Belt & Road Initiative

A closer look at B&R Countries

Infrastructure & recent developments

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Agenda for today

1. Overview
2. Review of infrastructure
3. Recent observations
4. Outlook
5. Q&A

Speaker today

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Gabriel lives in China for 17 years and oversees the corporate finance and infrastructure practice.

Gabriel has over 26 years experience of Investment Banking and Merger & Acquisitions.

In 2016, Gabriel's Corporate Finance team has completed 14 capital raising and Chinese outbound transactions with a total transaction value of Rmb 171 bn.

Gabriel is the Lead Financial Advisor for the Rmb $5.6bn acquisition of the global home appliance business of General Electric by Haier and he won the award of "Deal of The Year 2016" by China M&A Association.

Overview

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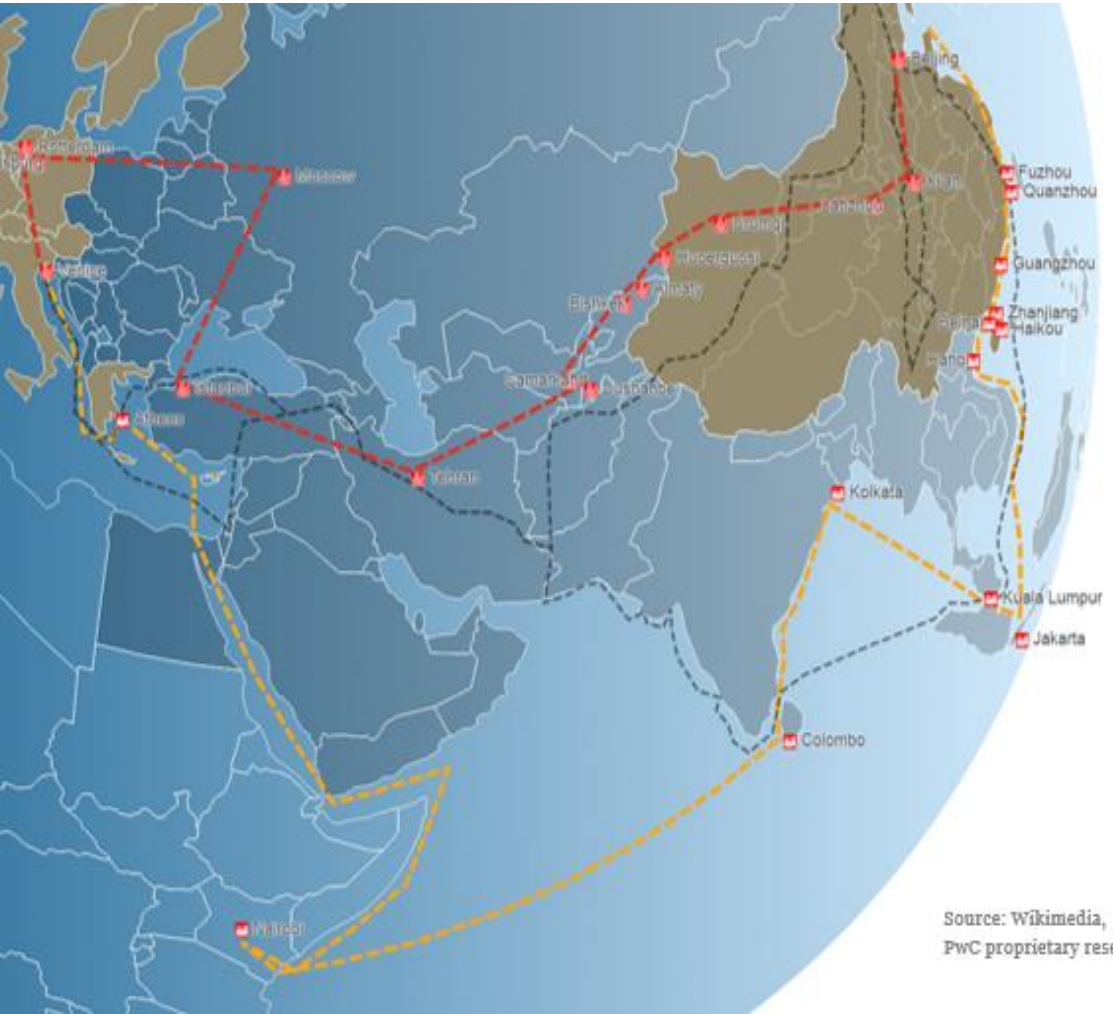
Belt & Road: resurrecting the ancient silk route

China's Han dynasty silk route is today resurrecting following Chinese President Xi Jinping's state visits to Asian neighbours in 2013



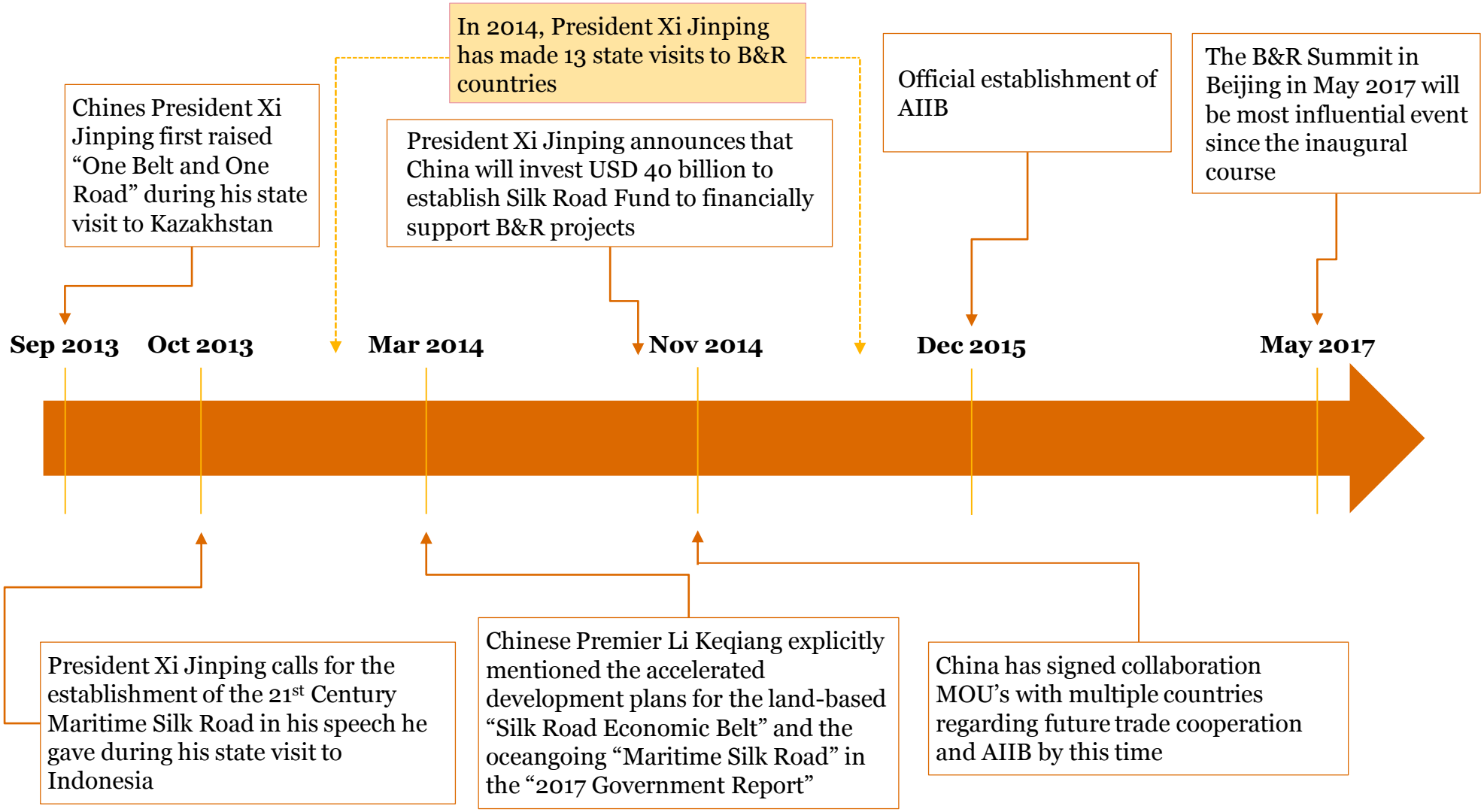
Source: Wikimedia, PwC proprietary research

Unveiled in October 2013, the Belt & Road (B&R) initiative is a development framework promoting Eurasian trade and integration

- Includes two complementary components : a terrestrial 'Silk Road Economic Belt' and a 'Maritime Silk Road'
- Underscores China's drive to play a greater role in global affairs. Institutions supporting the initiative include Asia Infrastructure Investment Bank (AIIB)
- A cornerstone of the proposed initiative is a vast infrastructural network connecting China to Europe via South, Central Asia and the Middle East
- Seeks to unlock investments for priority projects in a number of 'economic corridors'

