago.... There are many skeptics who think that Chinese enterprises don't yet have the marketing skills and innovativeness to succeed internationally. I'm not saying this is a sure thing. It is a test case."

Xia notes that China has, until now, used its large foreign currency reserves to buy U.S. Treasury securities, and that the CNOOC and Haier bids seem to signal a shift from a strategy of holding foreign financial assets to owning physical foreign assets. "I would say that this is a good and sensible direction for China to go in given that the yield on U.S. Treasuries is so low," she says. "It is also beneficial for the U.S., since one of the important roles of capital markets is to allocate resources efficiently. The shift means that there is less rigid constraint on capital flows and a larger supply of capital to the real sector of the economy."

Xia says she understands why many U.S. politicians are upset with China, even if the reasons are not always justified. Bold public statements calling on China to revalue the yuan to make exports to the United States more expensive may play well with domestic textile producers and others that have been harmed by China's ascent as a major economy. But she believes that CNOOC's acquisition bid is an altogether different issue from revaluing the yuan.

For one thing, Xia points out that letting the yuan appreciate against the dollar -- which the Bush administration has called for and which China is resisting -- could end up encouraging more acquisitions of U.S. firms by Chinese companies since the U.S. assets would be cheaper. But more than that, she says, "It is not wise to bundle different issues together and make them excuses to block a cross-border merger. While the large trade deficit and the worry about losing jobs due to outsourcing make a lot of politicians uneasy, neither issue has anything to do with CNOOC's proposed transaction." Congress, she adds, should let the parties involved determine if the deal is economically sensible to shareholders.

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