Investors beware: Europe's top firms are highly exposed to China

Clingendael Report

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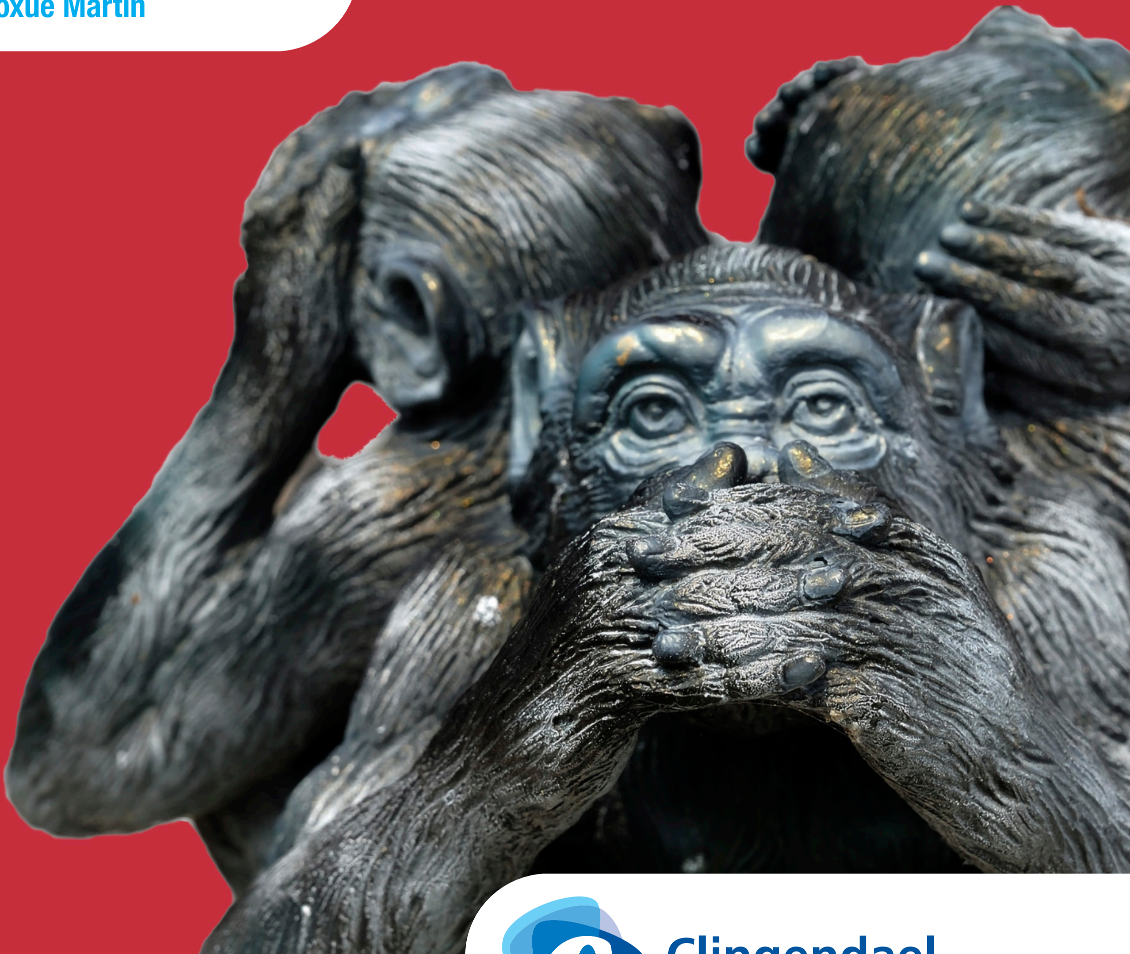

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The Netherlands Institute of International Relations 'Clingendael' is a leading think tank and academy on international affairs. Through our analyses, training and public platform activities we aim to inspire and equip governments, businesses, and civil society to contribute to a secure, sustainable and just world.

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About CPEII

CPEII

The China Platform for European Institutional Investors is an initiative aimed at supporting financial institutions in Europe with an interest in the Chinese financial sector. The Platform enhances awareness and knowledge of relevant developments, both in China and internationally, by providing original research, publishing a fortnightly newsletter and organising expert events. Two themes in particular are significant: green finance in China, a highly dynamic field with major relevance for international efforts to address climate change; and geopolitics, given the increasingly volatile and uncertain international political context of European investment in China.

The platform is open to all European financial institutions. It was launched jointly by the Clingendael Institute and AXA IM in 2019. Clingendael China Centre acts as its secretariat. We are open to requests for tailored research. For more information please contact Frans-Paul van der Putten via fputten@clingendael.org

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Executive Summary

Europe’s top firms are highly exposed to China, and therefore to China-related geopolitical risk. This risk is only set to increase in the coming years, as geopolitical tensions between China, the US and the EU are not expected to decrease. Moreover, case studies of LVMH, HSBC, ASML and BMW show that some of Europe’s biggest listed firms could and should offer investors more transparency on their risk-management strategies. Intelligence on China and geopolitical risk exposure is key for investors, and investors that get ahead of the curve may have the edge in the long term.

1 Should investors in Europe's biggest firms worry about exposure to China?

Last year, China dethroned[1] the US as the European Union's most important trading partner.[2] No less than 60% of Europe's companies plan to extend their business in China, according to a recent 2021 survey by the European Chamber of Commerce in China.[3] At the same time, geopolitical tensions between China and the West are escalating, exacerbated even further by the war in Ukraine. This raises the question: should investors in Europe's biggest firms worry about their exposure to China?

This report is aimed at investors in Europe's biggest listed firms.[4] It argues that investors have a growing need for transparency amongst European biggest companies with regard to their strategies in dealing with China-related geopolitical risk. Even investors without direct interests in China are or will be affected by China-related geopolitical risk due to the various forms of exposure of companies in the European home market. This means that investors may be increasingly exposed to the risks linked to great power competition, without having the knowledge necessary to anticipate geopolitical changes.

As geopolitical tensions between China, the US and the EU are not expected to decrease, investors would be wise to seek greater transparency about European companies' exposure to the Chinese market – and indeed get ahead of the curve and gain a competitive advantage by investing in those firms that have forward-looking geopolitical strategies in place. This report aims to put this point on investors' strategic agenda by making the following three points:

I Europe's top firms are highly exposed to China.

II China-related geopolitical risk is spreading.

III Case studies suggest that Europe's top firms may not be sufficiently transparent about geopolitical risk management.

