B|D|A
PARTNERS

China Outbound M&A – Tilting the Flow

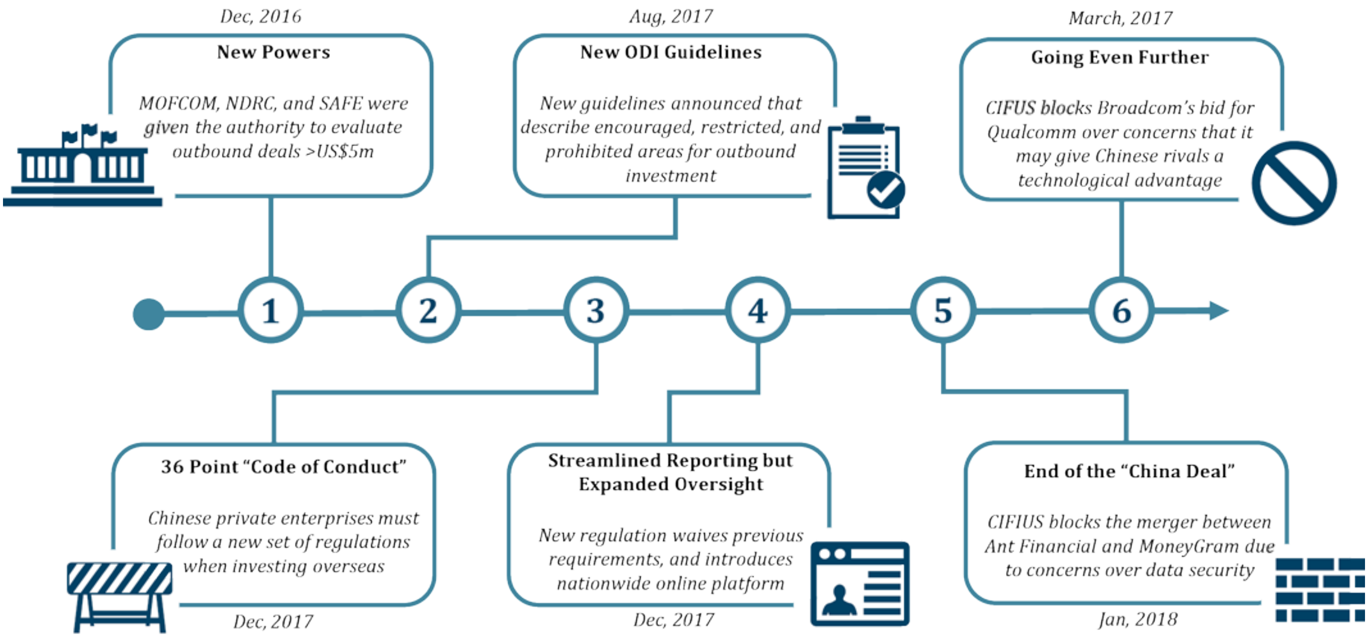
2018 is already looking more challenging for China-outbound acquisitions with an ever-more unfriendly regulatory environment, both overseas and at home. However, BDA believes that carefully selected cross-border deals will still get done by Chinese buyers.

West won't sell…

The blocking of the Ant Financial – Moneygram deal by CFIUS in January was declared as the death of the "China deal", at least from a US sellside perspective. This month's nixing of Broadcom's bid for chip maker Qualcomm upped the ante by showing how America's national security concerns can be extended to any overseas company perceived as simply being within China's sphere of influence. Meanwhile stricter legislation to reinforce CFIUS's powers – the Foreign Investment Risk Review Management Act or "FIRRMA" – is wending its way through Congress.

The US is not alone. Other governments, from Europe to Australia, have also signalled sharper official scrutiny will be applied to attempts by Chinese corporates to acquire in their respective geographies. For example in Germany, where China struck deals at a pace of almost one per week in 2016, government officials have called for increased national powers within the EU to screen takeover transactions, and to be able to block them when necessary. German legislation was introduced in the summer of 2017 following Midea's acquisition of Kuka, a leader in applied robotics.