Silk Road Economic Belt (SREB)
Maritime Silk Road (MSR)
The travels of Marco Polo (1276-1291)

B&R Timeline


In 2014, President Xi Jinping has made 13 state visits to B&R countries
Chines President Xi Jinping first raised "One Belt and One Road" during his state visit to Kazakhstan
President Xi Jinping announces that China will invest USD 40 billion to establish Silk Road Fund to financially support B&R projects
Official establishment of AIIB
The B&R Summit in Beijing in May 2017 will be most influential event since the inaugural course
Sep 2013
Oct 2013
Mar 2014
Nov 2014
Dec 2015
May 2017
President Xi Jinping calls for the establishment of the 21st Century Maritime Silk Road in his speech he gave during his state visit to Indonesia
Chinese Premier Li Keqiang explicitly mentioned the accelerated development plans for the land-based "Silk Road Economic Belt" and the oceangoing "Maritime Silk Road" in the "2017 Government Report"
China has signed collaboration MOU's with multiple countries regarding future trade cooperation and AIIB by this time

Central and Local Government Actions

Chinese Central and provincial authorities have rolled out local policies to support the development of the Belt & Road initiative. These include:

Central Government

- President Xi Jinping and Premier Li Keqiang paid state visits **to over 20 neighbourhood countries**
- **Singed collaboration MOU's** with multiple B&R countries with focuses on key cooperation projects in industrial investment, resource development, economic and trade cooperation

Xinjiang Province

- Established the **first SREB Core Area Construction Work Leading Group**
- Set goals to "coordinate B&R projects, build information sharing mechanisms, integrate overseas resources, and provide guidance to local parties"

Municipality of Chongqing

- By 2020, Chongqing government promises to inject approximately **CNY 1.2 trillion** into the infrastructure sector
- Investments will mainly focus on the central hub of the Yangtze River Economic Belt, innovative industries, reforms and opening-ups of China's inland cities

Shaanxi Province

- A strategically indispensable area in charge of promoting trades and engaging culture exchanges
- Put in law several new **preferential tariff measures** to those trading items that are originally made in or exported to B&R countries

Key Milestones and Selected Projects

China has already reached a number of milestones since launching the B&R initiative

Milestones

Silk Road Fund

- Established in 2014 with a founding capital of USD 40 billion from State Administration of Foreign Exchange, China Investment Corporation, Export-Import Bank of China and China Development Bank
- Provides financing support for trade and economic cooperation under the B&R framework
- A medium to long-term development and investment fund focused on infrastructure, energy & power, etc.

AIIB

- Founded in 2015, A new multilateral financial institution that brings countries together to address the immediate infrastructure needs across Asia
- Offers sovereign and non-sovereign finance for sound and sustainable projects in the conventional infrastructure sector

Projects

Colombo, Sri Lanka

- Port city is located in the centre of Colombo's CBD zone, covering an area of over 5.3 million sq. metres
- An investment value surpassing USD 14.4 billion, bringing local community 83 thousand new jobs

China-Laos Railroad

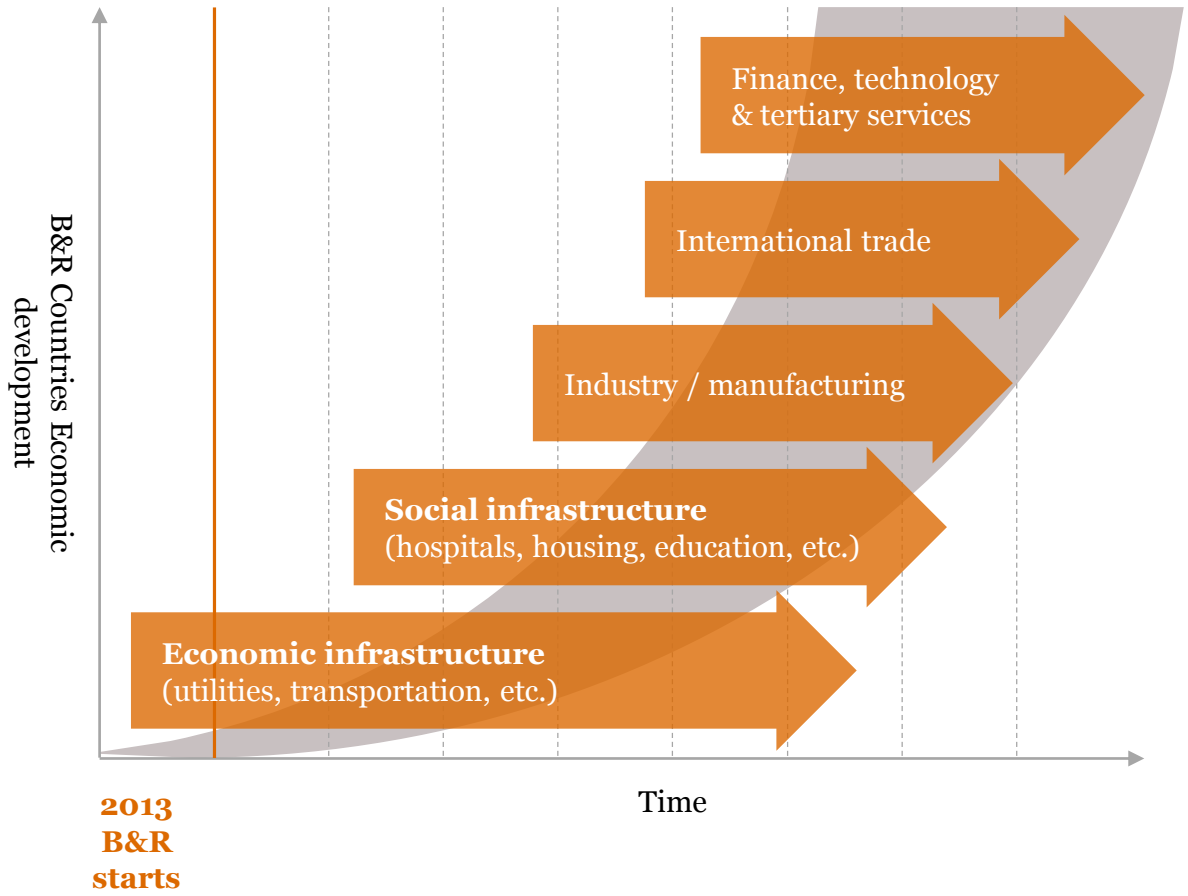
- An essential part of Trans-Asian Railway, China-Laos Railroad achieves a 508-kilometre total length and designed speed of 160 km/h
- The construction involves a RMB 50 billion investment and a 5 year project span
- Investment ratio is 28(China):12(Laos):60(private sector)
- Boosts Lao's economy and transportation efficiency significantly

The B&R initiative's push for infrastructure will unlock significant growth in the region

Infrastructure capital goods are a crucial 'first step' for economic development. The B&R's initial focus on infrastructure will trigger subsequent waves of investment in other sectors, and will serve to promote both trade and economic integration

Infrastructure has traditionally served an important role in growth performance in developing Asia. Countries that have invested heavily in infrastructure (eg. Japan and Korea) have seen a big boost to GDP and rapid development of their services economy

Countries that have not invested in infrastructure, or adopted uncoordinated infrastructure development policies have seen less impressive economic growth and integration



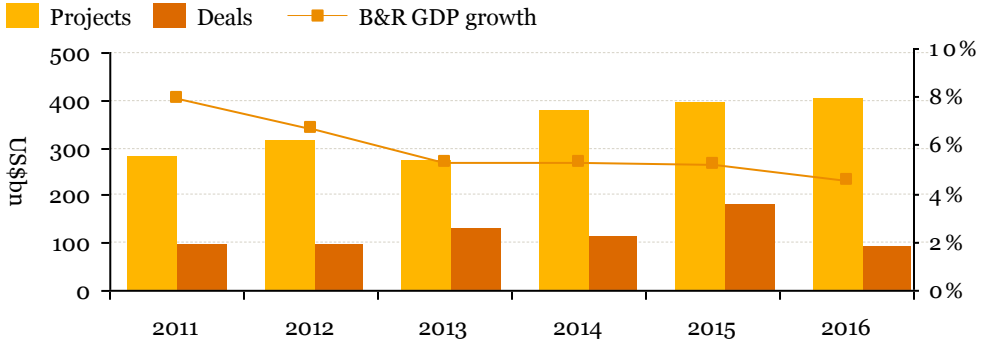
Review of infrastructure

2

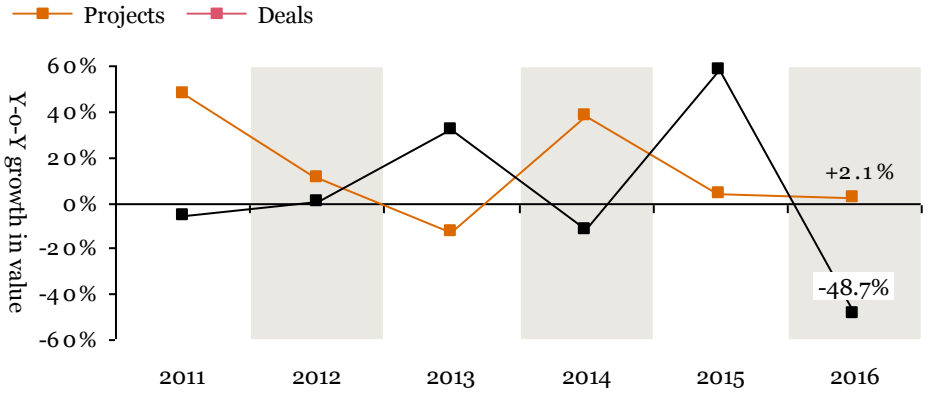
2016 saw a rise in project dollar value, as governments battled to revive growth. Data points to a drop in M&A

