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What Chinese companies must do to succeed in cross-border M&A

Chinese companies are playing an increasingly important role in the global mergers and acquisitions (M&A) market. Foreign direct investment by Chinese companies overseas continues to grow in response to the adoption of the "go global" policy (aimed at establishing China's national champions as international players), from US$4 billion in 2004 to US$43.3 billion in 2009. Factors influencing this growth include stimulus measures implemented by the Chinese government, a lack of capital available to competing Western investors because of the credit crisis, the easing of rules in China governing overseas acquisitions and a desire to invest in other emerging markets, as well as in strategically important assets – particularly in the energy and mining sectors.

In a report, *A Brave New World: The Climate for Chinese M&A Abroad*, published in March 2010, the Economist Intelligence Unit (EIU) identifies the issues that drive Chinese companies to invest in overseas assets. These include the need for natural resources, access to technology and western management expertise. The EIU Report was sponsored by Clifford Chance, China International Capital Corporation and Accenture.

Chinese companies face a number of challenges – some of them unique – in their cross-border M&A activities. A failure to address these challenges may have potentially damaging consequences for Chinese outbound activity and for any Western businesses looking for capital investment. The EIU report indicates that, as the world economy begins to recover, a revival of interest in M&A among Western businesses may mean that Chinese companies may find themselves either having to compete much more vigorously to secure their targets, or having to lower their expectations.

Unfortunately, there is no such thing as a step-by-step guide to successful cross-border M&A. There are too many variants on any M&A transaction and especially on a Chinese outbound transaction. In addition, regulatory practice within the People's Republic of China (PRC) and around the rest of the world is still evolving. However, we can offer some valuable insights into the crucial issues that need to be considered based on our experience of working on some of the most significant outbound China deals over the past few years. This experience includes acting for Lenovo on one of the first major Chinese outbound transactions, as well as the more recent ground-breaking transaction for resources and mining company Chinalco.

A Chinese company can improve the likelihood of success by focusing on some of the key aspects of managing an outbound transaction. These issues centre around identifying the best way to structure a transaction, securing regulatory approvals in the PRC, navigating foreign investment regulations, the Chinese financing process and ensuring the successful project management of the transaction. Each issue in isolation may not be extraordinary but it is the combination and interplay of all of these issues that set Chinese outbound deals apart.

Structuring an outbound M&A transaction

Choosing which structure to use is always a difficult decision in any M&A transaction

but particularly in a Chinese outbound transaction. Whether the deal is a public or private one, its size, the nature of the target and the sector in which that target operates, and whether a controlling stake is to be acquired and how it will be governed are all issues that need to be considered carefully from the outset.

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A Chinese company needs to understand how each type of structure will impact on all stakeholders – shareholders, regulators, the media, politicians, other potential bidders and the PRC authorities.

The main elements of any structure for Chinese outbound investment will dictate the need for and the availability and the timing of regulatory approvals as well as political and public perception. The level of regulatory and public scrutiny that Chinese outbound transactions attract means that Chinese outbound investors often have to be open to creative structuring to achieve their aims. Indeed, more unconventional structures may be required, such as tiered off-take arrangements, derivative or synthetic instruments and staged transactions.

The political and regulatory environment may require a Chinese investor not only to be creative but to be adaptable. For example, after Chinalco had acquired a 12 per cent stake in Rio Tinto it went on to agree a complex investment structure involving a convertible bond, a number of strategic alliances and intricate synthetic structures.

Regulatory approvals in PRC

The Chinese approvals process is still evolving and is not clearly defined. Various regulators may have to be involved including:

- State Council
- National Development and Reform Commission (NDRC) – the Chinese authority that is responsible for mapping out and supervising the implementation of macro-economic policies
- Ministry of Commerce (MOFCOM) – the Chinese authority that is responsible for the examination and approval of foreign investment
- State Administration of Foreign Exchange (SAFE) – the Chinese authority that is responsible for the administration of foreign exchange.

In addition, state-owned enterprises (SOEs) may also have to obtain approval from the State-owned Assets Supervision and Administration Commission (SASAC). SASAC is the agency that is the ultimate controller of all SOEs.

The Chinese regulatory review process is substantive and comprehensive. It includes a review of the deal structure, due diligence results, and the transaction terms and documentation. Comments and input from the various regulators should also be anticipated.

PRC approvals are also often the last approvals to be received.

Although many transactions are supported by the State from the outset, high-level support from the State Council or the NDRC indicates that approvals are likely to be given but it does not affect the nature or reduce the burden of the regulatory review.

From the perspective of a Western business looking to sell, the apparent lack of clarity and definition around the PRC approvals process and the lack of familiarity with the overall process can cause considerable unease. The insistence by the PRC authorities that their approval is the last to be obtained in a transaction invariably fuels this concern.

It is incumbent on the Chinese company and its advisors to explain at the outset of any outbound transaction how the process operates, the level of information and review that will be involved and amount of time that is likely to be required for approvals.

One important issue that may cause delay is the reluctance of the Chinese authorities to approve deals that are still at a formative stage and may potentially change. This issue constrains the Chinese company's ability to respond quickly if the deal changes. It makes the usual approach to negotiating M&A deals even more challenging.

