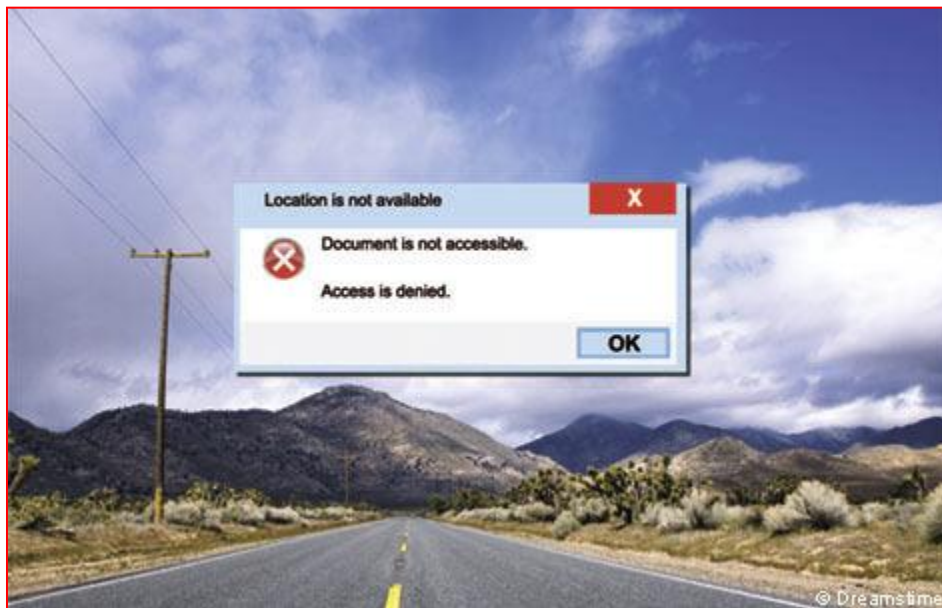


China and the US: Access denied

By Kathrin Hille, Stephanie Kirchaessner and Paul Taylor



Closed off: Huawei's failed attempts to enter the US have prompted Ren Zhengfei, chief executive, to develop a new strategy for a market that served as his original role model

In December 1997, Ren Zhengfei and his management team gathered by the fireplace in a Silicon Valley hotel to discuss their recent meetings with a clutch of US technology firms. While their American counterparts headed home for Christmas, the boss of Huawei, the Chinese telecommunications equipment maker, and his team remained at work, analysing what they had seen and heard. In Mr Ren's vision for global expansion, the US was to be the role model.

"We must respect them, learn from them, critically carry on [their work]," he concluded in an article praising companies such as IBM and Bell Labs for their innovative power, speed of movement and scale. Ever since, his company has paid up to 3 per cent of its revenue each year to consultancies including IBM, Accenture and Hay Group to model its

management systems on US multinationals. “This has helped us develop a common language with customers all over the world,” says a Huawei board member.

But 14 years on, its love affair with America is on the rocks. While the lessons from Silicon Valley have helped the Chinese company storm markets in Africa, the Middle East, Latin America and Europe – and elevated it to the global number two slot – **it has hit a brick wall in the US.** In spite of \$28bn in global revenues, \$4.4bn in operating profit and a world market share of 14.2 per cent last year, it has yet to win a single network contract with a leading telecoms carrier in the US.

Huawei’s frustrated attempts to make serious inroads in the US add up to more than just a corporate saga. They reveal deepening mutual distrust between China and America. In the US, there is growing frustration and alarm in the intelligence community and in Congress at its companies’ dependence on China for critical components in highly sensitive industries. There are also concerns that US groups are placed at a disadvantage by hidden financial support from Beijing for their rivals. China, for its part, suspects that America is seeking to contain its rise on all fronts, including economic.

The extent of Huawei’s problems became apparent last year when the company tried to raise its stake in the US market, and each attempt ended in failure. In October, it appeared close to winning a multibillion-dollar network infrastructure contract from Sprint Nextel, the third-largest carrier in the US. Though the administration of Barack Obama lacked a formal mechanism to prevent the deal, such was its concern that Gary Locke, the commerce secretary since named ambassador to Beijing, telephoned Sprint’s chief executive. In the event, Sprint chose Samsung.

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Washington toughens stance but says America is still open for business

The Obama administration is taking a harder look at foreign takeovers of US assets than its predecessors, a move that observers say reflects a desire for caution when investigating deals that could affect national security, *writes Stephanie Kirchgaessner.*

Bush administration officials were caught off guard by the political furore that erupted in 2006 after they approved a bid by Dubai Ports World to take over US port assets after examining the deal for just 30 days.