- Regional growth moderated in 2016 on the back of weaker Chinese demand
- Rising oil and commodity prices fed into construction costs, heaping further pressure on sector profitability
- Public expenditure on projects remained strong, however. China's 'silk road' is materializing and driving investments across B&R
- Available data suggests infrastructure project spend tends to be counter-cyclical, correlating negatively with economic activity. M&A activity is driven by investor confidence and is typically pro-cyclical
- M&A activity points to a decline in volume and dollar value. Disclosures for 2016 are however still trickling in, meaning that there is still (limited) scope for more upside

Deals and project dollar value



Deals and projects move against one another



Focus on new projects saw value rising 2.1% at the expense of M&A activity

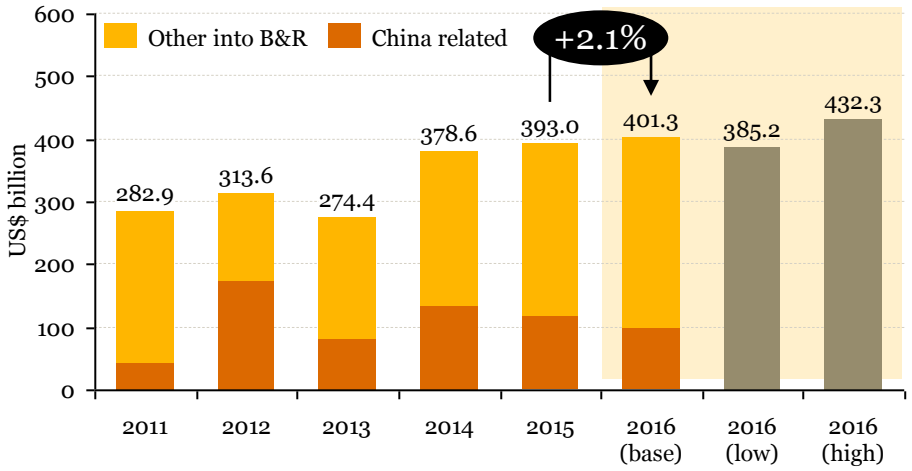
Projects: countercyclical strength

- Provisional numbers for 2016 see total new announced project value rising 2.1% to roughly US$400bn
- Final numbers could see 2016 value rising by as much as 10%

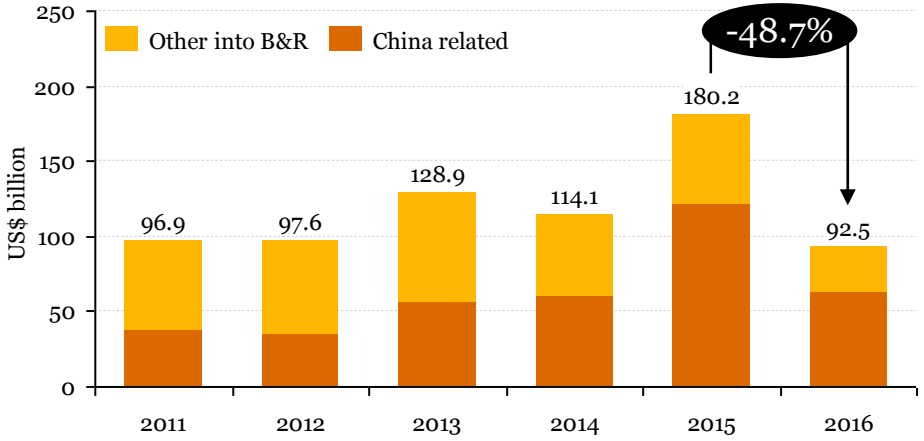
Deals: pro-cyclical weakness

- Economic headwinds were not as kind to deal activity, with available data pointing to a 49% fall in dollar value
- The drop partly reflects peak levels reached in 2015, when deal activity rose to a record $180bn
- China domestic deal value is also down, according to available data, but up 15% from 2014

Total project dollar value in B&R markets



Total deals dollar value in B&R markets



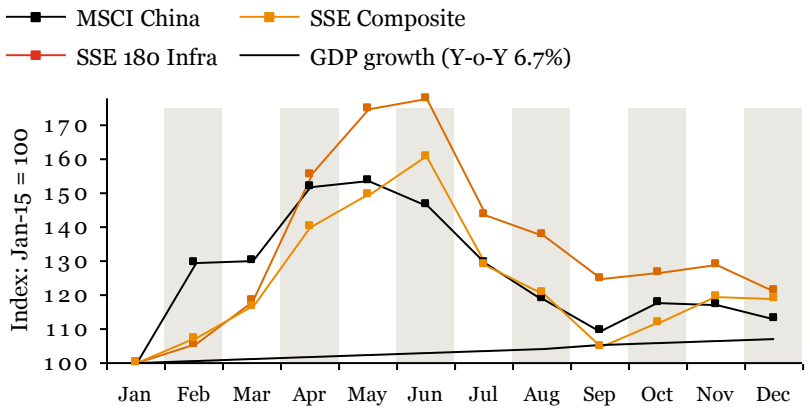
Source: BMI, Thomson ONE, Bloomberg, PwC proprietary research

Equity infrastructure underperformance reflects downward M&A trend

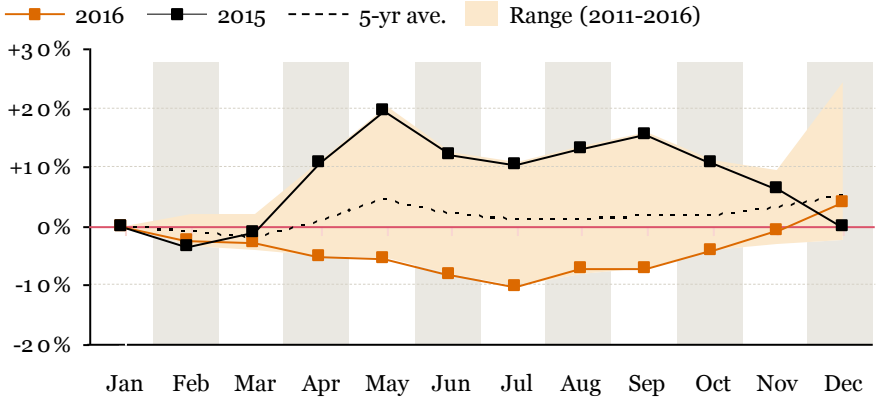
A subdued performance

- After two bumper years that saw the Shanghai infrastructure index surge by 85% between 2014-2015, the index rose only by a modest 9.9% in 2016
- Infrastructure equities trended at an average 4.1 percentage point (pp) discount to the Shanghai composite index, an average 6.9 pp discount to GDP, and a 12 pp discount to the MSCI China Index

