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Briefing note

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Leveraging Up & Out: The Rise of Outbound Chinese Leveraged Acquisitions

With an estimated US$44 billion of outbound acquisitions in 2015, China now represents a major participant in the global M&A market. This deal volume is from an increasingly diverse range of China based acquirors who are increasingly using sophisticated international leveraged financing structures such as internationally syndicated bridges to high yield bonds, covenant lite loans as well as Chinese bank-funded leveraged loans to acquire larger targets and maximize investment returns.

Background

On February 3, 2016 ChemChina announced plans to acquire the Swiss agribusiness company Syngenta for approximately US$43 billion. If consummated, this deal would be one of the largest ever acquisitions of a foreign entity by a Chinese company.

This transaction comes as part of a record breaking series of acquisitions by Chinese companies over the last six months. China's slowing growth rate, a need to diversify and a growing appetite among domestic consumers for global brands have combined to drive the number of Chinese outbound deals. Chinese outbound M&A accounted for an estimated US$44.1 billion in 2015, a growth of 330% compared to 2010.

This deal volume has placed China as the world's largest outbound investor, significantly ahead of other emerging market economies such as India, Russia, the Gulf States and Brazil who combined accounted for outbound M&A worth approximately US$16.3 billion in 2015.

Historically Chinese outbound acquisitions were dominated by State Owned Enterprises ("SOEs"), but today there is a growing number of Privately Owned Enterprises ("POEs"), alongside China based Private Equity firms ("Chinese PE") that are aspiring to global leadership and acquiring businesses with global platforms.

Enhancing the importance of the growth of Chinese outbound acquisitions and amplifying China's power is the increasing use by Chinese buyers of leverage within their financing structures to maximize investment returns.

In addition to the introduction of the use of US/European style leverage, Chinese buyers have also been innovative in terms of how and where they have arranged their financings.

Many market commentators expect these trends to continue. As discussed herein, the economic slowdown in China, the resulting need

Key Issues

- China is now a leading outbound investor.
- There is a diverse range of Chinese participants in the global M&A market using sophisticated international leveraged financing structures for acquisitions.
- Leveraged finance structures from bridge to high yield bond, covenant lite loans, Chinese bank-funded leveraged loans, as well as alternative financing structures are being utilized for China outbound leveraged M&A.
- As more Chinese entities pursue acquisitions and the Chinese economy becomes increasingly consumer driven and diverse, the international M&A environment is likely to become increasingly competitive driving acquirors to use leveraged finance to maximize returns.

to diversify, along with the One Belt, One Road initiatives, are all likely to provide further impetus for Chinese investors to seek marquee acquisitions and better returns abroad.

Who is making outbound leveraged acquisitions?

While historically Chinese SOEs have dominated outbound M&A activities through deals in resource extraction, notably in developing economies; Chinese outbound M&A has become increasingly focused on corporate acquisitions. These organizations, large institutional investors, conglomerates and real economy players, as well as Chinese PE, are increasingly seeking to utilize their large pools of capital to achieve global leadership positions in their industries. In addition, such investments often serve to balance domestic revenues with international income as domestic competition increases and growth slows.

Furthermore, these investments are generally strategic and often designed to upgrade and transform the Chinese economy for sustainable growth, as well as to account for its movement towards greater domestic consumption. Such deals are often focused on technologies or brands that can be leveraged in China, but there is also an underlying goal to internationally diversify revenue streams.

These developments have resulted in Chinese investors (i) increasingly looking towards Europe and the US for acquisitions that provide access to advanced technologies, global brands, extensive industry experience and global distribution networks; and (ii) diversifying across a range of industries including energy, finance, automotive, agriculture, real estate, industrial equipment, IT and communications and hospitality.

How do Chinese investors approach the market?

The growth and development in outbound acquisitions by Chinese POEs and Chinese PE has resulted in changes in how Chinese buyers approach deals. While historically Chinese SOE buyers may have taken longer than US or European acquirors to decide on acquisitions, as well as utilizing more conservative financing, Chinese POEs and Chinese PE have proven themselves to be flexible, dynamic, and able to compete on financing with European and US competitors, a trend that will likely strengthen through Chinese POEs and Chinese PE having increasingly large pools of capital, a growing track record and an increased willingness to utilize leverage and optimize their acquisition financing structures.