1 Silvia Amaro, "China overtakes U.S. as Europe's main trading partner," CNBC, February 16, 2021.

2 News release, "Euro area international trade in goods surplus €29.2 bn," Eurostat, December 20, 2020.

3 This figure is based on the annual survey completed by 585 European Chamber member companies, answering questions about 2020 performance, as well as future outlooks. "Business confidence survery 2021," European Chamber, 2021.

4 This report defines 'Europe's biggest listed firms' as those listed in the MSCI Europe.

2 China Exposure Top 25[5]

Divesting from Chinese firms may seem like an obvious strategy for European investors worried about geopolitical risk. President Xi Jinping's regulatory revolution in the internet-related tech sectors and the spread of the US-China trade war to the financial world arguably make Europe a relatively safe bet away from this turmoil. And yet, this is only half the story. The indirect China-related risk flowing from European firms' exposure to China demands greater priority from investors.

The following top 25 ranking of MSCI Europe firms' exposure to China shows European corporate exposure to China based on two basic proxies: % of revenue derived from China and % of total suppliers based in China.

		% Revenue from China		*% of Suppliers with HQ in China*
1	Rio Tinto plc	56.6	Volkswagen AG	28
2	Compagnie Financière Riche-mont SA	27.6	BMW AG	25
3	Adidas AG	23	Schneider Electric SE	23
4	BMW AG	21	Daimler AG	22
5	Atlas Copco AB Class A	20	Siemens AG	19
6	AstraZeneca PLC	19.6	ABB Ltd.	18
7	L'Oréal SA	17.5	Kering SA	11
8	ASML Holding NV	16.2	Dassault Systèmes SA	11
9	Schneider Electric SE	15.5	Nestlé S.A.	9
10	ABB Ltd.	15.3	Novartis AG	9
11	Merck KGaA	14	Unilever PLC	9
12	HSBC Holdings Plc	13.5	L'Oréal SA	8
13	Daimler AG	13.5	Anheuser-Busch InBev SA/NV	8
14	Siemens Healthineers AG	12.7	Roche Holding AG	8
15	Volkswagen AG	12.6	Industria de Diseño Textil, S.A.	8
16	BP p.l.c.	10.6	Sanofi	7

5 Source: Factset GeoRev (2021). Confidence Level = 0.95. Factset's data is based on companies' own reports. Where self-reporting proved inconclusive, indirect reporting was used, weighed with a lower confidence level. A minimum confidence level of 0.95 was used as a limit. The top 25 of exposed firms is derived from the top 50 MSI Europe firms by market cap. These figures were compiled in cooperation with AXA IM. 'China' refers to mainland China.

		% Revenue from China		*% of Suppliers with HQ in China*
17	Novo Nordisk A/S Class B	10.4	Air Liquide SA	7
18	Hermès International SCA	9.2	Merck KGaA	7
19	Nestlé S.A.	8	Adidas AG	7
20	Dassault Systèmes SA	7.8	Novo Nordisk A/S Class B	7
21	Royal Dutch Shell	7.1	AstraZeneca PLC	6
22	Kering SA	6.9	TotalEnergies SE	6
23	LVMH Moët Hennessy Louis Vuitton SE	6.8	Rio Tinto plc	6
24	Anheuser-Busch InBev SA/NV	6.7	Siemens Healthineers AG	6
25	Sanofi	6.6	Royal Dutch Shell	6

These figures indicate that indirect exposure to China proves to be a substantial factor for investors in European firms. The following observations arise.

I Exposure is substantial for all selected firms, across sectors and countries

The German automotive industry is heavily dependent on Chinese suppliers and on the Chinese market. In fact, the exposure of Germany's industrial engine – and therefore Europe's – is probably bigger than these figures show, as underlined by Volkswagen calling China its "second home market".[6]

But it is not just the German automotive industry that faces high exposure to China. Five European firms derive more than a fifth of their yearly revenue from China and an additional five firms between 15% and 20%. In the top 25, we see firms from sectors as diverse as high-tech, textiles, luxury goods, chemicals and biomedical engineering, food, renewables, energy and banking.

The UK, France, Germany, Spain, the Netherlands and Scandinavian countries are strongly represented in the China Exposure Top 25, making China-related exposure an issue that covers many European countries.

6 Press release, "Powerhouse for the mobility of tomorrow," Volkswagen, 2019.

II Geopolitically sensitive sectors are exposed

While exposure is cross-sectoral, risks are especially important for geopolitically sensitive sectors with strategic relevance, such as the semiconductor industry, energy, and finance. The company Rio Tinto is an outlier in term of exposure, deriving more than half of its yearly revenue from China. This is especially interesting as the mining giant is based both in the UK and in Australia. Given the ongoing tensions between the UK and China on Hong Kong, and the escalating sanctions war between Australia and China, both home bases point to exposure to China-related risk.

III Revenue exposure is often correlated with supplier exposure

The two proxy variables show a relatively similar picture: for most firms, revenue exposure seems to be positively correlated with supplier exposure. This implies that many firms are doubly exposed to different kinds of risk. Depending on the characteristics of a certain sector and the importance of a specific supplier, the relative impact of the two types of exposure may not be the same for all firms.

IV The China Exposure Top 25 shows conservative estimates: more intelligence is needed

It should be noted that the China Exposure Top 25 in the figure shows conservative estimates. The methodology only explores two variables of exposure, whereas in reality more exist, that may be more difficult to gauge. Moreover, it focuses on a top 25 of the biggest listed firms, whereas investors' interests may have a wider scope. There are at least three reasons to believe that firms' exposure to China is bigger than the figures show.

- **China's global presence**
  China's presence is global – and so are China-related geopolitical risks. For example, European firms are involved in China's Belt and Road Initiative (BRI), in the form of China-financed projects in Europe and across the globe. Siemens[7] is a good example of a company deeply involved in BRI projects in third countries.

- **Strategic partnerships**
  European firms may have long-term strategic partnerships with Chinese firms whose importance does not show up in statistics on China exposure. Shell's strategic

7 Press release, "Siemens embraces belt and road initiative," Siemens Corporate, June 6, 2018.

partnerships[8] with major national oil companies PetroChina, Sinopec, CNOOC and Yanchang are examples of this. The weight and complexity of such relationships cannot be boiled down to one figure, and more specific intelligence on the characteristics of such partnerships is needed to gauge their geopolitical weight.

- **R&D and investment**
  Substantial factors may also be European firms' investments in China and R&D carried out in cooperation with Chinese partners – either at Chinese research institutes or in third countries but (co-)financed by Chinese institutes. Amsterdam-based Prosus is an interesting case, as it does not show up in our rankings but is considered to be highly exposed to China as a consequence of its 28.9% stake in Tencent[9]. Investors in Prosus saw their investments tumble as Tencent's value fell.