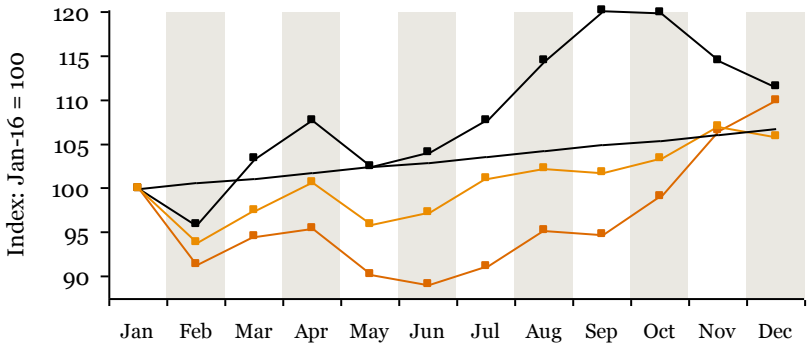
After a bumper year in 2015…



SSE 180 infrastructure index vs SSE composite



…infra equities underperformed in 2016



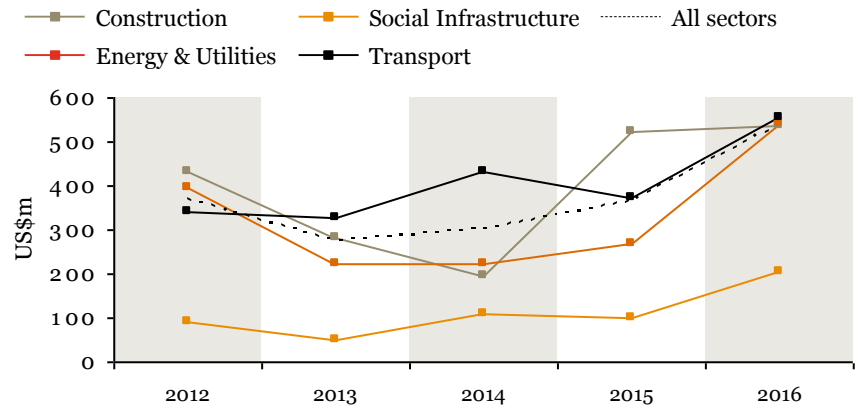
Source: IMF, MSCI, National Interbank Funding Center, Bloomberg, PwC proprietary research

Rising average project value points to a flight to quality

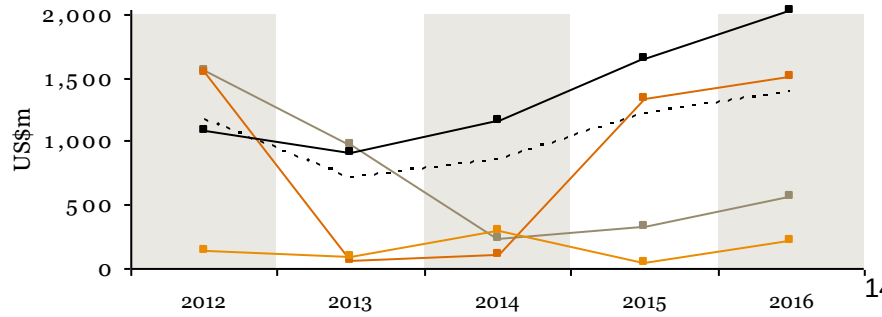
A multi-year trend of rising value

- Available data sees average project value rising 47% in B&R and 14% in China, and suggests more value was generated despite an absolute drop in projects
- The trend was at play in all sub-sectors, with noteworthy rises in utilities and transportation
- Available data suggests average value has been on the rise since 2013, with a CAGR of 33% for B&R and 27% for China
- Rising average project value is the flipside of growing uncertainty and feeble growth in regional markets, with investors and public authorities pooling investments away from riskier, non-essential ventures

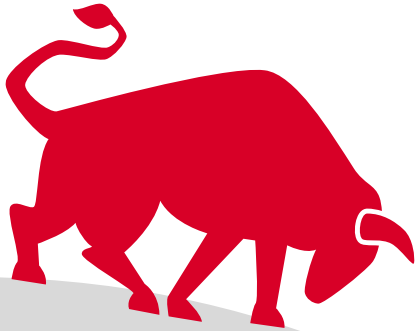
Average B&R project value by sector



Average China project value by sector



Government policy across B&R was bullish for projects but bearish for deals



M&A bears

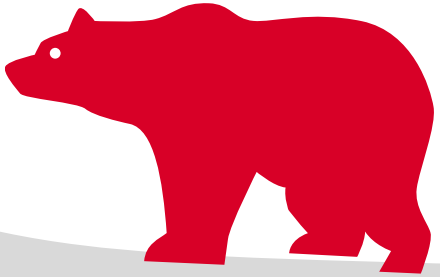
- Monetary policy is fuelling lending and likely generating a real estate bubble. This weighed on investor sentiment
- Real lending rates fell but were high for much of 2016
- The yuan weakened in 2016, moderating China's appetite for foreign acquisitions. This was compounded by lengthy

Sagging fundamentals

- Construction costs bounced back on rising crude and steel. This was bearish as reflected global markets and domestic production cuts more than rising domestic demand
- Loosening fundamentals. Freight volumes, port throughput and industrial power demand fell. Overcapacity drove down fixed asset investments
- Sovereign debts suffered a couple of downgrades in 2016 (although the picture is broadly stable)

Project bulls

- Monetary policy in China remained accommodative. Base rates hovered at their lowest level in two decades. New loans reached record highs
- Fiscal policy continued to fuel growth in China and B&R
- GDP growth rates soften across the region. This was a bullish driver for projects in 2016 as governments scrambled investments to offset declines



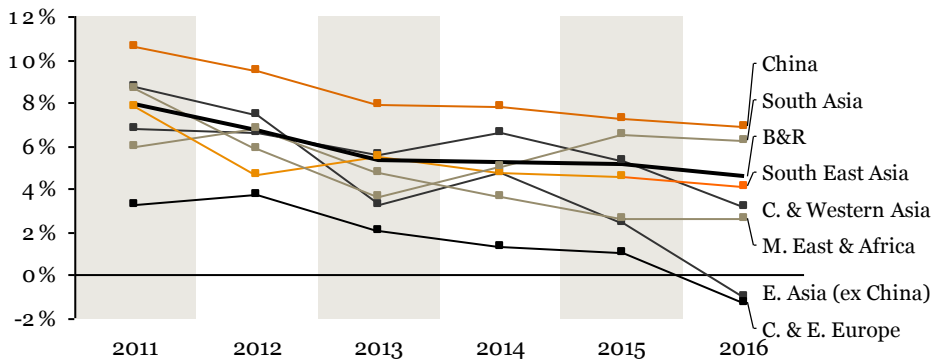
B&R GDP growth moderated in 2016 but trended high above global output. China exceeded expectations in Q4

A challenging growth environment

B&R GDP growth decelerated in 2016, expanding by 4.6% against 5.2% in 2015 and a 5-year average at 6.1%

- In 2016 South Asian output fell for the first time in three years. The IMF downgraded India on the back of Modi's rupee note ban
- Countries with trade exposures to China have seen cooling demand for exports

B&R growth rates by key regions

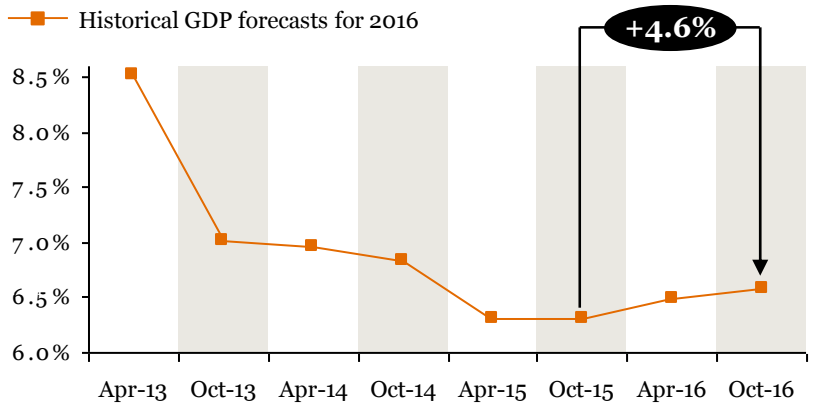


China is slowly bottoming out of its multi-year decline

B&R growth outstripped global output (3.1%) and that of advanced and emerging groupings at 3.4% and 3.6% respectively

- China's GDP for 2016 came in at 6.7%, within the government 6.5-7% target range. Growth outperformed expectations in Q4
- IMF forecasts have been firming up since Oct-15
- The December Caixin PMI registered its fastest rise in 3 years