These developments can be seen with Chinese POEs and Chinese PE becoming increasingly ambitious and completing more and larger transactions. For example, POEs accounted for 41% of Chinese outbound M&A in 2014 (by value), up from 31% in 2013 and 10% in 2010.

Of the top 10 Chinese outbound M&A deals in 2014, POEs accounted for five, compared to only one in 2010.

What leveraged acquisition financing techniques are being used?

The use of leverage in outbound Chinese acquisitions developed as a means to, among other things, make bids more competitive, enhance investors' returns and allow larger targets to be acquired. In turn this has resulted in acquisition financing structures that have taken the following forms: (i) internationally syndicated structures including (a) bridge to high yield bond acquisition financing, such as Hony Capital's acquisition of UK based restaurant operator Pizza Express, and (b) covenant lite term loan B acquisition financing, such as HNA's acquisition

Recent Significant Leveraged Acquisition Financings

- **Biosensors (2015).** CITIC led consortium to acquire Biosensors International, a medical device company listed on SGX (pending regulatory approval) which used a Chinese bank funded leveraged loan structure.
- **Pirelli (2015).** ChemChina's US$7.7 billion acquisition of Pirelli, the world's fifth largest tire manufacturer, financed in part by a hybrid bridge to bond loan.
- **Swissport (2015).** HNA's US$2.8 billion acquisition of Swissport, a global provider of cargo and ground handling services at airports. The acquisition's debt structure included a term loan B and high yield bond.
- **OmniVision Technologies (2015).** Chinese PE firms Hua Capital, CITIC Capital and GoldStone acquired OmniVision Technologies a maker of chips for smartphone and table cameras, for about $1.9 billion in cash.
- **Pizza Express (2014).** Hony Capital's £900 million acquisition of UK based restaurant operator Pizza Express from Cinven which used a committed bridge financing and was funded with high yield bonds and equity.

of the global provider of cargo and ground handling services Swissport; or (ii) principally Chinese bank-funded leveraged loans using international financing techniques such as the US$800 million acquisition facility arranged by Bank of China and China Merchants Bank to support the take-private acquisition of Omnivision Technologies Inc.

In determining the optimal leveraged acquisition financing structure the acquiror and its advisors need to analyze a range of factors including: (i) the current capital structure of the acquired business, (ii) the acquiror's strategy for the business (i.e., further acquisitions, aggressive roll-out, merger with existing business, retain existing management) and risk appetite, (iii) operational flexibility of the acquired business, (iv) acquisition timetable, nature of the sale process, legal requirements associated with the M&A transaction, availability of staple financing options; (v) desire to finance internationally (including / excluding the US market) or through Chinese relationship banks, (vi) the legal and regulatory environment; (vii) comparable financings by industry, jurisdiction and capitalization, (viii) market conditions at the time of the acquisition, and (ix) the impact of the proposed financing on the competitiveness of the deal itself.

Bridge to High Yield Bond and Covenant Lite / Term Loan B –

Bridge to High Yield Bond

Acquisition financing structures utilizing committed bridge loan financing tied to a subsequent high yield bond financing (or refinancing) have long been used in the international leveraged finance market with the product having its origins during the US leverage buy-out boom of the 1980s. Since then high yield has become increasingly internationalized and today it represents a staple financing technique used across the globe.

A committed bridge loan is utilized by the buyer to provide the seller with sufficient comfort that it has committed financing that can be drawn upon to pay the acquisition price for the business being sold (and, in Europe, often a "certain funds" confirmation). A bridge is needed because a buyer intending to finance its acquisition through high yield bonds, a capital markets instrument typically sold by banks on a non-underwritten "best efforts" basis, must show it has committed funding in order to provide the seller with sufficient comfort surrounding the certainty of its financing package.

Once the acquisition agreement is signed, the buyer together with its financing banks, will implement the required structuring and documentation and launch, price and close a high yield bond offering for the business being acquired, into the international capital markets before closing of the acquisition – such a process can often involve the use of a staple offering memorandum prepared in advance by the seller to facilitate a financing.