Crucially, for these reasons, we believe that the Top 25 has a conservative bias, meaning it is more likely to under- rather than overestimate the China exposure of selected firms. As geopolitical relations between Europe and China increase, methodologies for gauging economic interdependence from an investor's point of view are in urgent need of further development.

The China Exposure Top 25 points to the fact that exposure to China-related risk may be a bigger issue for European investors than often thought. But does that exposure translate to risk?

8 "What we do | China ," Shell Corporate, 2022

9 Press release, "Prosus 2021 annual report," Prosus, 2021.

3 China-related geopolitical risk is spreading

Exposure is a precondition for risk, not its equal. Only if exposure is met with adverse geopolitical trends do risks mount. However, this is exactly what is happening in many areas. Research[10] shows that geopolitical risk has already negatively impacted growth in developed economies in recent years.

Trade, finance, and environmental, social and governance (ESG): more and more is becoming geopolitical. To make sense of this rapidly changing risk environment, it is important to distinguish between at least eight categories of China-related geopolitical risk – four currently in play and four coming game-changers.

Currently in play

I US sanctions and tariffs

The Biden administration – like the Trump administration before it – is committed to using financial instruments to counter China's geopolitical ascent, which it considers a threat to US national security.

In particular, the White House[11] considers 'the threat posed by the military-industrial complex of the People's Republic of China' an 'ongoing national emergency'. It has issued an executive order that prohibits US investments in a large number of Chinese companies. Biden's executive order considers the use of technology developed by these companies outside of the PRC 'unusual and extraordinary threats'. Moreover, the Biden administration has not yet lifted the US tariffs on Chinese goods that were imposed by the Trump administration.

10 Menno Middeldorp, Jesse Groenewegen & Inge de Vreede, "Visie op 2018: de gevolgen van geopolitieke risico's en crises voor de Nederlandse economie," Rabobank – Economisch onderzoek, December 18, 2017.

11 "ADDRESSING THE THREAT FROM SECURITIES INVESTMENTS THAT FINANCE CERTAIN COMPANIES OF THE PEOPLE'S REPUBLIC OF CHINA," The White House, November 12, 2020.

Currently, three US sanctions lists are active.

- **The Specially Designated Nationals List**
  The first is the *Treasury's Specially Designated Nationals and Blocked Persons List.*[12] It lists, amongst many other Chinese nationals, a large number of senior CCP officials, such as the current Communist Party Secretary of Xinjiang Chen Quanguo, as well as the Deputy Director of the Hong Kong and Macau Affairs Office Zhang Xiaoming and Secretary of the Secretariat of the Chinese Communist Party and Director of the United Front Work Department You Quan. US law prescribes that any US and non-US nationals doing business with the listed persons and companies are subject to US penalties and sanctions, including European businesses.

- **The Chinese Military-Industrial Complex List[13]**
  The Treasury's *Chinese Military-Industrial Complex Companies List*[14] prohibits 'any US company from trading in any publicly traded securities, or any publicly traded securities that are derivative of such securities or are designed to provide investment exposure to such securities of any company mentioned in the list.' This implies that American companies may not invest in European companies in a way that provides investment exposure to a Chinese company mentioned in the list.

- **The Entity List[15]**
  The third is issued by the Department of Commerce and is usually referred to as *the Entity List.*[16] It targets Chinese companies' entities worldwide. European companies investing in or trading with said Chinese entities risk losing access to the US market. It was last updated[17] with an addition of several entities related to, amongst other factors, Chinese military quantum computing applications on November 24th 2021.

These sanctions in turn pose a risk to European companies as well. Past experiences prove that EU regulations aimed at protecting European firms from the extraterritorial effects of US sanctions in relation to other geopolitical competitors have largely been

12 Press release, "SDN List by Country," The White House.

13 The extraterritorial legal implications of the latter two sanctions lists are uncertain.

14 Statements and Releases, "FACT SHEET: Executive Order Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," The White House, June 3, 2021.

15 The extraterritorial legal implications of the latter two sanctions lists are uncertain.

16 Press release, "Supplement No. 4 to Part 744 – ENTITY LIST," US Bureau of Industry and Security, March 3, 2022.

17 Press release, "Addition of Entities and Revision of Entries on the Entity List; and Addition of Entity to the Military End-User (MEU) List," Federal Register, November 26, 2021.

ineffective.[18] The extraterritorial power of US sanctions vis-à-vis Russia and Iran already has a significant impact[19] on European business.

By all expectations, there is more to come. In its latest yearly report, the influential Congress's US-China Economic and Security Review Commission[20] recommends expanding the scope of sanctions vis-à-vis China. The US and the EU are responding to the current war in Ukraine with sanctions packages that can have extraterritorial effects on Chinese firms as well.

II EU economic security policies

In March 2021, the Council of the EU decided to impose sanctions[21] on China for the first time in three decades for human rights violations in Xinjiang. Only four months earlier,[22] China and the EU reached an agreement in principle on the Comprehensive Agreement on Investment (CAI),[23] providing in the words of Commission President Von der Leyen 'unprecedented access to the Chinese market for European investors'. The sanctions targeted four officials and one organisation. The listed individuals and entities are subject to an asset freeze in the EU, listed individuals are subject to a travel ban to the EU and persons and entities in the EU are prohibited from making funds available, either directly or indirectly, to those listed.[24] As the EU-China relationship deteriorates, European companies and their investors will not be able to escape the damage.

18 Mary E. Lovely & Jeffrey J. Schott, "Can China Blunt the Impact of New US Economic Sanctions?," Peterson Institute for International Economics, June 2021.

19 Tobias Stoll, Steven Blockmans, Jan Hagemajer, Christopher A. Hartwell, Henner Gott, Kateryna Karunska & Andreas Maurer, "Extraterritorial sanctions on trade and investments and European responses," Think Tank | European Parliament, November 20, 2020.

20 Press release, "SECTION 4: U.S.-CHINA FINANCIAL CONNECTIVITY AND RISKS TO U.S. NATIONAL SECURITY," USCC, November 2021.

21 Council of the European Union, "Implementing Regulation (EU) 2020/1998 concerning restrictive measures against serious human rights violations and abuses," Official Journal of the European Union, March 22, 2021.

22 Press release, "EU and China reach agreement in principle on investment," European Commission, December 30, 2020.

23 Press release, "EU – China Comprehensive Agreement on Investment (CAI): list of sections," European Commission, January 22, 2021.