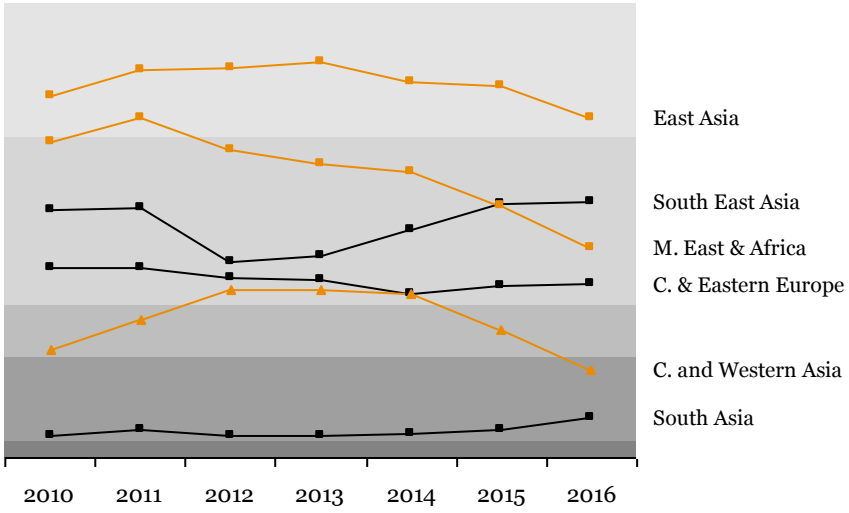
Trending GDP forecasts for China



A few downgrades did not destabilize the B&R sovereign debt environment

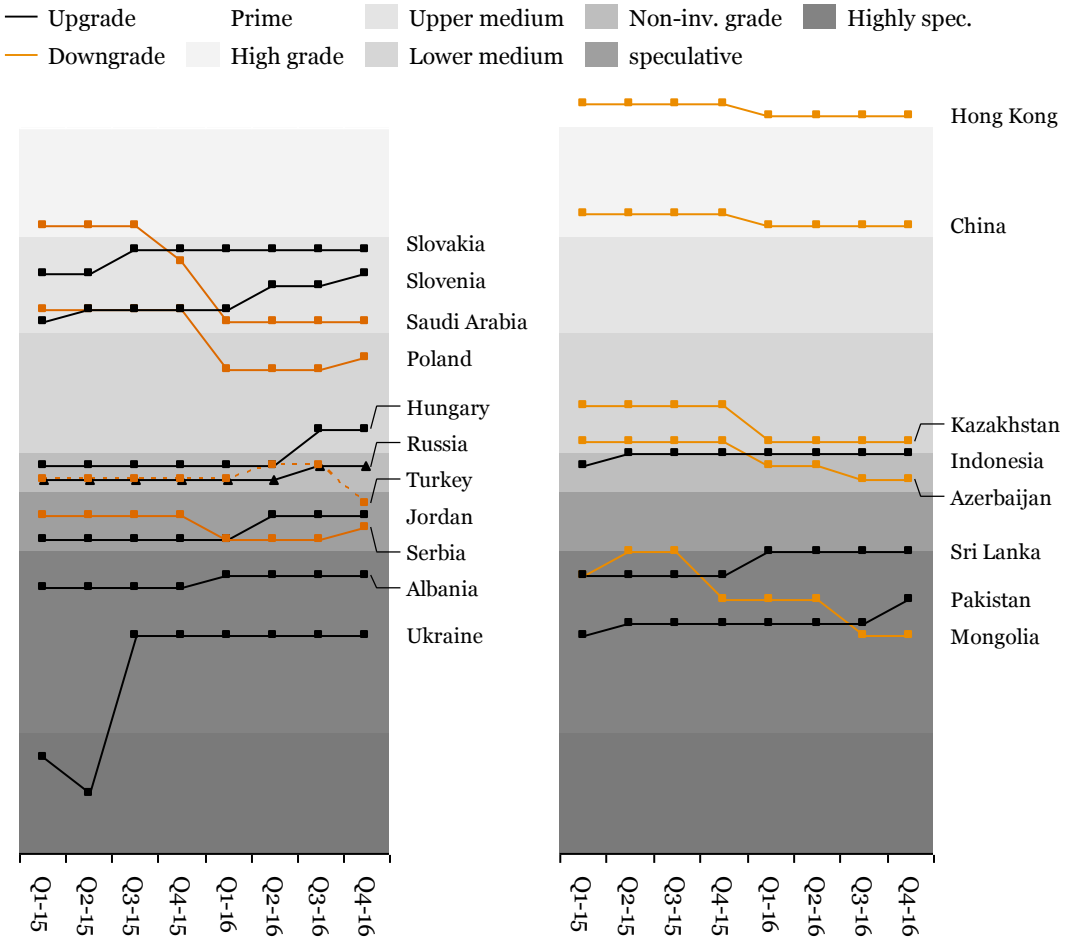
- Europe and MENA saw some downgrades on the back of political instability (e.g. Turkey and Poland) but was more upbeat overall. Russia was upgraded from BB+ negative to stable in September (S&P)
- Asia saw some downgrades in Central Asia, but the credit environment was otherwise stable

B&R regional ratings crude average (S&P)



Source: Standard & Poor's, PwC proprietary research

Sovereign reassessments: Europe & MENA vs. Asia



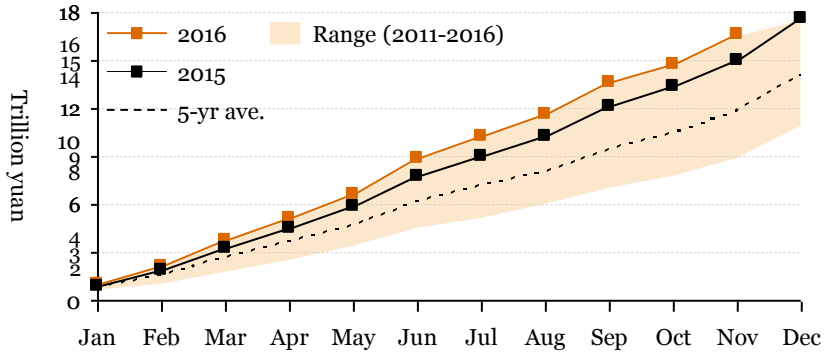
China's fiscal stimulus announcements and infrastructure spending had another bumper year in 2016

Infrastructure remained a policy lever of choice

Total spending is expected to reach 20 trillion yuan this year, which is more than 10% over that of 2015 and 40% more than the 5-yr average

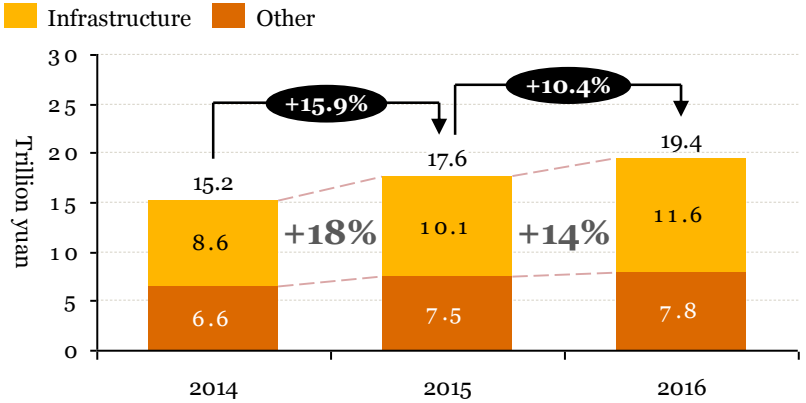
- Beijing announced a series of fiscal stimulus measures in infrastructure, including 4.7 trillion yuan package for transportation in June
- In December, the Government announced plans to invest 3.5 trillion yuan in railway networks from 2017-2020 to connect 80% of China's major cities
- We believe infrastructure spending growth will come in at 14% for 2016, which is down slightly from an average five-year growth rate at 14.5%
- Infrastructure spending will continue to grow robustly, however we expect its relative share to decelerate over time

Cumulative Government expenditure



Source: National Bureau of Statistics of China, PwC proprietary research

Infra spending growth remains robust



Source: CEIC, PwC proprietary research

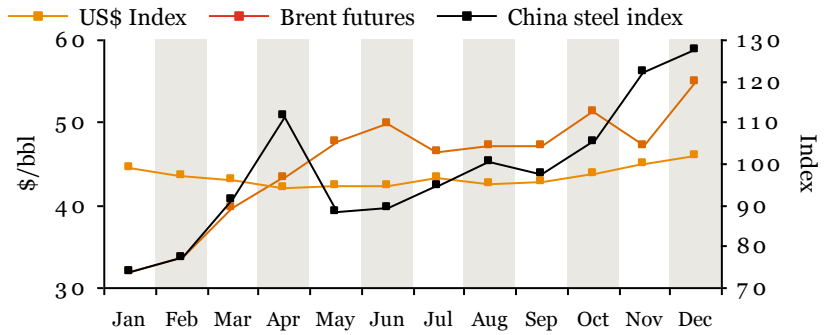
Construction costs rise on the back of materials and wage inflation

Input costs recover from multi-year declines

Rising input prices increased pressure points on the infrastructure value chain

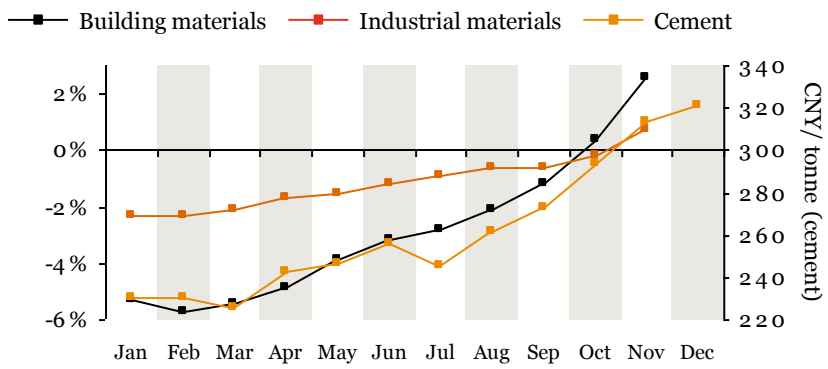
- Crude prices rebounded on the back of global tightening fundamentals and the US dollar trended low up until the December Fed rate hike
- Domestic steel prices surged on construction demand, shrinking inventories and Beijing removing 45 million tonnes in capacity. Rebar prices rose higher still on Beijing moving to close coal mines
- Indices for industrial and building materials bottomed out in 2016 and expanded for the first time in five and three years respectively
- Nine provincial regions raised minimum wages in 2016. Construction wages will have risen somewhere between 5-8% in 2016