If successful, the proceeds from the high yield bond will be used to fund the acquisition price for the business. However, any failure to launch, price and/or close the high yield bond offering in time will not derail the acquisition as the buyer could draw upon the committed bridge loan, complete the acquisition and refinance the bridge loan with a high yield bond issuance – with any failure to do so post acquisition resulting in the bridge loan rolling into a term loan after an agreed period of time.

High yield acquisition financings provide a range of benefits for acquirors including the following:

Bullet Maturity: Unlike an amortizing term loan a high yield bond only requires interest to be paid on a semi-annual basis with the bond's principal due upon maturity, typically seven or eight years.

Opportunity for Higher Leverage: A high yield bond's bullet maturity, along with a tenor that is longer than a typical term loan, provides an acquiror with the opportunity to utilize higher leverage within its financing structure and thus maximize financial returns upon any sale of the business.

Incurrence Covenants: The covenants contained in the indenture governing the high yield bond are incurrence only, meaning they are tested only when the issuer and its restricted group undertakes certain actions, e.g., incur debt, pay dividends, sell assets or merge with another company. This is a significant departure from traditional term loans that contain covenants requiring the maintenance of certain financial ratios and other metrics, thus high yield provides greater operational flexibility. The inability to comply with an incurrence covenant simply means the desired action cannot be undertaken whereas the failure to comply with a maintenance covenant, absent a cure, is an event of default.

Ease to Use and Manage: Once issued, the high yield bond, with its incurrence covenants is easier to manage compared to a typical term loan. With reporting only on an either semi-annual or quarterly basis, as well as, for significant events, the

requirements are less onerous than that typically seen in a term loan.

Furthermore, additional debt under the high yield bond can be issued (tapped) with relative ease – an update to the offering memorandum being the only significant workstream thus allowing a high yield issuer to opportunistically tap the capital markets for additional financing.

Broad Investor Base: Since the 1980s, the range of investors in high yield bonds has significantly grown and diversified. While pools of capital remain deeper in the United States, high yield investors are now global with a diverse range of institutional investors. Moreover, as high yield bonds are generally freely tradable securities investors are able to buy and sell with relative ease.

Covenant Lite / Term Loan B

Acquisition financing structures utilizing covenant lite loans also started in the US but over the last few years there has been a significant increase in the use of such instruments in the European acquisition finance market and covenant lite loans have also been notably used by China based buyers during 2015.

Unlike a bridge to a high yield bond financing, a covenant lite loan is a single financing structure, on the same basis as traditional term loans, with the buyer using the committed covenant lite loan financing to support a bid and sign an acquisition agreement. Upon closing of the acquisition, the loan is drawn down and the acquisition price paid with the acquired business being used to guarantee and secure the debt obligations under the loan.

Covenant lite loan acquisition financings provide a range of benefits for acquirors including the following:

Bullet Payment with Minimal Amortization: Unlike a traditional term loan, a covenant lite loan has minimal amortization, usually 1% per annum, with the remaining principal due at maturity.

Covenant Lite: The covenants are principally, like a high yield bond, incurrence based and thus the borrower will only test its covenants when it comes to undertake a significant action, e.g., incur debt, pay dividends, sell assets or merge with another company. However, and unlike a high yield bond, covenant lite loans often feature a springing financial covenant tied to the working capital facility, with such covenant being tested and applying only to the working capital facility, when it is drawn above specified levels. Failure to comply with the financial covenant could result in a default.

Additional Debt Tranche: A covenant lite loan can often feature an approved but not committed additional facility that the borrower can use in the future in case of a material event, such as an acquisition.

This facility would be in addition to the other flexibilities in the debt covenant allowing for further debt incurrence.

