Mergers and Acquisitions in China

In the past 20 years, since the adoption of the “Open Door” policy, most foreign investments have been Greenfield projects in the form of WFOE’s or JV’s. Whilst the structure and composition of China’s economy have changed dramatically during that time, China still needs to reform its economic regime and related legal system for the purposes of fulfilling its WTO accession commitments, integrating the operations of its economy with international norms and practices, as well as coping with increasing competition from foreign investors. From the perspective of foreign investors themselves, they have long needed a quicker and more efficient way than direct investment in Greenfield projects to enter the Chinese market or expand their China business.

For these reasons, Mergers and Acquisitions (“M&As”) commonly used in Western economies to acquire, divest and restructure businesses are gradually finding their place in China. Although M&As still only constitute a minor portion of foreign investment in China, they are becoming increasingly common amongst many foreign companies looking to either access or expand their operations in China, and appear to be characterizing the next wave of foreign investment into China. In addition to the underlying advantages of M&A, specific drivers behind this recent trend have been the sell off of State-Owned Enterprises (SOEs), the opening of traditionally restricted industries, and the fierce competition in a range of more developed industries. From 2005 to the beginning of 2010, M&A activity has been prevalent in the materials sector mainly in metals and mining, but as China continues to liberalize its sectors, M&A activity is expected to become more widespread.

Many companies are also exploiting M&A as an investment vehicle. It is important for companies looking for M&A opportunities to understand the China specific factors that will come into play, including not only the M&A process, but also what they are buying and for how much. The primary differences between M&A deals in China compared to M&A deals in the West are the duration, difficulty and success rate: Chinese deals take more time, are more complex and fail more frequently. Each M&A transaction, whether it be an SOE asset purchase or an FIE equity purchase, will have its own unique set of circumstances.
I. What is M&A in China?

This is a difficult question to answer as China’s M&A investment environment is incredibly complex. However, it is best answered by understanding the regulatory framework, different M&A types, possible M&A targets, as well as the M&A vehicle options.

M&A Regulatory Framework

MOFCOM has been closely monitoring the many M&As taking place around the world over the past few years and are working on a single, integrated legal framework for cross border M&As in China. However, this framework remains elusive, and instead a flurry of new regulations has been promulgated sporadically. Whilst these new regulations that have considerably improved the investment environment for M&A transactions, opening up new investment opportunities that were previously closed (QFII scheme allowing investment in A-Shares), as well as providing greater clarification in certain areas (M&As with foreign investment) and improvements in others (valuation methods, transfer process, liability management), they have also introduced new barriers and uncertainties.

One of the uncertainties that has arisen out of the recent flurry of regulations is the approval process, as different governmental departments (MOFCOM, CSRC, MOF, SASAC etc) have jurisdiction over different aspects of an M&A. An M&A involving a foreign investor is subject to the approval of, and/or registration with, one or more of these governmental departments, depending upon the specific nature of the transaction. Despite the many gray areas and overlapping approvals that result, there are some general rules of thumb:

Firstly, investors may be able to avoid approvals altogether for an offshore deal, where the foreign investor indirectly acquires the Chinese target by purchasing its offshore parent.

Secondly, for an onshore share or asset deal, government approvals are usually necessary, with the main approval body for any deal involving foreign investment being MOFCOM or regional or local-level equivalents, depending on the categorization of industry and size of deal.

Accordingly, it is important for foreign investors to ascertain at the outset of the M&A which governmental approvals and/or registrations would be required and at what time such approvals and/or registrations should be obtained or made. Even then, due to the changing regulatory environment and the lack of detailed implementation guidelines, government officials are reluctant to assume responsibility for the approval of M&A transactions in which they don’t have much experience.

InterChina recommends that companies intending to acquire Chinese enterprises seek professional guidance in navigating China’s complicated legal framework.

M&A Types

Generally speaking, however, M&A in China can be divided into the following two categories (i) equity M&A (ii) asset M&A.