Crude and steel are up 70% since January



Source: Bloomberg, ICE, MyspiC steel index

Key construction costs are rising



Source: National Bureau of Statistics of China, Bloomberg, PwC proprietary research

Recent Observations

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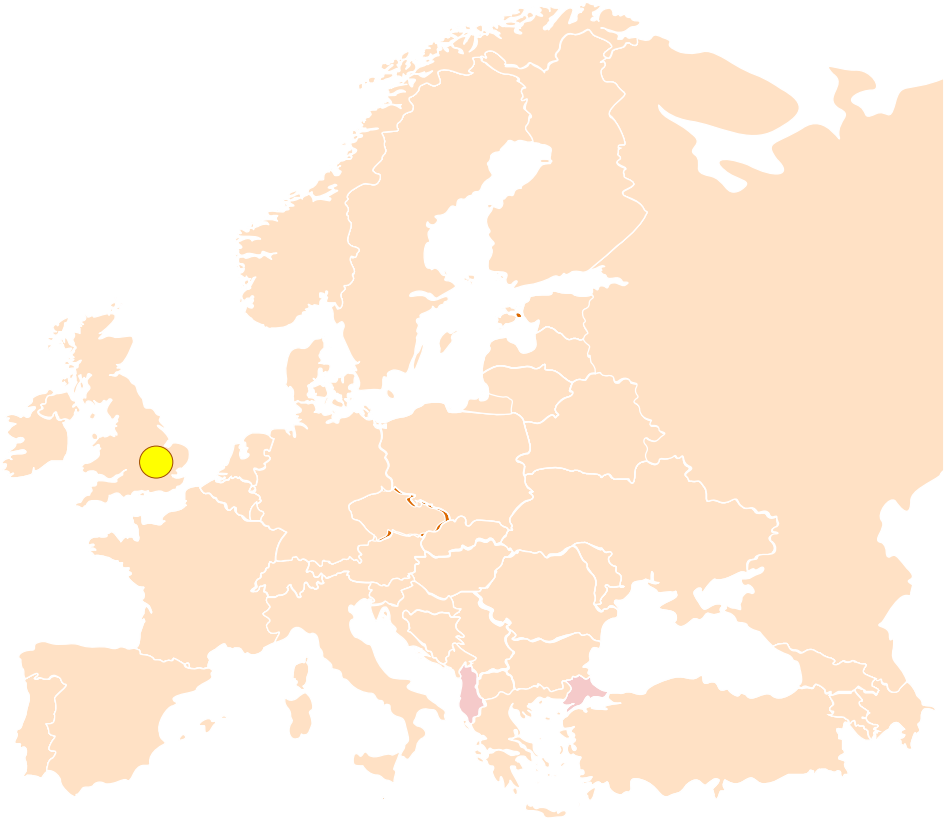
Recent Observations – Increasing Connectivity



London-Yiwu Railway

B&R is not a political tool but a platform to connect countries to join and grow

- The 12,451-kilometre London-Yiwu Rail launched in April 2017
- A 30-container cargo train carrying whiskeys, soft drinks, vitamin pills, infant products, medicine and other UK-made products traveling to Yiwu, China
- A bilateral trading relationship is formed since three months ago when a cargo arrived in the UK with home appliances, clothing and traditional gift accessories originally made in Yiwu, China
- Cargo train stops at major B&R countries along its journey, including France, Belgium, Poland, Belarus, Russia, and Kazakhstan
- Will stimulate economy in above countries and create great potential for online shopping/delivery options
- Offers the UK a great opportunity to build networks among neighbour countries, which will become useful after Brexit becomes effective

Recent Observations – Changes of Political Landscape

While B&R smoothens bilateral trading cooperation, it stimulates competitions among B&R countries, and thus pushing the economy forward to a more engaging level

China

- Bangladesh's largest military weapon supplier since November 2016
- China has delivered two submarines last year to Dhaka, Bangladesh
- Offered Bangladesh a **USD 23 billion** loan allowance in October last year for Bangladesh's national defense
- Offered Bangladesh advanced production facilities that enable manufacturers in Bangladesh to reduce production cost and achieve more output value

India

- Proposed another attractive financing package to Bangladesh in April 2017
- **USD 5 billion** low-interest loan allowance for national defense and key infrastructures projects between the two countries
- India has invested USD 9 billion in Bangladesh's infrastructure sector in the past 4 years, totaling 17 projects including airport construction and highway upgrades

B&R framework forced India to express its resolution to compete with China and to have a defining say in the overall macro economy and political situation in Asia

Recent Observations – Increasing Business Activities

Pakistani Donkey Market

- Pakhtunkhwa Province government shows Chinese investors their latest plan to export excess donkeys to Chinese market during a roadshow on April 17, 2017
- One of the many agriculture investments under the B&R framework, the donkey project will attract approximately CNY 60 million in financing
- Although a very cheap material in Pakistan, donkey skin is considered highly valuable in China for traditional Chinese medicine market

Bigger Africa Health Role

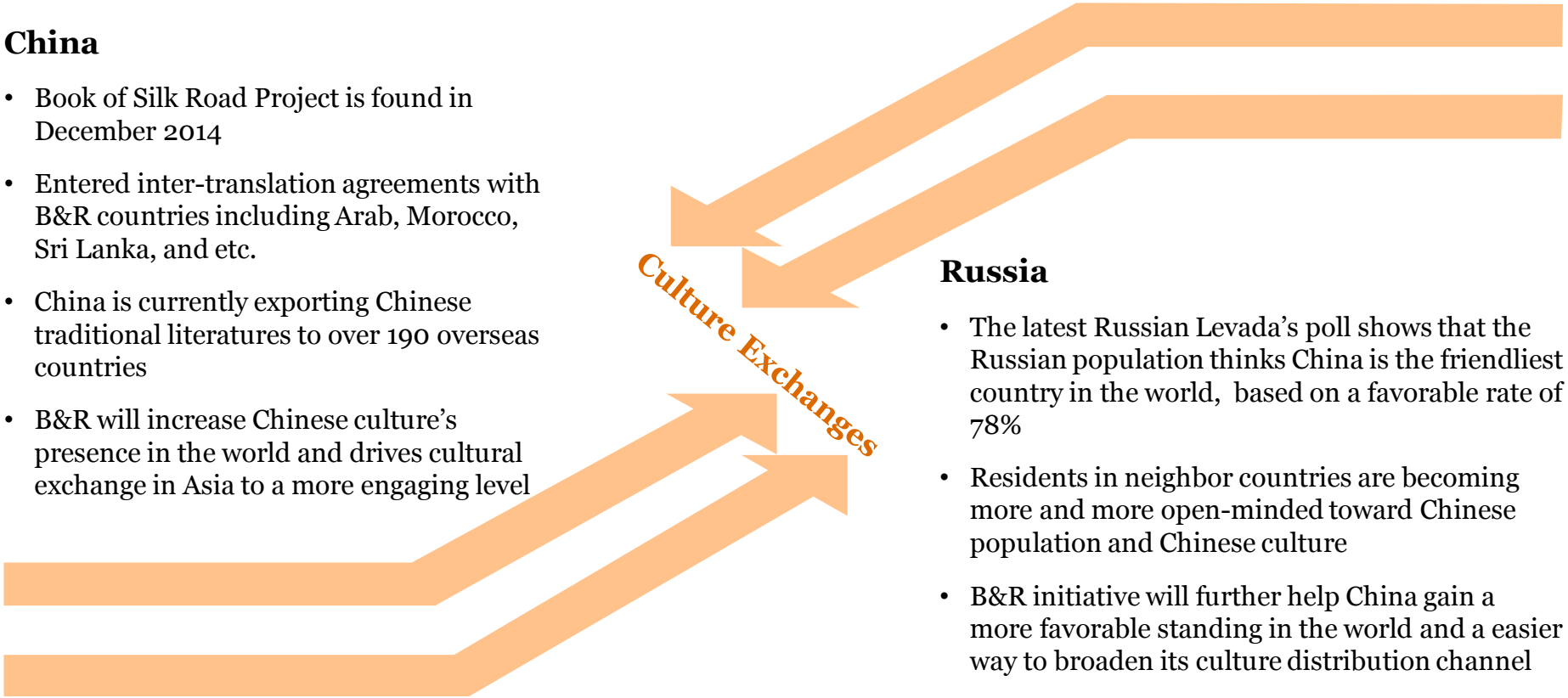
- Chinese delegates met 30 health African ministers and global funds to speed up the pace of technological transfer and production on April 24, 2017
- China already has medical teams in Africa and conducts medial missions including cataract, cardiac and oral surgery and has supported the establishment of an African Centre for Disease Control.
- A recent report estimated that the African pharmaceutical market who relies on the Chinese medical products, vaccines and equipment, would grow to US$40bn a year.