In our experience it is imperative to explain the process and face up to the challenges it presents as early as possible in discussions with a seller. Complete transparency is essential to avoid the risk of delays being misconstrued. The constraints of the PRC approvals process make it particularly difficult for a Chinese company to participate in a traditional auction process. If a Western seller wishes a Chinese company to participate in an auction, it will have to go some way to accommodate the constraints that will apply.

Foreign investment regulations

Foreign investment regulations around the world have a major impact on deal structures and the timeline for any Chinese outbound investment. Minority stakes may trigger a review and there is significant variation in approach and timing applied by various regulators around the world.

Any foreign investment review must also dovetail with any antitrust review, which itself may involve multiple regulators with different rules and enforcement regimes.

The key jurisdictions that undertake foreign investment reviews are the USA (Exon-Florio), (CIFIUS), Australia (FIRB), Canada (Investment Canada Act), and a number of EU member states regimes such as France, Germany and Spain.

The foreign investment review process is often a political one either overtly or ‘behind the scenes’. Protectionist trends have increased in recent years owing in part to the global financial crisis. This increasing trend towards protectionism is fuelled by the myth of ‘China Inc.’ and the commonly-held perception that SOEs are, in effect, extensions of the Chinese state. This anxiety is further fuelled by a misunderstanding of the nature of SOEs and Chinese investment principles and motivations.

There is limited awareness or understanding in the West that SOEs are ultimately accountable to SASAC and that there are safeguards under Chinese law to ensure the independence of SOEs to maintain commercial competition among them. There are numerous examples of competition among Chinese SOEs that operate in the same sector, as well as examples of SOEs competing for the same assets. Yet again, it is incumbent on a Chinese company and its advisors to address this issue directly because it will be an important part of any regulatory review, whether it is for foreign investment approval or for antitrust approval. Transparency and clarity of communication are essential if such myths are to be dispelled successfully.

It is also essential from the outset for the Chinese company to have a clear vision and strategy for the outbound acquisition. The antitrust and foreign investment approval process can become complex which makes it vitally important that clear and consistent messages are delivered to all regulators.

In our experience, developing and articulating such a vision and strategy has to be addressed from the outset of any transaction. It should not be developed as the transaction progresses.

Other Stakeholders

It is imperative in any Chinese outbound transaction to be aware of the concerns of all potential stakeholders, particularly if it is a public transaction. As with any transaction, public relations and communication need careful management. Our experience shows that deals can be jeopardised or lost without them.

The public relations process always runs ahead of the regulatory process. It is essential, therefore, to have a clear strategy and clear messaging from the outset. The overlap between public relations, government relations, the political arena and the various regulators that may be involved means that consistency of messaging is absolutely vital. The Chinalco/Rio Tinto transaction was ultimately abandoned in June 2009 because of insufficient support from Rio Tinto shareholders but the backdrop of political and regulatory opposition played a major part.

Chinese Financing Process

Chinese companies commonly use Chinese banks to finance offshore acquisitions. SAFE approval is required for currency flows, guarantees and the granting of security. It is imperative to factor this approval process into the overall approval regime. The experience of PRC banks has grown rapidly in recent times but there may still be some instances where limited experience of outbound deals and the impact of regulatory requirements may mean that additional time is needed for explanation and approval. This issue can also have an impact on the timing of the transaction as a whole and can cause unease unless it is explained and integrated into the deal timeline from the outset.

Project Management

Effective project management in any Chinese outbound transaction will play an important role in determining a successful outcome. The quality of project management can have an impact on the speed of response in what is likely to be a dynamic and evolving M&A and regulatory landscape.

Strong project management is required for any cross-border transaction with multiple work streams, but it is more important for a Chinese outbound transaction where the approvals process invariably places constraints on the Chinese company. It is essential to anticipate issues and to be as flexible as possible in finding solutions and to endeavour to finalise key decisions as early as possible so that approvals can be obtained. This type of project management requires a small and dedicated deal team, and an experienced group of advisors who can work collaboratively to overcome any potential hurdles.

The likely scarcity of team members who can speak Mandarin, the logistical obstacles posed by different time zones and the frequent need for face-to-face meetings are project management challenges that need to be addressed in any successful transaction. These issues are just as likely to pose a risk to the outcome of a deal as any of the more specific political and cultural issues that are commonly associated with a Chinese-led acquisition. The experience of the advisory team supporting a Chinese client on the outbound transaction and their ability to anticipate issues and project manage the transaction is critical.

Future is bright for Chinese companies embarking on outbound M&A

In its report, the EIU highlights the extraordinary transformation that Chinese companies have undergone from being relatively unknown players, snapping up small deals on the periphery of M&A markets, to being catapulted into major, high-value deals.

The rate of acquisition does not appear to be slowing during 2010, despite the hurdles Chinese companies are encountering in their pursuit of new assets. Their financial strength and the appetite to expand beyond their borders are powerful drivers to growth as is their desire to secure a fair return on their capital.

The challenges ahead may prove to be testing, but Chinese companies have shown themselves to be ambitious and adaptable. If they can adapt to the challenges outbound M&A transactions present, they can continue to grow and to build on their success to date.

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