Since then, the Committee on Foreign Investment in the US (Cfius), a secretive panel chaired by the Treasury department that includes top defence and intelligence officials, appears to have sharply stepped up the number of probes it conducts – a fact that has not gone unnoticed by foreign investors.

Under Cfius rules, the takeover of a sensitive asset is investigated on a voluntary basis for 30 days. During the Bush era, companies were only rarely subject to longer, 45-day

investigations after that 30-day period. That has changed. In 2007 just 4 per cent of deals were subject to full investigations in 2007, according to Cfius data. By 2009 the figure was 38 per cent.

A Cfius official told the FT there had been no change to how deals were scrutinised, and that the increased number of investigations simply reflected that the panel reviewed transactions that were especially complicated in 2009. While the administration was absolutely in favour of inward investment, the chief task of Cfius was to focus on national security and clear deals as quickly as possible, the official added.

“We are seeing the number of investigations has grown exponentially,” says Ivan Schlager, a top Cfius lawyer at Skadden Arps. At the same time, the negative connotations of such investigations has diminished, he says.

Neal Wolin, deputy Treasury secretary and one of the officials who oversees Cfius, says the US is “one of the most open” economies in the world for foreign investment. “We strongly support the longstanding bipartisan US commitment to welcoming foreign investment, consistent with national security.”

But lawyers working on deals say a change of stance is apparent. Paul Marquardt of Cleary Gottlieb, says: “In the prior administration, there was more of a drive to keep the deals going. The current staff errs on the side of caution. In their view, they are going as fast as they can but there is no one pushing their foot on the gas.”

Last year, Huawei also lost out to Nokia Siemens Networks in a bid for Motorola’s wireless assets, and failed to win a bid for 2wire, an internet software firm that went to Pace of the UK instead. People familiar with both failures say that concerns about the risk of regulatory delays played a role in each.

Last month, Huawei was forced to agree to unwind a \$2m acquisition of patents from 3Leaf, an insolvent California-based startup, after the Committee on Foreign Investment in the United States (Cfius), which vets foreign takeovers of US assets, refused approval.

In the Sprint case, Huawei had offered external validation of its equipment through Amerilink, a company set up by William Owens, a former vice-chairman of the joint chiefs of staff, and Kevin Packingham, a former Sprint executive. But US officials never believed the group had the necessary technical capability or independence, according to people familiar with the matter. Instead, the attempt to appease government concerns was perceived as a ploy.

“Things have clearly gotten much worse for Huawei,” says Mario Mancuso of Fried Frank, a global law firm, and former undersecretary of commerce.

This is in part because of the rocky state of Sino-US relations, including reports of cyberattacks on US companies such as Google in China. Fairly or unfairly, says James

Lewis of the Center for Strategic and International Studies in Washington, America will be loath to entrust a Chinese group with access to its communications network if it has reason to suspect doing so would bolster cyberwarfare capabilities.

“Awareness in the national security policy community of threats in the cyber domain has greatly increased,” says Mr Mancuso. “So if you believe that the Chinese government is engaging in cyber-intrusion, you’ll have a problem with Huawei because Huawei sits smack in the middle of the industry supplying the critical infrastructure.”

Huawei sees itself as a victim of a relationship poisoned by distrust and demonisation of China. Bill Plummer, spokesman for Huawei North America, reels off a list of other stress points, including currency disputes, disagreement over Tibet and Taiwan and China’s inclination to use information security and innovation policies to shut foreign companies out of the market. “We are always seen through this prism,” he complains.

Concern about the expansion of China Inc has hurt other Chinese companies. In 2005, a \$18.5bn bid by state-owned China National Offshore Oil Corporation for Unocal, the US oil company, failed because of fierce political resistance. At the time, a senior official at US-based oil group Chevron, which had offered a counter bid for Unocal, told the Financial Times that the Chinese oil company had an unfair advantage thanks to “free money” from Beijing.

In a recent letter to Mr Obama, senior Republican lawmakers warned about Beijing’s “extensive support” for Huawei and ZTE, another Chinese technology group, and that such financial ties “[increase] the risk that the companies feel obliged to follow its instructions”. Huawei acknowledges having several credit lines from state banks but acts only as a “bridge” between the banks and customers who need loans to buy its equipment, and says it has received no other significant government support.

In 2008, Huawei retracted a bid with Bain Capital for 3Com, a US technology company, after it became clear the deal would not pass Cfius scrutiny. People familiar with the Cfius process say US concerns about Huawei are based on classified information known to only a handful of officials.

