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M&A Madness

Judie Ng Shortell of Paul, Weiss, Rifkind, Wharton & Garrison describes the hottest trends fueling Chinese deal activity, solutions to top regulatory issues and vital tips for foreign and domestic M&A parties.

1. WHAT HAVE BEEN THE KEY REGULATORY DEVELOPMENTS AFFECTING INBOUND M&A IN THE PAST 12 MONTHS?

In September 2016, the Standing Committee of the National People's Congress adopted a decision under which the foreign investment approval requirement was replaced by a filing system for foreign-invested enterprises (FIEs) that engage in a business that is not subject to restrictions or "special administrative measures for access" with effect from October 1, 2016. These non-restricted FIEs only need to make a filing with the Ministry of Commerce (MOFCOM).

To implement the new filing process, MOFCOM issued rules for filings in respect of the establishment of, and changes to, non-restricted FIEs (Filing Measures), and jointly with the National Development and Reform Commission (NDRC) released *Announcement [2016] No. 22* (Announcement 22), which defines restricted businesses as those (i) specified under the restricted and prohibited categories of the *Foreign Investment Industrial Guidance Catalogue (Amended in 2015)* (Catalogue); and (ii) specified under the "encouraged" category but subject to foreign shareholding limits or requirements for senior management.

The Filing Measures simplified acquisitions of non-restricted FIEs. MOFCOM approval is no longer a condition to the completion of transfers of equity interests in non-restricted FIEs, as the filing can be made after completion. A new requirement is that the ultimate actual controller of the FIE must be disclosed under the rules.

In practice, MOFCOM still needs to provide details for the implementation of the Filing Measures to enable local commerce bureaus to proceed with the new filing regime.

In May 2015, China broadened its national security regime for all foreign investment activities in free trade zones (FTZs) in China.

Inside the FTZs, all foreign investments that have national security implications must undergo national review, regardless of whether they are structured:

- As new enterprises;
- Through a merger or acquisition of a pre-existing enterprise; or
- By way of other investments, such as through contractual arrangements, share entrustments, trusts, reinvestments, overseas transactions, leases or convertible bond subscriptions.

It is anticipated that a similar type of extensive review regime will ultimately be adopted nationwide.

2. CAN YOU DESCRIBE CHINA'S MERGER CONTROL REGIME AND PROCESS?

Under the *PRC Anti-Monopoly Law*, transactions triggering a change of business concentration must file a pre-merger notification to MOFCOM if the concentration reaches certain thresholds.

The relevant thresholds are met where either of the following are satisfied:

- The combined worldwide turnover of all business operators in the prior fiscal year is more than Rmb10 billion, and the domestic turnover of each

of at least two of the business operators in the prior fiscal year is more than Rmb400 million.
- The combined domestic turnover of all business operators in the prior fiscal year is more than Rmb2 billion, and the domestic turnover of each of at least two of the business operators in the prior fiscal year is more than Rmb400 million.

The process:
- Upon receipt of all the application documents, MOFCOM will conduct a preliminary review and decide whether to initiate a further review within 30 days.
- If initiated, MOFCOM must either complete the further review within 90 days following the date of its decision to do so or extend its review for a further 60 days, after which time it is required to give its decision.
- However, the time periods above only commence when the application is formally accepted by MOFCOM.

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MOFCOM is aware that merger reviews have caused delays for the completion of M&A transactions.

To streamline the merger review process, MOFCOM launched a simplified merger review procedure in 2014. The simplified procedure is available in the following circumstances:
- Horizontal mergers where in the same relevant market, the collective market share of all operators concerned in the concentration is less than 15%;
- Vertical mergers where the market share of each of the operators concerned in the concentration in each of the relevant upstream and downstream markets is less than 25%;
- Mergers that are neither horizontal nor vertical where the market share of each of the operators concerned in the concentration in each of the markets is less than 25%;
- Offshore joint ventures or acquisitions where the arrangement or target does not engage in business within China.
- Reduction of the number of controlling parties.

The simplified track may reduce review timing to two to three months (as opposed to four to six months for the normal procedure).

3. WHICH INDUSTRIES HAVE ATTRACTED THE MOST FOREIGN INVESTMENT AND EXPERIENCED THE MOST M&A ACTIVITY?

Throughout the past year, the TMT industry in China has attracted the most foreign investment and experienced the most M&A activity.

Foreign investment into China has attracted growth despite a slowing domestic economy, specifically in the technology sector. Investors from the U.S. and EU have been some of the biggest contributors to this trend. According to MOFCOM, FDI into China rose 4.2% to reach $98 billion (Rmb666.3 billion) in the first ten months of the year.

We expect to see continued growth in FDI in China in the future due to MOFCOM's reforms aimed at benefiting FIEs.

The TMT industry continues to be the most active M&A sector in China with over $100 billion in deal value despite fluctuating macroeconomic conditions. This trend has been led by mega-deals such as Tencent's $8.6 billion acquisition of Supercell, Didi Chuxing's $7 billion takeover of Uber's operation in China, HNA Group's $6 billion acquisition of Ingram Micro, among others. The fintech sector has seen a particular rise in M&A activity from top Chinese internet companies like Alibaba, Baidu, Tencent due to the huge growth potential in financial infrastructure in China.

