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July 2010

Investment strategies for successful M&A in China

While China's acquisitions overseas make the headlines, foreign investment continues to flow into the country at double the rate of outbound investment.

International and regional companies are eyeing China's continuing modernisation and growing army of consumers which the government is encouraging to increase domestic consumption and to avoid over-reliance on the export economy model.

Investing in China today has its challenges but is not so different to mergers and acquisitions (M&A) in other emerging or developing markets. Investors face healthy competition and regulatory pitfalls and approval processes that should be factored in to any acquisition plan.

Learning from the global financial crisis

China has taken away a number of hard-learnt lessons from the global financial crisis.

First, it made the government keen to reduce its reliance on exports (badly hit by the drop in international trade last year). With export industries so dominant in the economy – and supporting some 90 million jobs – the government has realised the risk and wants to engineer a shift towards production for domestic consumption.

This is not all bad news for inward investment, particularly for foreign companies that are looking at China as a fertile domestic market rather than a cheap manufacturing park.

Second, the crisis gave further impetus to China's "national champions" policy. The government wants to consolidate industry players and to create a number of market leaders. For foreign multinationals targeting the same companies to fold into their global portfolio, the stakes have become even higher.

At the recent National People's Congress, Chinese Premier Wen Jiabao set a modest 8 per cent target for gross domestic product (GDP) growth for 2010, compared to previous year's actual 8.7 per cent GDP growth – "quality" of growth is now prized above growth for growth's sake.

This means that bringing money to the table may not be enough for the bigger M&A deals. Satisfying the government's criteria for quality is an important part of the process. Investments that share valuable technology and skills, which help to conserve energy, reduce greenhouse gas emissions, or enhance domestic manufacturing, will be welcomed. Investments in sectors that are suffering from overcapacity will be discouraged.

Identifying companies for acquisition

In a large, developing and fragmented economy such as China, finding the right company with the right market share and at the right price may leave you with a surprisingly small range of options – and a large group of competitors.

It is common to find a number of buyers vying for the same targets. As a foreign investor, you will be up against domestic buyers, international competitors and private equity houses (most private equity houses in Asia are still cash-rich).

With such fervent attention from suitors and flattering valuations from comparable listed Chinese companies, the pricing gap between buyer and seller can quickly become a chasm.

This gap can be reduced by effective due diligence, negotiating price adjustments for issues uncovered by it and earn-out payment mechanisms that link payment with post-closing performance targets (at least for the 12 months permitted by Chinese law after closing a deal).

Approval process for acquisitions

A more China-specific challenge is government approvals. If your business is in a sector that is not heavily regulated, the main approval authority is the Ministry of Commerce (MOFCOM).

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Other agencies may also be involved depending on the sector, or if you are expanding the production capacity of the target, or if it involves a Chinese state-owned business.

Approvals do two things to your deal. The first is that they introduce uncertainty. If you have to go to MOFCOM for approval, especially if it happens to be a large deal, the government may restrict your ability to take over the company or to acquire control. The second and more commonplace problem is that it slows the deal process down. And delays can seriously undermine a deal in a fast-moving market such as China.

A recent deal, which involved the purchase of the principal business of a company listed in China, illustrates some of these challenges. The acquisition first required a restructuring of the business, and a backdoor listing of the listed company by another player to enable the foreign investor to purchase the target.

The deal involved four different approval agencies, including the agency responsible for monitoring the sale of state-owned assets and the securities regulator.

Altogether, the deal took six months to gain all the necessary approvals. During that time, the target company went through a major reversal in its business fortunes. This led to a discussion around whether to proceed with the transaction or to re-negotiate the price based on the material adverse change clause.

Ultimately, the deal closed – but only 15 months after signing the initial agreement.

Benefits of creating joint ventures

In terms of structuring a China acquisition, joint ventures appear to be coming back into fashion. In some sectors, joint ventures cannot be avoided because of government limits on foreign ownership – this is the case for most financial services such as life insurance, securities, and fund management and banking, where foreigners cannot hold a majority stake.