Equity M&A: This is a transaction by which a foreign investor purchases, by agreement, the shares of a Chinese domestic company. There are actually three ways to structure an equity M&A:

Firstly, foreign investors may directly purchase shares of the target, either by acquiring existing shares from the seller or by acquiring newly issued shares from the target, or purchase the assets. Of note, a project needs a foreign shareholding of 25% or more to qualify as an FIE and be subject to
preferential tax policies. Shareholdings of less than 25% are allowed but would not escape having to receive MOFCOM approval.

Secondly, foreign investors may also indirectly acquire the target by purchasing shares in its offshore parent company.

And thirdly, a foreign investor may merge one of its existing Chinese FIEs with another company in China, which can be either another FIE or a non-FIE domestic enterprise. A merger is sometimes an attractive option since it is basically “tax-free”, but the statutory procedures for notifying creditors and obtaining government approvals can take a year or longer to complete.

**Asset M&A:** This is a transaction by which a foreign investor purchases and subsequently operates the assets of a Chinese domestic company. As in other jurisdictions, the main advantage of an asset deal is that it can be structured to avoid assumption of the target’s liabilities. In China, this is particularly pertinent where SOEs have surplus employees and unwanted social welfare obligations, although it should be noted that employee “settlement plans” need to be included in the transfer papers and are subject to government review. Asset deals can, however, be complicated to complete in China. For example, creditors of the target must be notified of the sale in case they require the target to give security for its debt, and if no security can be agreed upon with objecting creditors, then the liabilities owed to those creditors must be discharged before the deal can be completed.

**M&A Targets**

Subject to legal limitations and restrictions, a foreign investor can basically purchase any type of company in China, though the purchase would be subject to government approvals, and some of the more archaic forms of corporate vehicle, such as collectively owned enterprises (COEs), would first need to be converted to some other form. Clear legal procedures are now in place that permits foreign investors to buy shares or assets of a foreign invested enterprise (FIE), a privately owned enterprise (POE), or a state owned enterprise (SOE). If the target company is listed on the Shenzhen or Shanghai stock exchange, the investor can either buy the unlisted shares, which generally take up about two-thirds of the share capital of listed companies in China, or the listed “B” shares. Although an ordinary foreign investor still may not buy listed “A” shares, they can indirectly acquire “A” shares by buying the investment products offered by qualified foreign institutional investors (QFIIs), which are financial institutions that have been accredited to invest in companies that have issued “A” shares.

**M&A Vehicles**

Not only has the choice of targets multiplied over time, but so has the choice of acquiring vehicle that a foreign investor can adopt:

- Firstly, a foreign investor outside China can buy a direct stake in the target
- Secondly, a foreign investor can use its own existing FIEs inside China to buy the shares. This is conditional upon the acquiring FIE already being profitable, with its Registered Capital fully paid up and its investments in other companies amounting to less than 50% of its net asset value.
- And thirdly, a foreign investor can establish a special purpose vehicle (SPV) in a favorable offshore jurisdiction to hold the shares in the target. This is a preferred option for many foreign companies given that any future disposal of the SPV can then usually be done without PRC approvals.
II. So, how can my business benefit?

There are a broad range of reasons why European companies are using M&A as an investment vehicle for accessing the China market. Naturally, these reasons are complemented by a number of challenges that also need to be overcome. The advantages and disadvantages are summarized in the table below:

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<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<td>Standard advantages of M&amp;A: acquisition of market share, increased production capacity, removal of competition, creation of synergies etc.</td>
<td>Standard disadvantages of M&amp;A: uncertain value creation, problematic post-merger integration etc.</td>
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<td>Potentially complete control over the major decisions and operations (dependent on structuring and size of shareholding) leading to strategic alignment with parent and sister companies and avoiding risk exposure to partner disputes.</td>
<td>Need to do proper due diligence on the target in China, where quality of information is often poor, then negotiate a transaction with its shareholders, probably also in China.</td>
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<td>Can leverage government approvals, human resources, raw materials supply chain, land &amp; production facilities, access to marketing &amp; distribution channels, sales know-how, product mix with local brands etc. already in place.</td>
<td>Will likely have to assume the baggage of the target, including excess workers and social welfare obligations, and high risk of also assuming hidden liabilities, such as unpaid taxes.</td>
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<td>Thus, M&amp;A has much lower upfront investment risks compared to WFOEs, particularly due to acquisition of the target's existing customers and sales contracts.</td>
<td>Complicated and opaque regulatory environment and approval procedure, and as this is a relatively new form of investment vehicle, many of the government authorities don't have much experience of what is involved.</td>
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<td>And also, as the target is a going concern, M&amp;A has no time lag to initiation of operations as with the establishment of WFOEs.</td>
<td>There are restrictions on valuation, and in many cases the payment of a premium over asset value is needed in order to close the deal.</td>
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<td>M&amp;A potentially has lower risk exposure to IPR infringement than JVs, as there is no Chinese partner (dependent on structuring and size of shareholding) which may set up in competition or transfer know how, trade secrets etc. to third parties.</td>
<td>As the target will effectively be a going concern, it will likely have unorthodox corporate governance practices, and M&amp;A allows less control over corporate culture than with a WFOE (independent of structuring and size of shareholding).</td>
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III. Problem areas and risks with Chinese companies

Although acquiring a Chinese company can provide certain competitive advantages for a foreign investor, there are many problems and risks the foreign investors must be aware of and deal with appropriately.

Commercial

The sales practices of Chinese companies are generally unorthodox and are not consistent with those of companies in Europe. Depending on the industry, a target’s sales capacity and distribution channels can be the determining factor on whether to move forward with the acquisition or not. As such, prospective purchasers should pay particular attention to the following commercial risks:

- Quality of sales & marketing team.
- Pricing policies.
- Sales procedures (“black money”).
- Credit policies.
- Irregular sales & distribution channels.
- Poor brand and company image.

Financial

The accounting and financial practices of Chinese companies are often antiquated, unreliable and, in some cases, corrupt. A prospective purchaser that approaches a target for acquisition purposes will always find discrepancies between the data obtained through audit and the data in the target’s books. Many Chinese companies have two separate accounting systems, manipulating official statements in order to minimize tax burdens. Some companies even use triple accounting book practices: one for official authorities, one for minority shareholders, and the real one for influential shareholders. Prospective purchasers should pay particular attention to the following financial risks:

- Assumption of loans, debts and tax liabilities.
- Porous accounts receivables.
- Long term sustainability of the company given current market conditions.
- “Black Money”.
- Related party transactions.
- Asset valuation.
- Return on investment.

“Black Money”

In China, business relationships are nurtured in different ways than in the West. It is considered common practice to give large, unrecorded cash “gifts” to the most important clients or key business contacts. To a Western company, this may equate to corruption and graft, so one must be careful when dealing with this matter and hire professionals that understand the unique nature of China’s business environment, to ensure compliance with current laws.
Legal

The legal structures and practices of Chinese companies are often “gray” at best, and sometimes outright illegal. This is due to the developing nature of the Chinese economy, the legal system having been based on the “rule of man” rather than the “rule of law”, as well as the creativeness of Chinese entrepreneurs. Prospective purchasers should pay particular attention to the following legal risks:

- Hidden liabilities as a result of:
  - Tax evasion.
  - Mortgages & other contractual liabilities.
  - Fixed asset ownership.
- Illegal shareholding structures (“straw companies”).
- Dividend distribution arrangements.
- IP lawsuits or other legal claims against the target.
- Legal authority granted to Representative Offices.

“Straw Companies”

In order to take advantage of the tax holidays JVs enjoy, many Chinese companies have established “illegal” JVs with “straw companies”. The majority of such straw companies are incorporated in Hong Kong, set up by a Hong Kong friend, relative or business contact of the Chinese company. The straw company then holds a 25% share in the JV with the Chinese company, thereby entitling the JV to tax holidays under Chinese law. In many cases, however, the straw company in Hong Kong does (i) not exist and/or (ii) has not made any capital contributions to, or partake in any Board Meetings of, the JV. They are merely a method by which Chinese companies can avoid taxes. This can be a significant risk for Italian investors, as according to Chinese law, this practice is illegal. As such, careful attention should be paid in order to determine the true shareholding structure and decision-making processes of target companies.