24 Press release, "EU imposes further sanctions over serious violations of human rights around the world," Council of the European Union, March 22, 2021.

The EU has passed and is intent on passing a number of instruments implicitly targeting China or parties with strong interests in China.

- The *International Procurement Instrument* that is currently enables the EU to 'limit or exclude, on a case-by-case basis, access to its public procurement markets by economic operators originating in countries that apply restrictive or discriminatory measures to EU businesses'.[25]

- A newly operational *Investment Screening Tool*[26] has established EU-wide investment screening coordination which is aimed at guarding the European markets from foreign investors gaining leverage over strategic interests.

- In the months to come, a *Corporate due diligence and corporate accountability instrument*[27] will be introduced that obliges European firms to identify, prevent, mitigate and account for human rights violations and negative environmental impacts in their supply chains.

One major new geoeconomic tool is being put to the test before it is even good and ready to use. The Anti-coercion Instrument should allow the EU to react to the 'economic intimidation' of one or more of its member states with responses varying from 'imposing tariffs and restricting imports from the country in question to restrictions on services or investment or steps to limit the country's access to the EU's internal market'.[28] The need for more protective instruments was underlined by China's economic coercion of Lithuania, as it allegedly halted Lithuanian imports and pressured European businesses to cut Lithuania from their supply chains as a response to the Lithuanian government's decision to rename its Taiwan representative office[29].

25 "中华人民共和国反外国制裁法 (Opposing Foreign Sanctions Law of the People's Republic of China)," 全国人民代表大会 (The National Congress of the People's Republic of China), June 10, 2021.

26 Press release, "EU foreign investment screening mechanism becomes fully operational," European Commission, October 9, 2020.

27 Press release, "European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL))," European Parliament, March 10, 2021.

28 Press release, "EU strengthens protection against economic coercion," European Commission, December 8, 2021.

29 "China halts Lithuania beef, dairy and beer imports amid Taiwan row," BBC News, February 11, 2022.

The Dutch government has also signalled that it will strive for stronger use of the internal market's global influence to project geopolitical power. The Coalition agreement reads:

> We will make strategic use of the EU's economic power, for example by imposing sanctions that can be extraterritorial.[30]

It also says it will 'campaign to abolish veto rights concerning decisions on sanctions, [and] human rights violations' in the European Council. That would mean sanctions could be applied in a significantly swifter and more far-reaching manner. The current crisis in Ukraine is setting a precedent for the comprehensive use of sanctions by EU member states as a primary means of projecting shared European power. This geopolitical development will impact EU-China business as well.

III Chinese economic coercion

China is increasingly using sanctions and other means of economic coercion to project geopolitical influence over European countries.

The Chinese government responded to EU sanctions by targeting five MEPs, three national MPs, two scholars, two think-tanks, as well as the Political and Security Committee of the Council of the European Union and the Subcommittee on Human Rights of the European Parliament. The sanctioning reads thus:

> The individuals concerned and their families are prohibited from entering the mainland, Hong Kong and Macao of China. They and companies and institutions associated with them are also restricted from doing business with China.[31]

China has since adopted the Anti-Foreign Sanctions Law,[32] which formalizes that China will respond to potential further EU and US sanctions by counter-sanctioning the individuals and organisations directly or indirectly involved in sanctioning China, in addition to:

> spouses and immediate family members of individuals included in the counter-list; senior managers or actual controllers of the organisations included in the

30 "Coalition agreement 'Looking out for each other, looking ahead to the future'," Government of The Netherlands, December 15, 2021.

31 "Foreign Ministry Spokesperson Announces Sanctions on Relevant EU Entities and Personnel," Ministry of Foreign Affairs of the People's Republic of China, 22 March, 2021.

32 "中华人民共和国反外国制裁法 (Opposing Foreign Sanctions Law of the People's Republic of China)," 全国人民代表大会 (The National Congress of the People's Republic of China), June 10, 2021.

> counter-list; an organisation in which individuals on the counter-list act as senior managers; an organisation that is actually controlled by or participated in the establishment and operation of an individual or organisation included in the counter-list.[33]

Measures include not issuing visas, denying entry, cancelling visas or expelling targets, seizing movable property, immovable property and other types of property within China, prohibiting or restricting organisations and individuals in China from carrying out related transactions, cooperation and other activities with them, and, more ominously:

> other necessary measures.

As mentioned in the section above, China has allegedly started pressuring European businesses to cut Lithuania from their supply chains and has halted imports of Lithuanian goods, as a result of escalating diplomatic tensions. What is significant to note is that China has a larger array of informal measures in place to pursue its geopolitical interests than the EU, having the ability, for instance, to halt imports by large Chinese (state-owned) enterprises without officially sanctioning such a measure. It is also able to coordinate and execute a centralised geopolitical strategy more efficiently than the EU.

IV (Geo)politicisation of ESG issues

Chinese human rights violations have been a cause for Western concern and criticism since 1989. Currently, however, human rights issues are becoming politicised in a way that is affecting European businesses like never before. Human rights violations in Xinjiang and Hong Kong are rapidly becoming key drivers of public opinion on China amongst European audiences.[34] ESG issues have become instruments of geopolitics.

For example, the Swedish fast-fashion multinational H&M issued a statement – since deleted[35] – in which it says it will not use Xinjiang-produced cotton in its clothing over forced-labour concerns.[36] As a result, it faced a consumer boycott in China,

33 "中华人民共和国反外国制裁法 (Opposing Foreign Sanctions Law of the People's Republic of China)," 全国人民代表大会 (The National Congress of the People's Republic of China), June 10, 2021.

34 Ties Dams, Xiaoxue Martin & Vera Kranenburg, "China's Soft Power in Europe: Falling on hard times," The Clingendael Institute, April 20, 2021.

35 "H&M cuts ties with Chinese yarn producer over forced labour allegations," The Local SE – Sweden's news in English, September 16, 2020.

36 "H&M Should Lay Low Until China Anger Blows Over, EU Chamer Says," Bloomberg News, March 30, 2021.

outlets vanished from Apple Maps and Baidu Maps searches and H&M's stores were closed by landlords.[37]

The (geo)politicisation of ESG issues may affect firms and investors from both angles: the European public may become more critical of exposure to China and Chinese-sourced products, as well as dealing with a Chinese backlash when trying to reduce exposure.

Coming game-changers

The following four sources of geopolitical risk, in part already in play right now, are expected to grow in importance for European firms heavily exposed to China.