4. WHICH SECTORS HAVE RECENTLY OPENED UP TO INCREASED FOREIGN SHAREHOLDING OR OWNERSHIP?

- E-commerce: Online data processing and transaction processing is now fully open to foreign investment.
- Energy: The construction of power grids has been moved from the restricted to encouraged category in the 2015 Catalogue. The construction and operation of power stations using re-

newable energy is also encouraged under the Catalogue.

- Real estate: Restrictions on foreign investment in subways and real property projects have been lifted in the Catalogue. The construction and operation of rail transit is encouraged and no longer requires a Chinese majority shareholder.

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5. WHICH RECENT TRANSACTIONS HAVE HIGHLIGHTED THE ONE BELT, ONE ROAD INITIATIVE?

China's One Belt, One Road initiative set out by President Xi Jinping aims to create an economic belt in the Eurasia region and to develop a modern maritime "Silk Road" to connect China's ports with Africa's coasts and the Mediterranean through Southeast Asia and the Suez Canal.

A recent transaction that highlights this initiative is Shanghai Electric's majority stake investment in Pakistan's K-Electric; which was the largest M&A deal in Pakistan in a decade according to *Reuters*. This transaction comes after China's pledge of $46 billion in infrastructure projects in Pakistan, known as the "China Pakistan Economic Corridor", which will pave the way to link China's trade with the Arabian Sea.

Other examples of One Belt, One Road transactions include:

- The Thar Coal power project in Pakistan involving Chinese sponsors and lenders;
- China Everbright Group's takeover of an Albanian airport operator, the first major investment by a Chinese company into Albania; and
- China COSCO's takeover of the Greek port of Piraeus, the second largest privatization deal in Greece this year.

6. HOW IMPORTANT IS M&A DUE DILIGENCE IN CHINA?

Due diligence is a vital element for a successful M&A in China, especially for inbound foreign investors.

Legal, financial and tax due diligence must be conducted carefully and thoroughly. In addition, due diligence should also cover any third-party agents acting on behalf of the target to identify possible compliance violations.

Other types of due diligence should also be performed on the target company in China, in particular, reviews on anti-corruption compliance. Investigations on any violations of the *Foreign Corrupt Practices Act* of the U.S., the *Bribery Act* of the UK and other foreign anti-corruption regulations that may apply to foreign investors in China should be conducted. This must be a priority particularly for corruption-prevalent industries such as pharmaceutical and healthcare. Review of other matters such as environmental protection is necessary if the target is engaged in environment-related sectors. More care in the due diligence exercise is called for if the transaction involves government entities or state-owned enterprises (SOEs).

7. WILL OUTBOUND APPROVAL MEASURES BE FURTHER RELAXED? WHAT DOES THIS MEAN FOR THE GLOBAL BIDDING POWER OF CHINESE ACQUIRERS?

It is reported that the Chinese government plans to tighten controls on Chinese companies seeking to invest overseas in order to slow down capital outflow. It is understood that the measures to be adopted will mainly be targeted at large transactions of deal values exceeding $10 billion, property investments by SOEs above $1 billion, and investments of $1 billion or more by any Chinese company in an overseas entity unrelated to the buyer's core business. The new controls are likely to be temporary, remaining in effect until the end of September 2017, when the next leadership reshuffle takes place.

Hopefully, after stabilizing the market and currency, further relaxation can continue to push ahead, implementing the NDRC's *Measures for the Administration of the Check and Approval and Record Filing of Overseas Investment Projects (Draft for Public Comments)* (Outbound Draft), which was published in April 2016 for public consultation, further streamlin-

ing the outbound approval process. The proposed amendments are:

- The NDRC will assume final verification authority over outbound investments in a sensitive country or industry without reference to a minimum threshold amount, and State Council approval will no longer be required.
- The requirement for a confirmation letter will be removed.
  - In the initial stage, a simple "letter of receipt" will replace the "letter of confirmation".
  - In the second stage, registration will still be required but the filing process will be simplified.
- The requirement for a letter from a bank expressing its intent to finance the transaction will be removed.
- While the Measures do not apply to investments made by Chinese enterprises in Taiwan, the Outbound Draft proposes that investment projects in Taiwan will be subject to the same offshore investment regime with the additional requirement that the NDRC will consult with the Taiwan Affairs Office on the transaction.

If the proposed amendments are formally adopted, the approval process for outbound investment projects will be further streamlined. This will no doubt increase the bidding power of Chinese acquirers. More Chinese buyers will be encouraged to bid for offshore assets and they will be more likely to pursue deals involving sensitive industries. In addition, non-Chinese sellers will be more willing to consider multiple potential Chinese buyers.

8. WHICH SECTORS HAVE CHINESE INVESTORS BEEN MOST DRAWN TO OVERSEAS? WHAT ARE THE KEY OUTBOUND TRENDS YOU ARE WITNESSING?