Broad Investor Base: While the principal investor base for covenant lite loans has traditionally been US based loan funds, this has recently begun to diversify both through US based high yield investors investing in covenant lite loans as well as European and Asian based investors participating in them. Furthermore in the case of covenant lite financings for Chinese M&A, Chinese investors have recently been willing to

Overview of Key Features – High Yield Bond and Term Loan B

High Yield Bond	Term Loan B
✓ Bullet payment with long tenors (e.g., 7 or 8 years)	✓ Bullet payment with minimal amortization (e.g., 1.0% p.a.)
✓ Incurrence covenants – flexibility to incur debt, pay dividends, etc.	✓ Covenant Lite (*no financial covenant; springing with respect to the working capital facility, if any*)
✓ Freely tradable instrument	✓ Can incur further debt
✓ Opportunity for higher leverage	✓ Large US investor base (smaller Asian / European investor base)
✓ Global investor base	
✓ Easy to use/manage – limited reporting, taps, etc.	

underwrite some covenant lite loans.

Chinese Bank-Funded Leveraged Loans

Chinese bank-funded leveraged loans are not new but recently these loans have seen significantly increased flexibility in terms of economics and covenants.

With the current deep pools of liquidity within the domestic Chinese bank market and the Chinese government gradually changing its role in outbound investment from that of a regulator to a facilitator, Chinese bank-funded loans are becoming increasingly competitive within the leveraged financing market.

This development has resulted in a significant growth in both the size and amount of Chinese bank-funded leveraged loans in recent years. Alongside this growth the loan terms have become increasingly competitive in comparison to traditional amortizing term loans with developments such as (i) delayed and/or minimal amortization and bullet maturities; (ii) longer maturity profiles with some loans as long as seven or ten years; (iii) increasingly competitive initial margins; (iv) reduced maintenance covenants such as no debt service cover requirement, no interest cover requirement, no (or relaxed) annual limits on capital expenditures and semi-annual testing (vs. quarterly) and occasionally no step-down of the leverage ratio during the life of the acquisition facility; (v) lower guarantor coverage thresholds; and (vi) reduced (or no) excess cash sweep requirements. Moreover occasionally Chinese lenders have been willing to provide leveraged loans on a take-and-hold basis without the need for syndication.

These developments have made the Chinese bank-funded leveraged loan market a very competitive source of funding when Chinese buyers are looking at outbound acquisitions.

Alternative Leveraged Financing Options

Outside of the aforementioned financing options the leverage finance market in Asia has selectively seen other financing options utilized in leveraged acquisitions.

These alternative options are often used on a case by case basis and include leveraged loans from alternative lenders such as Taiwanese banks and mezzanine or second lien loan financings from Korean or Japanese financial institutions. Furthermore, acquisitions have used private note transactions, including financing features drawn from the loan and/or bond markets, being sold through privately to Asian institutional investors.

These alternative transactions can often see a significant amount of variation within the financing package, with the structures often dependent on the underlying asset, the nature of the investors, the regulatory environment, leverage levels and the buyer's strategy for the business.

Chinese Leveraged Acquisitions – Flow expected to broaden and deepen

With Chinese outbound investment being at all time highs, with a growing proportion of investment into Europe and the US, and showing no indication of slowing, this investment is expected to grow year-on-year leading to an increased diversification of market participant, broader investment geographies and industries and increased use of debt financing.

While concern has been raised that the current turmoil in the Chinese equity and other markets could adversely impact such transactions, most market commentators believe that such factors only emphasize the need for cash rich Chinese buyers to diversify their investments.

Moreover, as the Chinese economy develops into a larger exporter of capital, along with China's transition into a consumer driven and increasingly diverse economy, the environment for international acquisitions is likely to become increasingly competitive meaning acquirors will be driven to maximize their returns and build leverage into their financing structures.

In doing so, it will become critical for these buyers to have full knowledge along with financial and legal advice available to them across the full range of leveraged financing options - from internationally financed products to domestically financed leveraged loans.

Further Information

For further information on these market developments as well as the range of leveraged acquisition financing options available for Chinese based acquirors contact (i) Alex Lloyd (+852 2826 3447 / Alex.Lloyd@CliffordChance.com) for questions in Asia; (ii) Michael Dakin (+44 20 7006 2856 / Michael.Dakin@CliffordChance.com) for questions in Europe; (iii) Gary Brooks (+1 212 878 8242 / Gary.Brooks@CliffordChance.com) for questions in the US; or (iv) one of the global Clifford Chance contacts listed on the back of this briefing note.

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