I State-driven cyber threats

Business leaders acknowledge the strategic importance of cyber risk management to the future of their enterprises. But the nature of these threats is changing: although cybercrime and industrial espionage have been factors for a longer period of time, state-led cyberattacks on businesses for geopolitical purposes – i.e. punishing a country for political purposes by hurting its companies[38] – should be expected to become a significant factor as the geopolitical strife between China and the West intensifies.[39]

China's cyber capabilities are advancing rapidly.[40] The EU has sanctioned Haitai Technology Development for supporting the Operation Cloud Hopper cyberattacks, which

> targeted information systems of multinational companies in six continents … and gained unauthorised access to commercially sensitive data, resulting in significant economic loss.[41]

37 Casper Rouffaer, Siem Eikelenboom & Tom Claessens, "Half of the Netherlands' biggest pension funds invest in Chinese repression," Follow The Money, May 22, 2021.

38 Ties Dams, in collaboration with KPMG, "Gaming The New Security Nexus," The Clingendael Institute & KPMG, November 21, 2019.

39 Frans-Paul van der Putten, "The growing relevance of Policy Brief geopolitics for European business," The Clingendael Institute, May 2018.

40 "Cyber Capabilities and National Power: A Net Assessment," International Institute for Strategic Studies, June 28, 2021.

41 "EU sanctions Russian, Chinese hackers over alleged cyberattacks," DW, July 30, 2020.

As part of the hybrid warfare toolkit, targeted disinformation campaigns may well be used in a similar vein in the future, targeting companies' reputation rather than cyber vulnerabilities.

II Corporate patriotism

Competition with China – economic and geopolitical – is pushing European governments to pursue more proactive industrial policies, stepping away from neoliberal laissez-faire and towards a more mercantilist geoeconomic model. The EU has just launched its biggest industrial intervention ever, aside from its agricultural policies – the European Chips act, a multi-billion euro policy package aimed at securing European supply chains, averting shortages of semiconductors and promoting investment into the industry[42] – with clear geostrategic purposes in mind. This trend will significantly alter the demands governments and regulators impose on multinational European firms.

III Climate and energy politics

Climate change should leverage a global convergence on green finance standards, the EU and China being two of the main playmakers here. Geopolitical strife as a result of energy dependencies will also exacerbate the push by European governments to reduce firms' carbon footprint. With Europe already struggling with an energy crisis, further rapprochement between Russia and China may intensify competition over Russian gas, possibly leaving Europe with the prospects of cold winters ahead. At present, China is carefully balancing its relations with Russia with those of the US and Western countries. Russia is only a minor export partner for China compared to the US, the EU and other Western countries. In the Ukraine conflict so far, it seems that China is trying to manage not only the relationship with Moscow, but also with Washington, Brussels and Kyiv.

IV Global chokepoints

A vital part of Sino-US competition concerns global trade infrastructure. The US aims to maintain maritime hegemony; China aims to build a network of supply chains outside of US control, maritime and land-based. Great power competition converges on global chokepoints: vital places of connection in global transport chains, such as the Strait of Hormuz.

When Sino-US rivalry escalates to the point of outright conflict – direct or through proxy-states – these chokepoints can be used to coerce third parties. New transport

42 Press Release, "Digital sovereignty: Commission proposes Chips Act to confront semiconductor shortages and strengthen Europe's technological leadership," European Commission, February 8, 2022.

routes and chokepoints – such as those expected to arise in the Arctic[43] – will have a fundamentally disruptive impact on the significance of Europe to the global economy. European firms highly exposed to China may be forced to choose between or be blocked from using certain transport routes, if not cut out of one of two – Chinese or US – networks altogether.

All categories of risk – current and coming – show upward trends. In other words: risks are growing for European firms. The vital question is: are they dealing with this new reality of spreading geopolitical risk?

Are Europe's top firms sufficiently transparent about geopolitical risk management?

The following analysis is geared to the four risks currently in play – US financial warfare, European economic security policies, Chinese geoeconomics and the (geo)politicisation of ESG – rather than upcoming risks. As these risks are here to stay, European companies will have to show investors how they plan to manage this hostile environment.

Four cases – selected across sectors (luxury, finance, high-tech and automotive) and countries (France, UK, the Netherlands and Germany) – show that some of Europe's biggest listed firms could offer investors more transparency on their risk-management strategies with regard to China-related geopolitical risk.

43 Ties Dams, Louise van Schaik & Adaja Stoetman, "China's arctic strategy in Iceland and Greenland," The Clingendael Institute, June 4, 2020.

4 Are firms transparent about geopolitical risk? The cases of LVMH, HSBC, ASML, and BMW

LVMH: See no evil

- LVMH Moët Hennessy Louis Vuitton
- Headquartered in France
- Luxury goods company
- 34.8% of LVMH's revenue came from Asia (excluding Japan) in 2021.[44] In 2020, this was 34.4%, and in 2020 it was 30.2%.
- 1,746 stores in Asia (excluding Japan) in 2021, 232 more than the previous year.

French luxury giant LVMH seems in denial about China-related geopolitical risks, or the geopoliticisation of ESG that is relevant to its products. CFO Jean-Jacques Guiony, in response to a question on whether LVMH brands might be at risk of a Chinese boycott, stated in April 2021:

> I've never seen a big threat in being successful in a given country. Everybody's talking about China being an issue. As far as I'm concerned, it's more an opportunity than anything else…We are very happy with the business we do there and we believe that it's a complex country, like any other business, I would say, and we are not particularly worried that something very bad could happen there.[45]

After President Xi Jinping's August 2021 pledge to redistribute wealth in the country it automatically piled far more pressure on the country's wealthiest people and businesses.[46] The aim is to establish a system to redistribute wealth in the interest of

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44 Press release, "2021 Full Year Results – LVMH," LVMH, January 27, 2022.