Timeline – Recent Regulatory Developments



Chinese outbound investors thus face a much more challenging environment abroad today. However, this is only one half of the story. China's own policy announcements have independently raised the bar for ambitious corporates, even before considering the reception that their advances may receive from foreign regulators.

BDA Comment: *It is becoming increasingly important to target assets in sectors which align with the macroeconomic and political policy goals of the host country. Cross-border M&A involving Chinese buyers will be looked at more closely in the US and elsewhere. However, deals in non-sensitive industry sectors, with the correct positioning and process management, should continue to be successful in 2018.*

BDA expects a switch of China outbound deal flow to less sensitive destinations, especially for technology related deals. For example, last year BDA advised on the successful closing of the divestment of the IT services business of Turkish telecoms player Netas to Chinese giant ZTE – the type of transaction that is hard to see happening in the USA today.

...while China clamps down

In an effort to further alleviate stress on foreign reserves, and to keep active investment capital within its own borders, China has introduced additional measures to restrict - but most importantly regulate – domestic companies' outbound M&A activities. The goal is to improve the quality of deals, following a period where expansionist corporations such as HNA and Anbang embarrassingly over-reached themselves in pursuit of trophy assets.

The first moves on this front were made in December 2016. Three key agencies - MOFCOM, NDRC and SAFE - were handed powers to assess all outbound deals >US$5m, with broad discretion under the new legislation to block "irrational" overseas investments.

Unsurprisingly, this led to questions seeking clarification on exactly how the new rules were to be enforced. In an effort to increase transparency and to help investors make more informed decisions, the "New ODI Guidelines" were published in August 2017. These guidelines classified investment activities into three main categories: Encouraged, Restricted and Prohibited.

New ODI Guidelines – announced 18 August, 2017

Encouraged ODI: Investments that further the "One Belt, One Road Initiative", or enhance China's technical capabilities, or that are related to research and development, oil and mining exploration, agriculture, or fishing;

Restricted ODI: Investments in real property, the entertainment industry, sports clubs, obsolete equipment, private equity, investment platforms established offshore without actual business, or investments that contravene environmental standards;

Prohibited ODI: Investments involving the export of core technologies and military assets, investments in the gambling or adult entertainment industry, or investments contrary to national interests/security.

Encouraged ODI should be facilitated through tax, foreign exchange, customs, and insurance directives. For the other categories, the government will provide guidance on a case-by-case basis for companies to "cautiously participate" in Restricted ODI and will "strictly monitor and regulate" Prohibited ODI.

Two further regulatory announcements along the theme of avoiding overseas embarrassment were released in the pre-holiday period:

36 Point "Code of Conduct" for Private Firms – announced December 18, 2017
Chinese private enterprises must follow a new set of regulations to ensure that deals abroad are "in line with their own conditions and capabilities"
Investment plans must be submitted to authorities beforehand for "record-keeping"
Stated goal is to reduce "fraudulent overseas deals", highly-leveraged deals, and investments into offshore financial derivatives

Streamlined Reporting but Expanded Oversight – announced December 23, 2017
New regulation published by the NDRC to come into effect March 2018
Waives a 2014 provision requiring plans and bids for overseas projects worth over US$300m to be reported, simplifies approval procedures, and relaxes deadline requirements for companies to obtain approval
Introduction of a nationwide online platform to make management and services for outbound investment more convenient and transparent
Deals to come under additional scrutiny in terms of financing, valuation, and rationale
Tightened controls and supervision over foreign investments made by overseas subsidiaries.

These measures further enhance China's examination of proposed outbound deals. Currently implemented exchange controls effectively limit Mainland firms' ability to finance overseas acquisitions with their own onshore currency reserves. In trying to work through these challenges in the context of an M&A process, publically listed would-be acquirers can also be "timed out" on significant transactions. China's Securities and Regulatory Commission requires deal-related trading suspension of shares be limited to a few months. If the deal takes too long to conclude then it can be back to square one for both buyer and seller.