Recent Observations – Cultural Exchanges

B&R's goals is more than infrastructure, investment, but also culture exchange

China

- Book of Silk Road Project is found in December 2014
- Entered inter-translation agreements with B&R countries including Arab, Morocco, Sri Lanka, and etc.
- China is currently exporting Chinese traditional literatures to over 190 overseas countries
- B&R will increase Chinese culture's presence in the world and drives cultural exchange in Asia to a more engaging level



Russia

- The latest Russian Levada's poll shows that the Russian population thinks China is the friendliest country in the world, based on a favorable rate of 78%
- Residents in neighbor countries are becoming more and more open-minded toward Chinese population and Chinese culture
- B&R initiative will further help China gain a more favorable standing in the world and a easier way to broaden its culture distribution channel
- Significant potential profits for Chinese culture-related goods manufacturers, distributers and retailers

Outlook

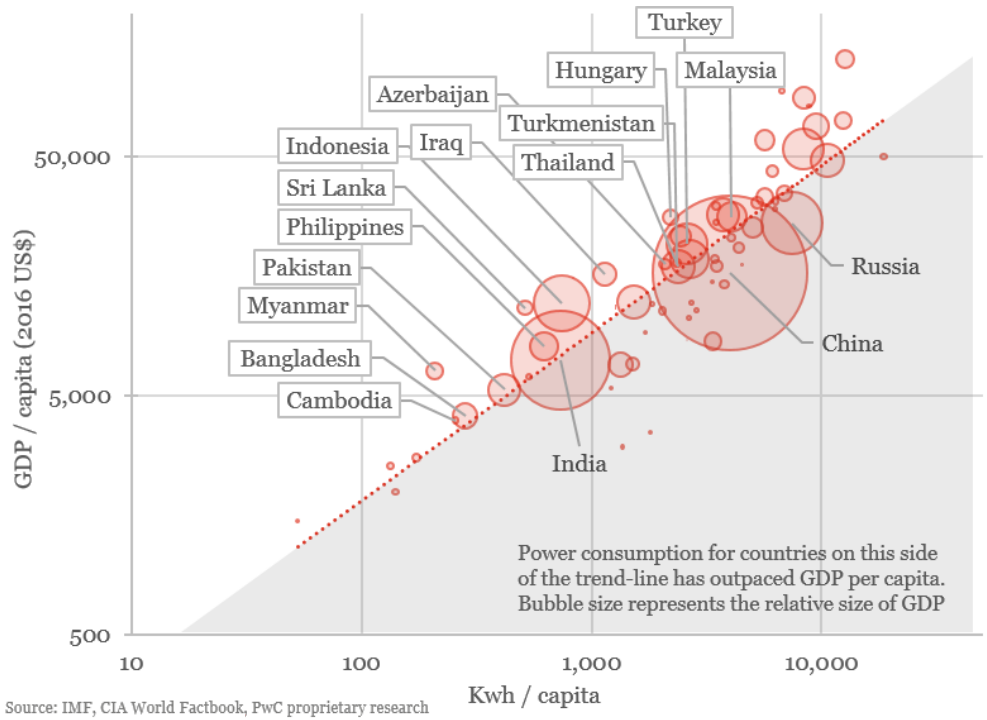
4

Potential for significant growth in power, rail and healthcare in middle-income B&R countries

A developmental sweet-spot

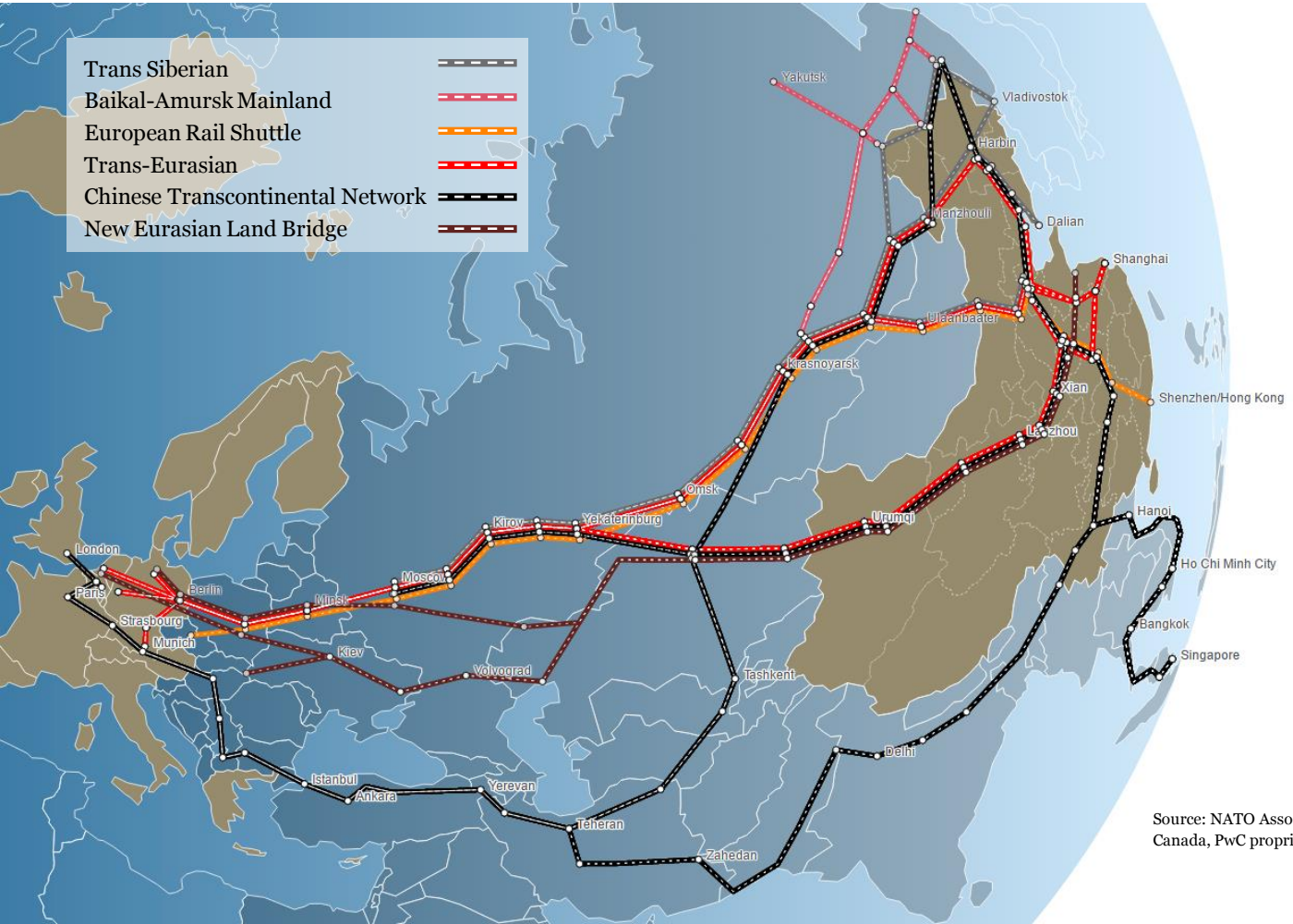
- Power consumption is trailing GDP per capita in a number of key B&R middle-income countries. We see a significant ramp-up in power projects in 2017 and beyond as Governments seek to bridge the supply gap
- A number of B&R countries are lagging behind in rail network density, and some have incentives to integrate their large territories via rail (e.g. China). Countries such as Kazakhstan and Mongolia that are located in B&R corridors and will see a ramp-up in projects
- Likewise, a number of B&R countries have ageing or fast growing populations that have not been matched by hospital capacity additions. We expect significant healthcare investments in these countries

B&R:GDP per capita vs power demand per capita (2017)



Source: IMF, CIA World Factbook, PwC proprietary research

Trans-Eurasian rail networks will dramatically reduce the time between China and European consumer markets



At the heart of China's Belt & Road initiative is a planned network of railways connecting China to Western Europe