45 Joelle Diderich, "LVMH Not Worried About Fallout From Xinjiang Cotton Controversy," WWD, April 13, 2021.

46 Laura He, "President Xi Jinping turns his fire on China's rich in push to redistribute wealth," CNN Business, August 18, 2021.

social fairness and common prosperity. LVMH CFO Jean-Jacques Guiony stated that this could be detrimental to the upper middle class that makes up the bulk of LVMH's customer base, but that he is 'not particularly concerned nor worried about the recent announcement'.[47]

LVMH's supply chain transparency is also limited, although it is part of the Better Cotton Initiative (BCI). This is a non-profit governance group that promotes better standards in cotton farming and practices that suspended links to Xinjiang in 2020. Still, LVMH has stayed silent on the controversies surrounding Xinjiang cotton.[48] It has not shared the amount of cotton originating from China that is used by its brands.[49] Instead, it has stated that cotton used by brands that are under the LVMH umbrella are mainly from other places like India, the US, Egypt and Turkey. Most of this cotton was certified by trade groups like the BCI.[50] In 2020, 1,325 audits were undertaken worldwide, 44% of which covered workforce-related aspects including forced labour.[51] LVMH disclosed very little on the locations of its supply chain, lagging behind companies like Kering or Hugo Boss in terms of supply chain transparency.[52] It has only taken basic steps to address supply chain forced labour risks, according to Know Your Chain. It seeks to fully integrate dedicated traceability systems in all of its strategic supply chains by 2030.[53] The risk of geopoliticisation of ESG issues thus remains unaddressed.

All in all, LVMH has carefully avoided mentioning China-related risk in its public statements or annual reports, and even seems to deny the existence of this risk in the first place.

47 Michelle Toh, "President Xi Jinping's pledge to redistribute wealth brings back bad memories for luxury brands in China," CNN Business, October 30, 2021.
48 Isabel Togoh, "As Burberry Faces Backlash In China Over Xinjiang Cotton, Other Luxury Brands Could Face Boycott," Forbes, March 26, 2021; Lauren Indvik, "Fashion, Xinjiang and the perils of supply chain transparency," Financial Times, April 9, 2021.
49 Isabel Togoh, "As Burberry Faces Backlash In China Over Xinjiang Cotton, Other Luxury Brands Could Face Boycott," Forbes, March 26, 2021; Lauren Indvik, "Fashion, Xinjiang and the perils of supply chain transparency," Financial Times, April 9, 2021.
50 Robert Williams, "Are These Fashions Linked to Forced Labour? Brands Can't Confidently Say No," Business of Fashion, December 16, 2020.
51 Press report, "2020 SOCIAL AND ENVIRONMENTAL RESPONSIBILITY REPORT – LVMH," LVMH, May 10, 2021.
52 Benchmark report, "2021 Apparel and Footwear BENCHMARK REPORT," KnowTheChain, 2021.
53 Press release, "2021 Full Year Results – LVMH," LVMH, January 27, 2022.

HSBC: Feeling the heat

- HSBC Holdings plc
- Headquartered in the UK
- Investment banking company
- The largest foreign bank in China
- 39% of HSBC's revenue, and more than 60% of profits, are earned in Hong Kong and mainland China.[54]

Unlike LVMH, HSBC openly acknowledges China-related geopolitical risk in its annual reports as well as in its public statements. It would have been difficult not to: as an international bank that derives most of its profits from China, HSBC has faced the consequences of rising US-China tensions and geopoliticisation first hand. Two instances are of particular relevance here. Firstly, HSBC was at the centre of the conflict over Huawei Technologies, stuck between complying with US legislation and maintaining its relations in China.

HSBC started falling out of favour with Beijing after it was revealed in 2019 that the bank had provided information about Huawei Technologies to the US Department of Justice, helping to build up criminal charges against Huawei CFO Meng Wanzhou.[55] This led to negative media attention in both China and the West, and damaged HSBC's position in China. John Flint, CEO of HSBC at the time, was summoned to the Chinese embassy in the UK to explain its involvement in the Huawei ordeal. HSBC's failing reputation in China has subsequently had real consequences for its operations. For example, several Chinese state-owned enterprises, including China Energy Engineering Group Co., Ltd., have reduced or completely terminated business with HSBC.[56] Secondly, HSBC broke its political neutrality over the anti-government protests in Hong Kong that started in 2019. Previously, HSBC managed to steer clear of involving itself in the political situation in Hong Kong. However, it faced rising pressure over its initial hesitance to take a stance on the protests, such as political heavyweight and former Chief Executive C.Y. Leung calling for a consumer boycott of HSBC. The pressure worked: in June 2020, HSBC publicly backed the new national security law in Hong Kong. This law was imposed as a response to the protests and is criticised for limiting Hong Kong's freedoms as a Special

54 Narayanan Somasundaran & Michelle Chan, "HSBC's bow to China stirs up internal anxiety and patience," NikkeiAsia, June 15, 2020.; Sumeet Chatterjee & Engem Tham, "How Beijing humbled Britain's mighty HSBC," Reuters, June 28, 2021.

55 Karen Freifeld & Steve Stecklow, "Exclusive: HSBC probe helped lead to U.S. charges against Huawei CFO," Reuters, February 26, 2019.

56 Sumeet Chatterjee & Engem Tham, "How Beijing humbled Britain's mighty HSBC," Reuters, June 28, 2021.

Administrative Region of the PRC.[57] Then-US Secretary of State Mike Pompeo, among others, condemned HSBC's decision to back the law.[58] HSBC thus faced reputational damage both inside and outside China.

HSBC attempted to restore its reputation in Beijing with an internal public-relations campaign named 'Beijing Visibility Strategy', launched in 2019.[59] The campaign budgets $2.5 million for marketing, involving media, sponsorships and outdoor advertising.[60] It involves targeting social media advertisements in areas close to government buildings, aimed at reaching policymakers.

HSBC's reports also shed light on its stance towards China-related geopolitical risk. As stated in its 1Q21 Earnings Release:[61]

> "Evolving developments in Hong Kong, US policy on strategic Chinese industries, claims of human rights violations and other potential areas of tension may affect the Group in terms of the impact of sanctions, as well as regulatory, reputational and market risks… How the US-China relationship will evolve over the coming months is as yet unclear. The US has recently indicated that it will cooperate with China on issues of mutual interest, such as climate change, but has also pledged to partner with its allies to confront China on certain issues. We continue to monitor the situation. Business sentiment in some sectors in Hong Kong remains dampened, although the financial services sector has remained strong and has benefited from stable liquidity conditions. The financial impact to the Group of geopolitical risks in Asia is heightened due to the strategic importance of the region, and Hong Kong in particular, in terms of profitability and prospects for growth."

HSBC explicitly lists geopolitical risks related to China as having a negative effect on its economic forecasts, stating in its 3Q21 Earnings Release[62]: "geopolitical risks also present downside threats. These risks include: continued differences between the

57 "The Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region," 2020.

58 Michael R. Pompeo, "On China's Attempted Coercion of the United Kingdom," US Department of State, June 9, 2020.

59 Sumeet Chatterjee & Engem Tham, "HSBC's bow to China stirs up internal anxiety and patience," NikkeiAsia, June 15, 2020.

