M&A Standpoint

Down, but not for long: China outbound M&A

In 2016, China's outbound investment surged, reaching a record high of US$170.1 billion, and surpassed inbound investment for the first time. Investment came from all types of Chinese companies, from state-owned enterprises to privately owned innovators, and in everything from chemical companies to football clubs.

Not everyone was pleased. The rapid drop in China's foreign exchange reserves and rise in risky state-owned bank lending that accompanied this boom resulted in a regulatory backlash against "irrational" and "non-genuine" outbound transactions.

As a result of various responses to this alarming drop, China's non-financial outbound investment fell in 2017, and stood down year on year by 41% to US$81 billion at the end of October.

However, the somewhat kneejerk reaction to 2016's capital outflows has developed into a much more transparent policy and procedures for Chinese outbound deals.

Capital crunched

The response to the unprecedented drop in capital reserves and increase in systemic risk was swift.

In December 2016, the state's key regulators issued a rare joint statement, warning that the government was paying close attention to certain types of outbound investments, such as "irrational" outbound investments in real estate, hotels, cinemas, entertainment and sports clubs.

The two approving authorities for outbound transactions, the National Development and Reform Commission (**NDRC**) and the Ministry of Commerce of China (**MOFCOM**), struck first. In December 2016, they beefed up their approval requirements, adding substantive review procedures for outbound transactions.

Simultaneously, banks in China were advised by State Administration of Foreign Exchange (**SAFE**) and the People's Bank of China (**PBOC**), the country's monetary regulators, to increase scrutiny on outbound transactions and refer to them any over US$50 million.

With little transparency and clarity, this new scrutiny caused considerable market uncertainty around China outbound transactions.

New deals – what China wants now

Nearly a year on, new guidelines, policy announcements and statements have helped to clarify China's goals for dealmaking.

In August 2017, several ministries jointly issued guidelines that classify investments into encouraged, restricted and prohibited categories:

The **encouraged** category includes infrastructure investments under the Belt and Road Initiative, investments promoting the development of high-tech and advanced manufacturing, and those in agriculture, trade, culture, logistics, energy and resources. Encouraged projects also enjoy additional support from the government in terms of tax treatments, foreign exchange, insurance, customs assistance, information, etc.

Investments that do not align with State foreign policy and those in real estate, hotels, cinemas, entertainment or sports clubs or made by certain investment funds are **restricted**. Such projects are not off the negotiating table, but will be guided by the government so that they can be carried out 'in a prudent way'.

Prohibited investments include those involving the export of technologies prohibited for export, those prohibited by international treaties, and those which may harm State interests. Strict controls will prevent any investments in prohibited areas.

Reflecting these principles, NDRC recently issued a new draft of measures for management of outbound investment.

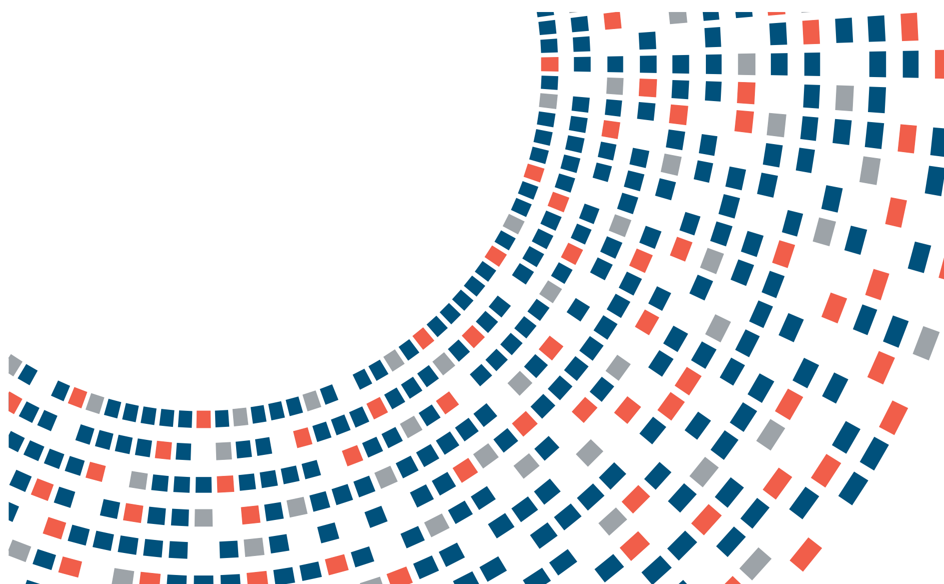
The draft measures streamline the approval process for outbound investment, yet at the same time increase oversight on the investment of Chinese companies' offshore subsidiaries.

So far activities of those subsidiaries have not been on the radar of Chinese regulators. Under the draft measures, however, the Chinese parent companies must obtain NDRC approval if their offshore subsidiaries wish to invest in deals in 'sensitive' sectors.

Positive words from the podium

Following these changes, the 19th National Congress of the China Communist Party concluded in October with a very strong message that China aspires to become a global leader in the coming years.

President Xi Jinping called for the country to develop "new ways of outbound investment" and emphasized that China will continue to push forward the US$90 billion Belt and Road Initiative. Combining the greater regulatory clarity with a very strong policy direction



delivered from the top means that Chinese buyers are likely to get back into the deal markets in 2018.

Our recent report, Redefining Asian Business, identifies the four 'super blocs' of Asian companies driving growth– the Old Guard, State Standards, Young Innovators and Asset Hunters. The last three of these are prevalent in China, and will drive the next phase of China's economic development.

The country's State Standards are deeply involved in the Belt and Road Initiative, dominant in agriculture, industrials and energy. They also have the financial clout and political connections to pull off the mega deals that require presidential signing ceremonies.

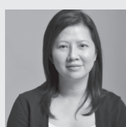
China's Young Innovators are ending the year on a very high note. In early November, Tencent joined the US$50 billion "market cap club", with Alibaba excruciatingly close on its heels. Both are moving steadily into overseas markets as well as investments, and can finance outbound deals from their massive domestic operations.

Many assume that China's Asset Hunters have the most to lose. Perhaps not so – for every hotel or football club deal that cannot proceed, there are solid manufacturing acquisitions and purchases of IP or technology that will be deemed perfectly sensible.

Overall, the signal from Beijing is that China is still buying, but selectively, carefully and with due attention to long-term goals. Sectors that will benefit are those tied to the Belt and Road Initiative – just under half of this year's investments so far were made in Belt and Road countries. Also high on the list will be deals that will benefit China's economy and people's wellbeing such as tech, advanced manufacturing, green industries, healthcare and education.

From a deal execution perspective, China has done much to streamline its approval process for outbound investment, but uncertainty in the regulatory approval and filing processes does remain, particularly for mega deals and those in sensitive sectors. It is important that the buyers and sellers anticipate and plan ahead for these possible hurdles.

Key contacts



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