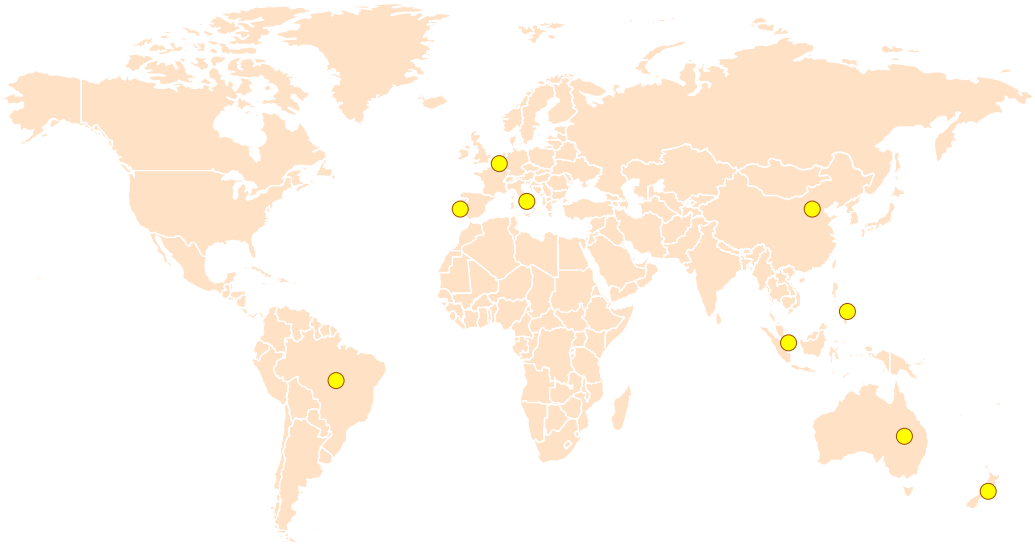
- Beijing hopes to complete this project within a decade
- The planned rail network will deepen economic integration in some of the word's most densely populated regions
- Once completed, it will provide a high capacity alternative for bulk-consumer good transportation. It will offer valuable freight time savings over ship transport
- In January this year a freight train arrived in London after completing a 12,000 km fro Yiwu, China, via Kazakhstan and Russia and France

Source: NATO Association of Canada, PwC proprietary research

State Grid has been expanding overseas rapidly

State Grid's global presence

- Invested 2 Philippine power companies for USD 3.95 billion and gained a 25-year concession in Philippine's electricity sector
- By 2010, purchased 7 Brazilian power distribution companies for USD 989 million and owned a 30 year concession right in Brazilian electricity transfer business
- In 2012, poured EUR 387 million to acquire 25% stake of Portuguese National Power Company and the same year, acquired another 41% stake of an Australian electricity supplier
- By 2020, State Grid expects to raise its overseas power plant asset to at last 10% of the total asset of the company by purchasing plants in B&R countries, aiming at an international business profit margin exceeding 20%
- State Grid's strategy will bring significant growth potential under the B&R initiative, given the high power demand in energy-hungry emerging countries along the B&R path



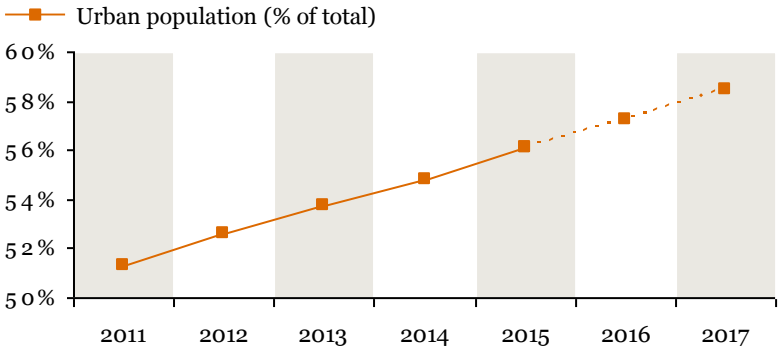
Urbanisation and population growth will spur continued demand for high-capacity transportation infrastructure

Powerful demographic trends

Twice as many individuals in China now live in cities than only twenty years ago. This is remarkable when you consider it took the United States 60 years to accomplish the equivalent demographic shift

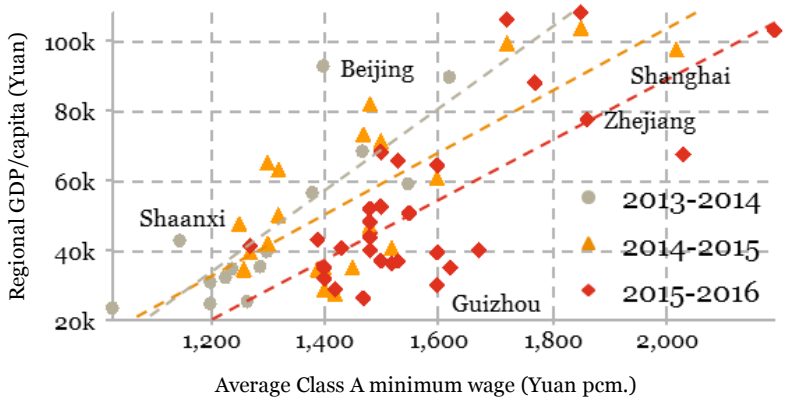
- Population mobility will continue to rise across China as unequal economic development leads to greater disparities in regional employment and wages
- Over the last six years the variance in regional minimum wages has risen across China which should lead to higher inter-provincial population flows
- The Government has announced plans to reform the 'huko' household registration system. This should allow workers to move between provinces
- These trends bode well for infrastructure demand as authorities work to achieve greater regional integration, absorb rising population flows and build added capacity in mass-transit transportation systems
- We see increased opportunities in intra / inter-city railway

China to be almost 60% urbanised by 2017



Source: National Bureau of Statistics of China, PwC proprietary research

Regional GDP/capita vs. class A min. wages



M&A infrastructure could rebound in 2017

China: domestic and inbound

We see potential for a rebound in domestic activity driven by a maturing and consolidation of the Chinese economy

- Infrastructure will outperform on countercyclical spending and as investors shun manufacturing and industrial sectors with lower potential for organic growth
- We do not expect a sharp rise in inbound M&A given rising interest rates and the accumulation of risks in overseas markets. Outbound restrictions will boost domestic M&A
- Key signpost for 2017 is the Communist Party 19th Congress. Investors will weigh up the risk of new regulations

B&R and China outbound deals

New regulation and capital controls will act as a drag on overall China M&A outbound transactions

- The infrastructure sector is considered strategic. Transactions will not be subject to inhibitive levels of scrutiny
- Outbound investments that dovetail with strategic objectives will instead be encouraged. Chinese investors with dollar reserves will have an advantage over pure Yuan players

B&R markets will continue to offer riskier but more attractive returns with higher potential for organic growth

- B&R region remains politically volatile, however, and subject to adjustments to external pressures, current account imbalances and currency movements
- Should the risks dashboard deteriorate we could see more sovereign downgrades affecting project economics

We see five key themes shaping the outcome for 2017

Investors broadening their horizons

To increase their returns, Investors will tackle a broader range of opportunities and risks, including

- Developing and 'frontier' markets with greater levels of country risk
- Greenfield projects, with heightened development and construction risks

This transition from pure-play, low risk infrastructure requires new skill sets and capabilities in deal sourcing, evaluation and asset management

Political leadership and ambitious goals

We see more project announcements across B&R in 2017 as governments continue to tackle economic slowdown

Many of these will come from China, as Beijing will need to supplement current announced packages to keep up the pace of investment and drive momentum behind its silk road ambitions

Ambitious infrastructure goals bring new challenges for policymakers. Spending will likely run up against budgetary constraints, and, even with the influx of private capital, there may not be enough to meet needs

Future-proofing against obsolescence

Rapid urbanisation, climate change, shifts in global economic power, demographic changes, and technological breakthroughs – can cause even traditional assets to lose relevance quickly

As a result of these trends, infrastructure (which was traditionally seen as a conservative asset class) now faces new risks. To future-proof their infrastructure spending, governments and investors will need new assessments and skills to prepare for emerging opportunities and challenges

Sustainable infrastructure for the long term

We see a growing push to decarbonise economies, implement green construction methods, and make cities more ecologically sustainable

Conflicts will of course arise between the green agenda and concerns about costs to consumers. These conflicts will be most apparent in countries where pressures from fast rising populations and urbanisation are the highest

The key question is whether governments prioritise short-term cost savings over longer-term benefits that come with sustainable development

Commodity-rich regions prioritize infrastructure

B&R Countries rich in natural resources have suffered from the fall in commodity prices, with government budgets taking a hit.

Many of these countries however see infrastructure as a way to maintain growth, support vulnerable sectors of the economy, and eventually transition away from commodity-dependent growth models

We think governments will increasingly consider innovative private financing options and turn to the private sector to support these plans

Q&A

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Thank you!

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