60 Harry Wilson & Alfred Liu, "HSBC Plans Chinese PR Blitz to Get Back in Beijing's Good Books," Bloomberg Law, September 20, 2019.

61 Aileen Taylor, "HSBC Holdings plc 1Q21 EARNINGS RELEASE," HSBC, April 27, 2021.

62 "All reporting," HSBC Corporate.

US and China over a range of issues, dampened business sentiment in Hong Kong…" As a mitigant to geopolitical risks, HSBC's annual report of 2020 states:

> "We monitor developments in geopolitical and macroeconomic risk and assess what impacts these may have on our portfolios…We have increased the frequency and depth of monitoring activities, and performed stress tests and other sectoral reviews to identify portfolios or customers who were experiencing, or were likely to experience, financial difficulty as a result."

Thus, while HSBC acknowledges geopolitical risks, its actual strategy to manage these risks remains opaque for investors. Moreover, regardless of these geopolitical struggles, HSBC's commitment and exposure to China is only set to increase. CEO Noel Quinn noted that navigating a complex geopolitical landscape that includes financial sanctions is a 'fact of life' for international banks like HSBC, one that can still continue to be managed.[63] In February 2021, HSBC even indicated a shift in strategy in response to the pandemic, stating an explicit focus on Asian markets including mainland China and Hong Kong.[64] This marks a move away from Europe and the US.

ASML: Mapping the risk universe

- ASML Holding N.V.
- Headquartered in the Netherlands
- Semiconductor company
- R&D is mostly located in the Netherlands and the US, only 3% is located in China
- IP portfolio patents are mostly owned in the Netherlands, 0% is owned in China
- In 2021, total net sales in China were €2,740.8 million (16.5%).[65] In 2020, total net sales in China were €2,324.4 million (16.6%) and in 2019 total net sales in China were €1,377.7 million (11.7%). China is the third-largest market for ASML, after Taiwan and Korea.

ASML's China-related geopolitical risk is high, and global geopolitics are an important industry dynamic for the sector, as the company's annual report of 2021 notes.[66]

63 Chad Bray, "HSBC boss Noel Quinn: Complex geopolitical landscape a 'fact of life' for global banks," South China Morning Post, October 11, 2021.
64 Justin Harper, "HSBC shifts focus from west to east as profits dive," BBC, February 23, 2021.
65 Annual report, "2021 Annual Report," ASML, February 9, 2022.
66 Annual report, "2021 Annual Report," ASML, February 9, 2022.

ASML explicitly discusses geopolitical tensions in its public reports and statements. Like HSBC, it was caught amid the deteriorating US-China relationship. Moreover, European governments have also started to shift towards securing and investing in semiconductor supply. According to the report, these trade tensions and protectionism lead not only to trading costs for the industry, but also to increasing complexity of supply chains.

The American push against China’s technological rise had a big impact on ASML.[67] The company failed to secure an export licence to China in 2018, as the Dutch government was reportedly pressured by the US to stop the sale.[68] Furthermore, US sanctions restricting the import of advanced chip-making equipment to China also hinder ASML’s China sales, with more restrictions potentially incoming.[69] CFO Roger Dassen expects that the level of sales into domestic China in 2022 will be similar to that in 2021, stating: “For next year I wouldn’t expect a dramatic increase in that number, but we would expect that number to be sustained, so also next year pretty strong sales.” On the possibility of more US restrictions of lithography sales to China, Dassen noted in November 2021: “If for whatever reason, something were to happen on the China front, for instance more stringent regulation ... in all likelihood that demand would be hoovered up someplace else.”[70] However, ASML remains wary of possible new restrictions, with CEO Peter Wennink noting in January 2022: “I am concerned about any initiative from any government to restrict shipping manufacturing equipment… We’re in dire shortage of mature semiconductor technology and we need that mature manufacturing capacity.”[71]

As such, ASML lists geopolitical tensions as threats in its annual report’s SWOT analysis.[72] On this issue Wennink stated in the 2020 annual report that “geopolitical tensions and export control issues could have a significant impact on our industry… Most important is that we continue to put the customer at the heart of our business. Listening to the customer may sound obvious, but having direct interaction and communication with our customers is no longer possible for all ASML employees.”[73]

67 Annual report, “2021 Annual Report,” ASML, February 9, 2022.; Annual report, “2020 Annual Report,” ASML, February 10, 2021.

68 Alexandra Alper, Toby Sterling & Stephen Nellis, “Trump administration pressed Dutch hard to cancel China chip-equipment sale: sources,” Reuters, January 6, 2020.

69 Final report, “Final Report,” National Security Commission on Artificial Intelligence, March 19, 2021.

70 Reuters Staff, “UPDATE 1-ASML sees around $2.3 bln of sales in China in 2021, 2022,” Reuters, November 18, 2021.

71 Cagan Koc & April Roach, “ASML to boost headcount by thousands to overcome supply crunch,” Bloomberg, January 19, 2022.

72 Annual report, “2021 Annual Report,” ASML, February 9, 2022.

73 Annual report, “2020 Annual Report,” ASML, February 10, 2021.

ASML employs a 'risk universe' to annually assess the business environment and drive risk response. Geopolitical tensions are listed as risk developments in recent years and included in the following risk categories: political, continuity of own operations, human resources, business model, industry cycle, violations of laws and regulations. The 2021 annual report states:

> Export restrictions are rising, and global trade is shifting from globalisation to regionalisation, particularly between China and the US and countries that strive for technological sovereignty. This may lead to a decoupled ecosystem and – in the longer term – overcapacity. Trade and export barriers have impacted our ability to sell and maintain systems to certain customers and impact our business by limiting our ability to sell our products and services in certain jurisdictions or to certain customers. Geopolitical tensions also result in movement restrictions of the employees across countries. …
>
> We aim to serve and support all our customers around the world to the best of our ability, while being compliant with laws and regulations set by the jurisdictions where we operate. Risk exposure with regard to political tensions, protectionism and restriction remains high in 2021.

Its consequent risk response is to:

- "Monitor geopolitical developments
- Apply for export licences as required
- Comply with (existing and new) regulations
- Collaborate with peers in global advocacy"[74]

Despite these risks, ASML has increased its business in China in recent years, and expects it to increase further.[75] Its strategy to stay ahead of competitors has always been focused on investing in innovation and maintaining business relationships in China, rather than decoupling. As its 2020 annual report warned: "The semiconductor industry is one of the battlefields in a trade conflict between the world's superpowers. ASML's position has always been clear: that while the company always operates within applicable rules and regulations, the world's electronics ecosystem is best served with a global and open market, where all players can collaborate and compete on equal terms."