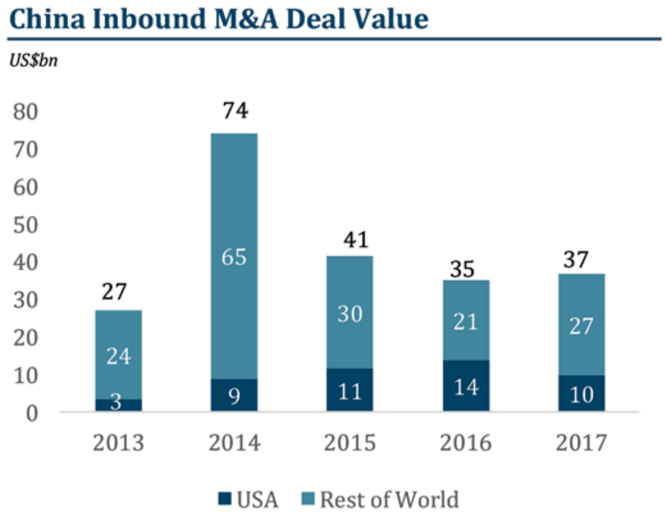
BDA COMMENT: *Rather than a complete "choking off" of China's outbound M&A activity at the source, we anticipate a greater role for private equity firms in partnering with and fronting up for corporates. Sophisticated and agile funds such as AGIC, CDH etc. should face less obstacles – at least domestically – and will play an increasingly important bridging role in getting deals done. AGIC's role alongside Wuhan-based Humanwell in acquiring the European pharmaceutical manufacturing service provider Ritedose last year was critical in following the process steps on a timely basis and securing the asset.*

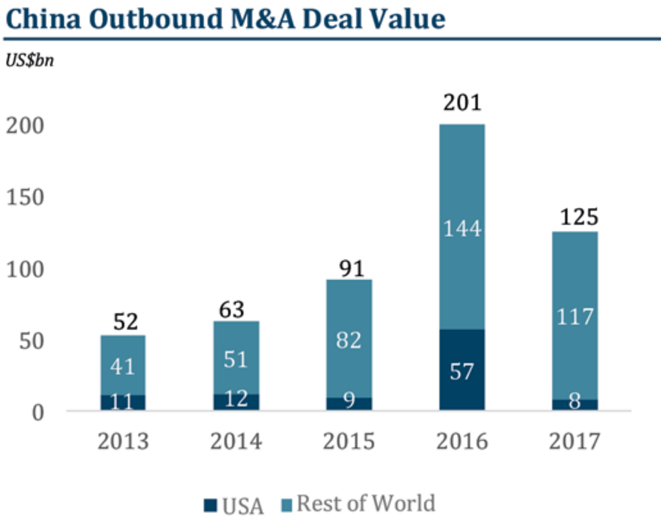
The greatest take away from these regulatory shifts is the increased importance of fit; the transactions should make sense from a scope and valuation standpoint, and satisfy government macro-policy initiatives.

Even as the pace of outbound transactions slow, BDA expects consumer branded, healthcare, industrial technology, and environmental protection businesses to remain attractive and executable targets for Chinese buyers, while M&A activity will feel the chill in sensitive sectors such as the US semi-conductor space. Fosun's 2018 acquisition of European luxury house Lanvin highlights this trend.

Tilting the deal flow

The latest data on historic deal values for china in-bound and out-bound M&A has been anything but stable, the question is, given the recent social and economic developments in the region, what is 2018 likely to hold?





Note (1): Bracketed figures denote US-related deal volume
Note (2): All deals sorted by announced year, target/bidder dominant country, excluding lapsed deals, including 10%-30% minority stake deals
Source: MergerMarket

BDA COMMENT: *As shown above, 2017 saw a significant decline in China outbound M&A deal value and volume, especially for transactions involving the US. However, BDA expects overall figures to remain more stable through 2018 as Chinese investors alter their investment goals and behaviour and adapt to both domestic and foreign policy objectives.*

In contrast, China's inbound M&A activity finally rebounded after experiencing a declining trend over the last three years. This increase is supported by new regulations designed to make the domestic market more attractive to foreign investors.

BDA expects to see robust levels of M&A activity within China's borders over 2018 as foreign investors capitalize on new subsidies, tax incentives, and other favourable legislation. More on this.

Contact

Jeffrey Wang, Managing Director
jwang@bdapartners.com

Mark Webster, Managing Director
mwebster@bdapartners.com