As China is moving from an export-driven manufacturing hub to a technologically-centered industrialized environment, Chinese investors have been drawn into investing strategically into the industrials and technology sectors overseas. This strategy focuses on acquiring industrial know-how, high-value products and brands, as well as technological capabilities that can be offered back to the Chinese consumer market.

The key outbound trends include:

- Government policies such as the One Belt, One Road initiative and relaxed regulatory reviews that encourage outbound investing in an effort to increase Chinese influence globally;
- Chinese companies investing overseas to diversify their assets in developed and mature markets;
- Rising stock prices and positive market reactions through strategic overseas acquisitions;
- Strategic focus on procuring technology-driven assets, as well as high-value foreign products and brands that can be offered to domestic consumers; and
- Heightened sophistication by Chinese M&A players as they increase their involvement in global transactions.

The Chinese government needs to balance both the need to control capital outflow and stabilize the domestic economy and the growing demands of Chinese enterprises to expand outside of China to diversify, internationalize and gain access to technology and knowhow. Although outbound investments may slow down in the short term as a result of the reported tightening measures, in the medium to long run, Chinese outbound acquisitions will inevitably continue to increase due to opportunities presented by the global economy and the domestic competitive landscape in China.

9. WHAT IS YOUR ADVICE TO FOREIGN CLIENTS ENGAGING IN DEALS WITH CHINESE INVESTORS, BOTH INBOUND AND OUTBOUND?

It is important for foreign inbound investors to:

- **Know your target:** It is essential to perform proper due diligence of the target in all relevant aspects thoroughly. In addition, understand why the target enters into the transaction and what it expects to gain from the deal.
- **Be aware of the limits:** Take note of any restrictions for foreign investment in the particular industry and whether there are specific approval requirements. Also, different regulations apply if the target is an SOE or a private company.
- **Optimize the deal structure:** Decide whether it is an equity or asset acquisition as different Chinese regulations are applicable.
- **Notify the regulators:** Be aware of the requirement to file for merger review. If such re-

view is necessary, it may significantly change the timing for the completion of the transaction.

- **Consider all factors:** Other key issues such as tax and foreign exchange must be taken into account. These may impact how the foreign investor should structure its inbound acquisition.

As for foreign companies working with outbound Chinese investors, it is advisable to ensure the following:

- **China's approval:** Confirm the Chinese investor has obtained approval for the outbound investment. An outbound investment of less than $2 billion involving a sensitive country or region or a sensitive industry requires NDRC approval. MOFCOM approval is also required, regardless of the amounts involved, if the investment is made in a sensitive country, region or industry. Approvals from other government departments, such as the State Asset Supervision and Administration Commission, and industry regulators such as the China Insurance Regulatory Commission may also be required.
- **Enough funds:** Confirm the Chinese investor's ability to obtain foreign exchange to fund the acquisition. The Chinese government has been tightening measures to prevent capital outflows. There have been reports that the State Administration of Foreign Exchange has tightened bank quotas for currency swaps to fund outbound acquisitions.
- **Thresholds:** Be aware of merger control filings, requirements for approval (such as by the Committee on Foreign Investment in the U.S. or the Foreign Investment Review Board of Australia), and security reviews required under the regulations of China or the host country.
- **Safeguarding measures:** To address the risks that may result from Chinese and foreign country regulation and review, foreign sellers may consider asking for reverse break fees and non-refundable deposits.
- **Integration details:** Consider separation and transitional services arrangements, including IT separation, de-branding requirements, technical support and other transitional services should be considered by both the foreign seller and the Chinese investor in their negotiations of the transaction.

10. HOW DO YOU SEE M&A TRENDS AND INVESTMENT STRATEGIES EVOLVING OVER THE NEXT 12 MONTHS?

The deal trends and investment strategies to evolve in the next year include continued growth in outbound M&A into developed countries, with a focus on sectors such as technology, high-value products, brands and industries. One Belt, One Road will also attract Chinese investors to acquire foreign assets in infrastructure globally. SOEs may play a less prominent role in outbound M&A due to a high leverage and their frequent reliance on debt financing.

We are likely to see a consolidation within China's top logistics companies within the next 12 months with companies such as ZTO Express, SF Express, YTO Express, and others raise funds to fuel their acquisition appetites. In addition, logistics technology and data analytics are advancing substantially, leading to a further appetite for M&A deals.

Another likely consolidation will be the media & entertainment sector in China, specifically in the cinema sector. While Chinese corporations like Dalian Wanda Group have been investing overseas into various media & entertainment assets, these companies have also begun acquiring other China-based cinema competitors to gain market share and increase synergy. ■

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A partner in the Corporate Department, based in the firm's office in Beijing, Judie's practice focuses on China-related private equity investments and cross-border mergers and acquisitions. She also has particular experience in strategic acquisitions and special situations. Judie's clients are primarily financial institutions, private equity firms, Chinese companies and multinational corporations which operate across a number of industries, including food and beverage, financial services, retail, real estate, health care and energy.