74 Annual report, "2021 Annual Report," ASML, February 9, 2022.

75 Annual report, "2020 Annual Report," ASML, February 10, 2021.

BMW: Indirect risk, big impact

- BMW Group
- Headquartered in Germany
- Luxury vehicles company
- In 2021, 846,237 BMW Group vehicles were delivered to customers in the Chinese market, representing growth of 8.9% compared to 2020.[76]
- BMW Brilliance Automotive Ltd – the joint venture between BMW Group and Chinese partner Brilliance Group – saw revenue of €23,913 million in 2020, compared to €21,910 million in 2019.

The Chinese car market is the largest in the world, which is also reflected in BMW Group's China strategy. The company is mainly focused on sustainability, innovation and electrification, digitalisation, and premium customer experience in China, as it noted during its Bankers Day presentation in July 2021.[77] In December 2021, BMW upgraded its strategy to a 'China First' approach, which would include "being independent enough to respond quickly to market changes".[78] That year, it also became the first European company to issue bonds via public offerings in China.[79]

BMW Group does note (geo)political risk in its reports, stating in its half-year report 2021 that they "*are likely to remain a source of uncertainty. However, [BMW] does not currently anticipate any further increases in customs tariffs*".[80] Risks other than tariffs were also considered in the 2020 annual report, such as import and export restrictions on certain technologies: "The potential introduction of further trade restrictions on both sides could have a significantly adverse impact on the BMW Group's business operations due to less favourable conditions for importing vehicles."[81] This risk could "lead primarily to additional expenses, but also complicate the import and export of vehicles and parts". Unlike many other global carmakers, BMW Group does not manufacture all its Chinese sales locally. On the other side of the coin, "any reduction in tariff barriers, import restrictions or direct excise duties could result in lower manufacturing costs or enable products and services to be offered to customers at more attractive prices."

76 Press release, "BMW Group strengthens partnership in China: Extension of Joint Venture Contract until 2040 enters into force," BMW Group, February 11, 2022.
77 BMW China, "Bankers Day Presentation," BMW Group, July, 2021.
78 Huazhong Wang, "BMW puts China first in upgraded strategy," China Daily, December 20, 2021.
79 Xinhua, "China's panda bond market thrives amid opening-up," China.org.cn, June 17, 2021.
80 Press release, "Half-year Report," BMW Group, June 30, 2021.
81 Press release, "BMW GROUP REPORT 2020," BMW Group, March 11, 2021.

Unfortunately for BMW Group, import and export restrictions did end up impacting its operations, though indirectly via its car part maker Continental.[82] Not US-China tensions, but EU-China political tensions were the cause. The source of the trouble is a worsening diplomatic dispute between Lithuania and China, which escalated as the former grew closer to Taiwan. In response, the Chinese government reportedly started blocking Lithuanian imports, as well as imports from other EU countries that contain Lithuanian components. Car part maker Continental also reportedly faced pressure to stop using Lithuanian components, as the European car industry was dragged into the conflict. Although the EU has since taken action and launched a case against China at the WTO, tensions are sure to simmer on. This illustrates how a political issue can severely impact businesses, and demonstrates European companies' exposure to China-related geopolitical risk.

Nevertheless, as in the other case studies, BMW Group is committed to the Chinese market for the long term. In February 2022, as it extended a joint venture contract with Chinese partner Brilliance China Automotive Holdings Ltd. until 2040, Chairman of the Board of Management Oliver Zipse stated: "We continue to expand our long and successful commitment to China. We firmly believe that our continued success in the world's largest automotive market can only go hand in hand with the growth and further development of our BBA joint venture."[83]

In short, while the companies in these case studies acknowledge and deal with China-related geopolitical risk to varying degrees, all indicate their continued commitment to the Chinese market. Investors could and should be better informed about the different ways in which these firms are able to and in fact are already dealing with China-related geopolitical risk.

82 Andrius Sytas & John O'Donnell, " EXCLUSIVE China pressures Germany's Continental to cut out Lithuania – sources," Reuters, December 17, 2021; Andrius Sytas, "Continental to keep investing in Lithuania despite China pressure," Reuters, February 18, 2022.

83 Press release, "BMW Group strengthens partnership in China: Extension of Joint Venture Contract until 2040 enters into force," BMW Group, February 10, 2022.

5 Investors beware: Europe's top firms are highly exposed to China

The current crisis in Ukraine shows that great power competition is back. China's rise brings risks that transcend bilateral relations or current crises; because of the historical significance, its macroeconomic impact and the global geopolitical effects of China's rise, there is no hiding from China-related geopolitical risk. Divesting from China seems not to be the answer. But what is?

Europe's top firms are doubling down on their engagement with China while risk exposure is growing. Investors will have to deal with the new geopolitical reality in addition to the economic opportunities the Chinese market continues to offer for both European firms and investors. Gaining greater transparency into the distinct geopolitical risk management strategies of Europe's leading corporates may be an important start for investor strategies that are more geopolitically resilient.

Based on this preliminary research, at least three key insights stand out:

I Geopolitical risk – especially related to China – is becoming a significant factor for investors in European firms

All risk factors are pointing upwards. The ascent of China represents a historical rebalancing of the economic and political world order. This implies volatile geopolitics for years to come. As such, China's rise impacts not just relations to or investments in China, but also the global economy in various ways. In many current and coming geopolitical risks, "China" is a defining factor.

II Intelligence on China and geopolitical risk exposure is key

Intelligence on geopolitical risk exposure of European firms is lacking – and yet, in managing the global shift of power, this intelligence is key. Geopolitical risk does not work in the same way as political or country risk: China's economy is a global system tied to the Chinese state. Disruptions of this system impact supply chains and financial networks worldwide. Competitive investors need to get to grips with this new – geopolitical – reality that China embodies. That starts with gaining more knowledge of China itself, but should be followed by gaining more transparency into the risk management strategies of the European firms investors are engaging with.

III Investors that get ahead of the curve may have the edge in the long term

Many European firms seem to treat geopolitics as a short-term issue: conflict brings temporary disruptions, that are levelled out whenever stability returns. This exposes a flawed understanding of the nature of the challenge. Moreover, many treat geopolitics as a factor they cannot impact. The contrast with European policymakers and political leaders is striking; in the past few years, the rise of China has – amongst other factors – brought home the point that the internal market should be better protected from geopolitics. This raises the question of the extent to which corporate strategies can make the same leap – and whether investors that focus on the companies that truly acknowledge the new geopolitical reality will have a competitive advantage in the future.