US politicians have long-running complaints about transparency. As a private company, Huawei does not disclose details about its owners. Mr Ren’s history in the People’s Liberation Army has fed insinuations that the PLA could have either a stake in or special relations with Huawei. He was an officer in the engineering corps from 1974 to 1983, losing his position when the military was downsized. The company refutes the insinuations, saying Mr Ren holds no more than a 1.42 per cent stake and the rest of the company is owned by employees through a holding structure. But that has helped little to dispel doubts in the US.

Excluding China Inc: Selected largest deals by Chinese companies in the US since 2007				
Date	Buyers/investors	Target/issuer	Status	Value (\$m)
Sep 2007	Huawei; Capital Equity	Bain Private 3Com	Cancelled	2,640
Nov 2009	China Investment Corp	AES Wind Generation	Cancelled	571
Dec 2009	Thayer Lodging Group; Shanghai Jin Jiang International Hotels	Interstate Hotels & Resorts	Completed	321
Jul 2010	Tempo Group; Beijing International Investment and Development	Nexteer Automotive	Completed	450
Nov 2010	China Huaneng Group	InterGen	Completed	1,232
Feb 2011	China Aviation Industry Aircraft	Cirrus Design Corporation	Announced	210
<i>Source: Capital IQ</i>				

Observers see a similar lack of transparency in Huawei’s recent approach to sensitive transactions in the US. Its “efforts to better engage US authorities have been perceived as self-serving and very limited. The way they approached the 3Leaf deal has been particularly damaging”, says Mr Mancuso. Huawei did not inform Cfius of the deal. “That created the impression that they were trying to sneak in,” says Mr Mancuso.

The company’s executives admit that they were ill advised and that communication strategy needs to change. “There has been the tendency to remain silent, and here in America that can be seen as consent,” says Matt Bross, co-president of Huawei North America. He says that from, now on, **the company intends to be more vocal in refuting what it sees as unfair allegations.**

Huawei also says the process of unwinding its patent deal with 3Leaf could have some benefits for its future in the US. The company has installed a compliance officer in charge of overseeing divestment to meet Cfius demands. “This gives us the chance for the first time to have a continuous dialogue with Cfius,” Mr Bross says.

Legal experts in the US stress that such dialogue is necessary to build trust with officials even when no deal is in the pipeline. But Huawei claims it was not given that chance in the past. “If you are Ericsson, you can have that. If you’re Huawei, you can’t,” says Mr Bross.

Huawei also intends to install product security mechanisms to address US criticism. It plans to replicate the “secure cell” structure it uses in the UK, whereby critical software code for network products is compiled by locals and put in escrow. That comes on top of a system where US customers can choose who they want to install Huawei products and who they want to support them.

This is part of the framework for a new offensive in the US. In the past year, Huawei has hired a battalion of senior sales and research staff from competitors to help win business that it has chased in vain for over a decade. For example, Jose Figueroa, former Europe sales chief for Motorola’s wireless business, joined in January especially to target AT&T, Verizon, Sprint and T-Mobile, who share more than 90 per cent of the market.

The company is also building up its research and development presence in the US. John Roese, Nortel’s former chief technology officer who joined last July, says that in the past the Huawei’s global research facilities would only “augment” R&D done in China; today, the American research base is responsible for “real innovation”. His focus is on developing cloud computing technology that will enable carriers to compete with the likes of Google and Amazon.

However, the company believes that its large size will make it increasingly difficult to keep growing at the same pace as it has done to date. It has identified corporate services as a new growth driver. It plans to expand its workforce from 110,000 by another 26,000 this year alone.

Even with this massive push, the task of breaking into the US market remains daunting. Although Huawei’s revenues in the US have grown almost 20-fold from \$40m in 2006, at \$772m last year they are still tiny compared with last year’s global revenues.

But while it keeps lobbying the top-tier carriers, Huawei has started selling gear for rural networks in the US. Last month, it sold a rural broadband network to Northeast Wireless in Maine, and currently it is in talks with Sprint Rural Alliance, a group of small rural operators that have “roaming” partnerships with Sprint Nextel, for infrastructure in a few midwestern states.

Even in the relatively straightforward Maine transaction, however, the problems Huawei faces in the US remain constant. At a recent congressional hearing, a senator from the state

asked law enforcement officials about the deal, and revealed that the FBI had discussed the transaction with Northeast Wireless. The deal was completed and did not in the end prove controversial. But it was one more sign of Huawei's uphill struggle in America.

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