Even in sectors where you can go it alone, joint ventures are commonly created to capture market share and to add a strong local partner with commercial or political clout.

Chinese-incorporated joint ventures are similar to Western models and are fairly simple legal structures with limited liability status.

Under the more common structures, although there are no shareholder level meetings, the shareholders are allocated a certain number of directors on the board according to their shareholding and decisions are taken by majority vote. There are no different classes of shares, and profits are split according to shareholding.

Negotiations normally focus around either veto rights at board level, or, on who appoints the key management positions. If control is crucial, you need to ensure that you hold an equity stake of 51 per cent or more, or otherwise you need to structure corporate governance rights that give you effective control.

Challenges of public M&A

If you are targeting market leaders, you may find yourself undertaking a public M&A process. Chinese companies are listed either on domestic stock exchanges or on overseas exchanges – those in Hong Kong, Singapore and the US feature the most Chinese companies, with Hong Kong taking the lion's share. There are two principal types of Chinese companies listed in Hong Kong. These are commonly known as "red chip" and "H-share" companies. Red chip companies are Chinese businesses that are listed on the Hong Kong Stock Exchange through offshore holding companies, most commonly Cayman

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Islands, Bermuda or Hong Kong incorporated companies. H-shares are PRC-incorporated companies with shares listed on the Hong Kong Stock Exchange.

Red chip companies are subject to the Hong Kong Takeover Code. H-share companies are, in addition, subject to China's local corporate laws and are more difficult to take private given the absence of any "squeeze out" provision.

There was strong interest during 2009 in PIPE (private investment in public equities) deals in Hong Kong, particularly by private equity investors.

According to *Asian Venture Capital Journal*, 60 per cent of all China-related private equity deals in 2009 involved PIPEs, including deals such as Bain Capital's investment in Guomei, China's largest retailer of household electronics, and TPG's investments in shoe retailer Daphne and supermarket chain Wumart.

Acquiring a stake in an A-share listed company – one listed on a mainland stock exchange – requires approval from MOFCOM and, depending on the structure, China Securities Regulatory Commission. The stake also comes with a three-year lock-up period.

One successful example of an A-share deal was CVC's acquisition of a 29 per cent stake in a Shenzhen-listed beverage bottling company, which manufactures plastic bottles for Coke and Pepsi in China.

China's antitrust regime

China's relatively new antitrust regime, which was introduced in 2008, adds another layer of government approval and uncertainty to deals.

A merger control filing is triggered if two of the undertakings to the transaction have a turnover of RMB400 million or more, and the combined global turnover of all the parties is RMB10 billion, or the combined China turnover is RMB2 billion.

If the competition analysis for a transaction shows product overlaps leading to a combined market share of 30 per cent or more, it is likely that the Anti-Monopoly Bureau will scrutinise the deal in greater detail.

The bureau will also scrutinise the deal more closely if it is a high-profile transaction, either globally or in China, and it is related to a sensitive industry sector.

A review generally takes two to three months, extending to six to nine months for more complex cases.

So far, around 90 notifications have been submitted to the Anti-Monopoly Bureau. Of these, five deals have been cleared subject to conditions and one has been prohibited, the Coca Cola-Huiyuan transaction. All the other cases have been cleared.

Anyone contemplating acquisitions in China must now take antitrust issues as seriously as they would in Europe, the US or Australia in light of the regulator's powers to unwind contravening transactions and the country's relatively low thresholds for merger control compared with international standards.

Given the growth prospects on offer, the regulatory and competitive hurdles faced by investors in China are unlikely to deter international investors.

Most of the country's conditions and market practices are not significantly different to those in other emerging and growth markets around the world – indeed, many of China's regulatory regimes, such as antitrust, are becoming as sophisticated as those in established markets.

With good planning and advice, M&A success will ultimately rely on careful deal selection and nimble execution in the current market.

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